4 Islamic Financial Services

In the last few years, Islamic banking has made extraordinary progress on the global front, in terms of growth in the number of Islamic financial Institutions and their asset base. The leading countries in this area are Malaysia and Bahrain though, in terms of total assets, the Islamic banks of Iran and Saudi Arabia are the largest. Kuwait, Sudan, and UAE have also made considerable advances in the field of Islamic finance. The products being offered by these banks range from consumer credit to long-term finance for big investment projects using Islamic modes of financing such as Murabaha, Ijara, Salam, Musharaka and Mudaraba.

Currently, there are over 250 Islamic banks encompassing both the Muslim and non-Muslim world. The total assets of the industry are estimated to be more than US$ 250 billion with a growth rate projected to range from 8 to 15 percent over the next five years.[1]

Islamic financial services in Pakistan, a relatively recent occurrence, have recorded a noteworthy progress during the year, constituting an asset base of Rs 44 billion and deposits of over Rs 30 billion at end CY04. Given its nascent stage of development, the share of the Islamic Banking industry in the total deposits and assets of the banking sector remains miniscule. However, given the rapid growth of this industry, it is expected that this share will grow considerably in the years to come.

This chapter discusses the advent and development of Islamic Banking in Pakistan, in addition to the measures taken for the implementation of *Takaful* i.e. the Islamic mode of Insurance.

4.1 Evolution and Origins of Islamic Banking in Pakistan

At the onset, it is important to understand why there is a need for a parallel Islamic banking system, as it exists currently in Pakistan and other countries. Primarily, the very origin of Islamic banking is rooted in the prohibition of interest (*Riba*) in Islam. A secondary issue relates to *Gharar* which signifies the underlying uncertainty about a transaction that can affect its transparency.[2] In addition, there are social and ethical objectives such as an equitable distribution of income and wealth in society which an Islamic Banking system aims to promote and achieve. Consequently, all these factors together led to a strong demand to introduce a banking system in accordance with Islamic principles. Efforts to provide an alternative system to interest-based banking practically started in the early sixties in Egypt[3], but picked up momentum when countries like Malaysia and Bahrain entered this field. Seeing the potential growth in Islamic Banking, conventional banks also started to offer Islamic banking products.

In Pakistan**,** the demand for Islamic banking in its initial phase came about as an outcome of constitutional and judicial[4] obligations rather than as a financial and economic phenomenon and efforts to implement it in its true spirit started only a few years back.

Earlier attempts at Islamizing the banking system were made in 1979 when the Banking Control Department of the State Bank, under the guidance of the Ministry of Finance and in collaboration with the Council of Islamic Ideology and Pakistan Banking Council, issued directives to banks for the

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[1] The 2005 guide to Opportunities and Trends in Islamic Finance, EUROMONEY - February, 2005.
[2] This could be either about the characteristics of the goods to be sold or their price.
[3] For details, please see "Islamic Banking and Finance : Theory and Practice" by Muhammad Ayub, SBP (2002).
[4] This is specifically with reference to the Objectives Resolution of 1949.

transformation of the conventional banking system into a non-interest based system. This process, which started in 1979, was finally completed in 1985 when all banking companies were asked to provide finance only under the identified interest free modes. A number of amendments in various laws were made during this period. From July 1 1985, no banking company was allowed to accept any interest bearing deposits. However these directives did not apply to foreign branches of Pakistani commercial banks and foreign currency deposits and loans.[5]

However, the procedure adopted by the banks to implement a banking system based on 'mark-up' was declared un-Islamic by the Federal Shariat Court (FSC) in November 1991. On December 23 1999, the Supreme Court of Pakistan endorsed this verdict, with the directive that laws involving interest would cease to have effect by June 30, 2001.[6] According to the Supreme Court, the financial system in the country had to be changed radically in order for it to be in conformity with the Shariah. On the Supreme Court's directives, a Commission for the Transformation of Financial System (CTFS) was set up by the Government along with two task forces to plan and implement the process of transformation. This directive also required specific measures to be taken in the associated legal framework.

The CTFS was formed in January 2000 in the State Bank, and constituted a committee for the Development of Financial Instruments and Standardized Documents to prepare model agreements and financial instruments for an Islamic banking system. In its two reports, the CTFS identified a number of prerequisites for an effective transformation of the financial system.

As a result of these efforts, in 2001, an Islamic Banking Division was established in the Banking Policy Department at SBP, which was expanded to a full-fledged Islamic Banking Department (IBD) in 2003. This time around, concerted efforts are being made by SBP to undertake Islamic Banking in its pure form, learning from the experience of Bahrain, Malaysia and Saudi Arabia etc. in this area.

4.2 Regulatory and Policy Framework

The Islamic Banking Department at SBP has formed a comprehensive regulatory framework aimed at the establishment and promotion of an Islamic banking system in line with best international practices. These measures are primarily demand-driven and provide an option to the customers to choose between the two banking systems in accordance with their preference.

As a first step, in December 2001, the State Bank issued detailed criteria for the establishment of Islamic banks in the private sector. A three-pronged strategy for the promotion of Islamic Banking in Pakistan was operationalized on January 1, 2003,[7] which allowed financial institutions, to decide at their discretion, to establish either full-fledged Islamic banks in the private sector; or Islamic Banking subsidiaries or stand alone Islamic Banking branches of the existing commercial banks. This is in sharp contrast to the earlier attempt, when Islamic Banking was required to be implemented by all banks across the board.

4.2.1 Shariah Board

A Shariah Board was established in the State Bank in December 2003. The constitution of SBP's Shariah Board is unique in the sense that in addition to two Shariah scholars, it also includes experts

[5] For details, please see "State Bank of Pakistan : Evolution, Functions and Organization" by Muhammad Farooq Arby, State Bank of Pakistan (2004).
[6] This was further extended to June 30, 2002, and was later set aside by the Shariat Appellate Bench (SAB) of the Supreme Court in its short judgment dated June 24, 2002 when the case was remanded back to FSC for discussing the unresolved issues in the previous judgment. Consequently, the CTFS was also dissolved in June 2002.
[7] Please see BPD Circular No 1 dated January 1, 2003 and IBD Circular No 2 dated April 29, 2004.

in law, banking and accounting. The Shariah board advises SBP on the procedures, laws and regulations pertaining to Islamic Banking in the light of Shariah principles.

The Board has reviewed the Essentials and Model Agreements for Islamic Modes of Financing[8] to facilitate the existing Islamic Banking Institutions (IBIs) in the development of financial products in particular, and to create awareness about Islamic banking products in general.

In order to further assist the IBIs, the Shariah approval process for offering various products has been simplified by SBP, by asking banks to appoint a Shariah advisor instead of a Shariah Board. Moreover, the Fit and Proper Criteria for the appointment of Shariah Advisors by banks has also been revised by the Board.[9]

4.2.2 Regulatory Developments

The minimum paid-up capital requirements for Islamic Banks are the same as those for conventional banks.[10] IBIs are currently required to maintain 11 percent of their demand and time liabilities in the form of cash with SBP to fulfill the statutory liquidity requirements (SLR), till such time that Shariah compliant liquidity instruments are made available to them. Efforts are underway to develop Islamic inter-bank market instruments to help banks in managing their liquidity**.** For this purpose, the Shariah Board has approved a *Sukuk* structure and the issue is under consideration by the Ministry of Finance, to finalize the structure, required documentation and the underlying assets of the instrument in consultation with SBP.

SBP continues to play a vital role in improving the awareness of market players and the general public about Islamic Banking, and has conducted presentations in various cities in addition to serving as a Distance Learning Center for local bankers and academicians vide 11 video conferences arranged in collaboration with the Islamic Development Bank during the year. SBP is a member of the Islamic Financial Services Board (IFSB) and International Islamic Financial Market (IIFM). The Governor SBP, is also a member of the Board of Trustees of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).

4.2.3 Accounting Standards

A major development in 2004 was the finalization of accounting standards for Murabaha and Ijara by the Institute of Chartered Accounts of Pakistan's (ICAP) Committee on Accounting Standards for Interest free modes of financing and Investments (in which SBP is also represented). These have been sent to SECP for notification under the Companies Ordinance 1984, while the accounting standards for Musharikas are in the process of completion.

4.2.4 Development of Shariah Compliant Inspection Expertise

Shariah compliant inspection of IBIs, the arrangements of which have been finalized by SBP, is a crucial step in the promotion and supervision of Islamic banking and finance as it would serve to enhance the credibility of the system. The draft Manual for this purpose has been prepared in consultation with a reputable Audit firm. For capacity building, the first Shariah compliant inspection of an Islamic bank was conducted with the help of the same firm to in order to set a precedent for the development of Shariah audit skills and provide hands-on training to SBP's inspection staff. As it is the first such inspection to be conducted by SBP as part of the supervisory framework, the Manual is being finalized keeping in view the experience gained during the inspection. Based on the rulings of

[8] For details, please see "Pakistan : Financial Sector Assessment 2003", State Bank of Pakistan.
[9] Please see IBD Circular No 3 dated October 26, 2004.
[10] Please see BSD Circular No 12 dated August 25, 2004.

the Shariah Board and experience gained during the inspection of other banks, SBP will continue to revise the manual as and when needed.

4.2.5 Taxation Issues

During 2004, SBP also took up the issue of double taxation on Murabaha transactions with the Central Board of Revenue (CBR) and proposed some amendments in the taxation laws in consultation with market players for providing a level playing field to the IBIs. Consequently, in the Federal Budget 2004-05, an amendment was made in the Sales Tax Act, in terms of which goods delivered under a Murabaha financing arrangement to or by a bank or a financial institution, shall not be treated as 'supply' to avoid double taxation.

4.3 Islamic Financial Sector in Pakistan[11]

One of the major developments in the year under assessment was the issuance of an Islamic banking license to Pakistani branches of Albaraka Islamic Bank in September 2004 through the conversion of their previous license. Consequently there are now two full-fledged Islamic banks in operation, including Meezan Bank. Both these banks together have 23 branches. In addition, by end-CY04, 25 licenses were issued for Islamic Banking Branches (IBBs) to 9 conventional banks (see **Table 4.1**). Out of these 25 branches, 21 branches of 7 conventional banks started operations in 2004. Hence the number of Islamic Banking Institutions (IBIs) licensed to undertake Islamic banking operations increased from 4 to 11 whereas the number of cities in which IBBs are operating increased from 6 to 12 with coverage in all the four provinces. Furthermore, during 2004, SBP gave in principle approval for the incorporation of two more full fledged Islamic banks[12], and opening of 34 more branches in 2005 by 6 existing Islamic banking institutions. Some other applications for setting up full fledged Islamic banks and Islamic banking branch operations are also under scrutiny. The increasing interest of conventional banks in opening Islamic branches and new applications for opening full-fledged Islamic banks show the promising growth prospects of Islamic banking in Pakistan.

Table 4.1: Number of Operational Islamic Banks and IBBs as at end CY04

Bank's Name	No. of Branches
A) Islamic Banks	
Meezan Bank Limited	16
Albaraka Islamic Bank	7
Total	**23**
B) Islamic Banking Branches	
Muslim Commercial Bank	5
Bank of Khyber	3
Bank Alfalah Limited	11
Habib Bank AG Zurich	1
Standard Chartered Bank	1
Metropolitan Bank	1
Bank Al Habib Limited *	1
Habib Bank Limited*	1
Soneri Bank Limited	1
Total of B	**25**
A+B	**48**

* These two banks started operations in January 2005.
Source: Islamic Banking Department, SBP

4.3.1 Deposits and Credit Growth

The extension of the Islamic Banking network in terms of both the number of branches and the cities covered, alongwith the conversion of Albaraka bank into an Islamic bank, brought with it an unprecedented boost in the total assets, deposits and the number of accounts of IBIs. Consequently, the asset base of Islamic banks and branches increased to Rs 44 billion in 2004 from Rs 12.9 billion in

[11] For International Developments, please see **Box 4.1**.
[12] Bank Islami Pakistan Ltd has been issued a license in 2005, in addition to Dubai Islamic Bank.

CY03, with a phenomenal growth of 242 percent (see **Table 4.2**).[13] IBIs' credit activities have also shown a tremendous increase in CY04.

Table 4.2: Islamic Banking Industry

million Rupees			Growth	As % of Industry	
	CY04	CY03	(Percent)	CY04	CY03
Deposits	30,185	8,397	259	1.26	0.43
Total assets	44,143	12,915	242	1.45	0.51
Financing	27,535	8,652	218	1.75	0.55
No. of IBIs licensed[1]	11	4			
No. of branches of IBIs licensed	48	17			
No. of cities covered by IBIs	12	6			

Source : IBD Data, based on annual audited accounts of 11 IBIs

[1] Two banks started operations in January, 2005

Note: Information presented in this table has been compiled for banks which have an Islamic Banking License

Due to their strong religious beliefs, a lot of people used to either avoid using the banking system or keep their money in current account deposits which do not provide any remuneration. Development of Islamic banking has presented such clients with alternative investment and funding opportunities of a lucrative nature. which will also serve to further enhance the performance of the IBIs.

Box 4.1: International Developments in Islamic Finance

The Islamic financial industry continues to face the challenge of expanding internationally in accordance with Shariah principles. Accordingly, the International conference on Islamic banking, held in Bahrain in December 2004, discussed a variety of important issues like improving the performance and ensuring the sustainable growth of Islamic Financial Institutions, Islamic financing of complex transactions, innovations in Islamic financial industry and emerging trends in *Sukuks* and key financial instruments. The Bahrain-based Liquidity Management Centre (LMC), established in 2002 to fulfill the liquidity requirements of Islamic Financial Institutions, managed a US$ 250 million Ijarah *Sukuk* issue for the Bahrain government to finance the airport expansion project, setting an example for other Islamic countries. Moreover, the International Islamic Financial Market (IIFM) was created to promote an active international market by endorsing and facilitating cross-border investment activities according to Shariah principles.

Another major development is that several big international conventional banks like BNP Paribas, Citigroup, HBSC and UBS have also started Islamic finance by offering various Shariah-compliant innovative investment opportunities. In 2004, the leading transaction in the field of Islamic finance was for Etihad Etisalat, a mobile phone company in Saudi Arabia, on Murabaha basis. The project has been funded by raising US$ 2.35 billion on behalf of Etihad Etisalat. It was the biggest Islamic financing and debt transaction in the world. The leading banks in this transaction were BNP Paribas, National Commercial Group, Abu Dhabi Islamic Bank, Citigroup and Al-Rajhi Bank. Similarly, Gulf Finance House, a Bahrain-based investment bank, started projects and investments of more than US$ 6 billion in total, mainly in real estate. Citigroup has been the leading manager of four big *Sukuk* issues internationally.

Although Iran has a major share in the total assets of Islamic Financial Institutions followed by Saudi Arabia, Kuwait and UAE, but Malaysia and Bahrain have shown a tremendous performance in the field of Islamic banking and *Takaful*, by introducing innovative Shariah compliant products. The total assets of 23 major Islamic banks were almost US$ 122 billion in 2003 (see **Table 4.3**). Meezan Bank Ltd is also part of this list despite being a new entrant in the industry.

Source : Islamic Finance Information Services

Islamic banks are adequately capitalized with a 13.1 percent capital adequacy ratio at end-CY04, well above the required level of 8 percent. Market share of Islamic banks in the total assets of the banking

[13] This table has been prepared in consultation with IBD by including only those banks and branches which have an Islamic Banking License. Faysal bank has not been included as it has a conventional banking license.

sector increased from 0.51 percent at end-CY03 to 1.45 percent at end-CY04, whereas the share of deposits increased from 0.43 percent to 1.26 percent. Financing activities have grown to gain a 1.75 percent share by end-CY04.

Table 4.3: Ranking of Islamic Banks by Total Assets 2003
'000' US Dollars

Ranking	Commercial Islamic Banks	Country	Total Assets	Share Capital	Customer Deposits	Reserves	Net Profit
1	Bank Melli	Iran	21,859,938	283,848	16,065,959	78,530	106,171
2	Al Rajhi Bank	Saudi Arabia	17,246,633	599,968	12,586,236	973,281	543,470
3	Bank Saderat	Iran	16,093,781	232,046	12,631,836	614,708	212,470
4	Bank Mellat	Iran	12,980,961	155,614	8,920,846	6,373	58,216
5	Bank Tajerat	Iran	11,037,557	NA	7,644,692	NA	699,910
6	Kuwait Finance House	Kuwait	10,318,641	243,244	7,804,564	586,156	197,340
7	Bank Sepah	Iran	7,832,718	132,128	5,942,028	1,623	52,049
8	Dubai Islamic Bank	UAE	6,201,388	272,250	5,413,208	70,639	204,368
9	Bank Islam Malaysia	Malaysia	3,309,778	131,579	3,253,958	161,349	20,582
10	Abu Dhabi Islamic Bank	UAE	2,510,335	272,250	1,667,127	43,102	27,377
11	Bank Al Jazira	Saudi Arabia	2,396,855	159,991	2,009,240	65,835	24,929
12	Bank Muamalat Malaysia	Malaysia	1,925,501	59,441	1,801,956	33,471	944
13	Qatar Islamic Bank	Qatar	1,537,567	68,661	169,574	57,854	39,832
14	Jordan Islamic Bank	Jordan	1,375,868	56,417	1,371,235	19,031	4,470
15	Shamil Bank	Bahrain	1,190,574	230,000	678,436	339,330	22,310
16	Qatar Int'l Islamic Bank	Qatar	1,072,948	34,330	242,144	191,065	17,679
17	National Bank of Sharjah	UAE	726,673	105,002	505,883	67,133	16,678
18	Bahrain Islamic Bank BSC	Bahrain	614,006	61,008	499,756	11,289	12,058
19	AlBaraka Islamic Bank	Bahrain	405,114	50,000	307,389	5,799	1,105
20	Bank Muamalat Indonesia	Indonesia	318,142	25,766	243,041	21,588	3,589
21	ABC Islamic Bank	Bahrain	276,000	42,500	243,000	NA	NA
22	**Meezan Bank**	**Pakistan**	**193,421**	**18,537**	**135,137**	**9,974**	**3,725**
23	Al Amin Bank	Bahrain	174,656	60,000	1,464	14,336	9,593
		Total Assets	**121,899,057**				

Source: Capital Intelligence, Islamic Finance Information Service

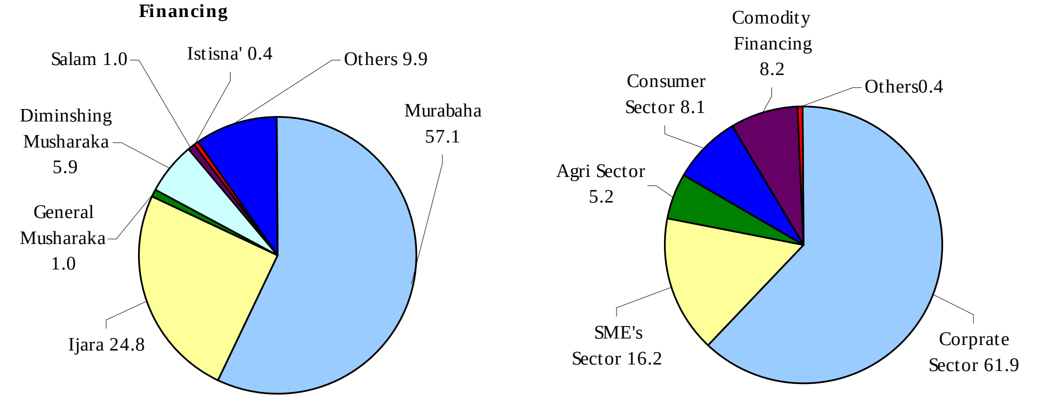
As in the case of conventional banks, the corporate sector got the biggest share of the total financing of the IBIs[14] (see **Figure 4.1**). The rest of the share was divided between the Agriculture, Consumer and SME sector. In terms of bank-wise shares, Meezan bank contributed most of the total financing with a 47 percent share followed by Albaraka Bank (28 percent) and Bank Alfalah (15 percent), with the rest of the financing contributed by the other banks.

The financing portfolio of Islamic banking Institutions shows that in 2004 banks still preferred modes of financing belonging to the low risk category i.e. those which usually generate a fixed return. Among these, Murabaha (cost plus mutually agreed profit margin) and Ijara (leasing) were the most attractive and popular modes of financing for IBIs with 57.1 percent and 24.8 percent shares respectively in total financing whereas Istasna' and Salam had a lower priority.

On the other hand, investment related participatory modes of financing which generate a variable return and are of a high risk category i.e. Musharaka and Mudaraba were used on a limited basis by

[14] Source: Quarterly Reports of Islamic banks.

Figure 4.1 : (a) IBIs Modes-wise Investment/ Financing **(b) Sectoral Disbursement of IBIs Advances**



the IBIs due to their conservative stance. As a consequence, Musharaka, both general and diminishing,[15] constituted a 6.9 percent share of total financing by IBIs.

4.3.2 Islamic Export Refinance Scheme

A Musharaka-based Islamic Export Refinance Scheme has been designed by SBP in order to provide refinance to IBIs for their export financing operations to eligible exporters on the basis of Islamic modes of financing under both parts of the SBP's Export Refinance Scheme. The scheme has been successfully running for over a year now and the amount of financing extended under the scheme has increased from Rs. 988 million as at end-CY03 to Rs. 2,705 million by end-CY04.

4.4 Islamic Non-Banking Financial Institutions

Among the Non-Banking Financial Institutions (NBFIs), Mudarabas and Islamic Mutual Funds together constitute to form Islamic NBFIs,[16] the financial data for which is given in **Table 4.4.** In 2004, there were 35 Mudarabas in operation and their asset base increased by around 14 percent in comparison with the previous year.[17]

The assets of Islamic Mutual Funds increased over threefold in 2004 due to the launch of a new Islamic Mutual Fund. The share of Islamic NBFIs in total NBFI assets remains the same as last year, at 6.4 percent.

Table 4.4: Islamic Non Banking Financial Institutions
million Rupees

	2003	2004
Mudarabas		
Equity	7,982.58	8,690.88
Assets	15,972.89	18,163.11
Advances	10,313.00	11,517.00
Income	4,604.40	4,444.86
Islamic Mutual Funds[1]		
Assets	499	1,981
Assets as % of Total Islamic NBFIs		
Mudarabas	97.0	90.2
Islamic Mutual Funds	3.0	9.8
Total Assets of Islamic NBFIs	**16,472**	**20,144**

[1] This data includes the shariah compliant mutual funds as specified by SECP

4.5 Islamic Capital Markets

Issuance of Islamic bonds is a major advancement in the field of Islamic Finance and is rapidly becoming a key source of financing. The difference between a conventional bond and

[15] In a Diminishing Musharaka, one partner (i.e. a bank) sells its share of assets to the other partner (i.e. the client).
[16] Leasing Companies have not been included as the underlying contract for their transactions is not in accordance with Shariah principles.
[17] For a detailed review of Mudarabas, please see Chapter 6, section 6.2.4.

an Islamic bond (*Sukuk*) is that the latter is asset-backed, and is in accordance with Shariah principles. *Sukuks* are used both for syndicated financing and securitization, and can be both sovereign and corporate. In terms of tenor, like conventional bonds, *Sukuks* can be long term (more than 5 years), medium term (two to five years) and short term (less than one year) in nature.

Islamic capital market issuers and investors are increasing in number and the niche market is showing signs of becoming a permanent and sizeable industry, as opposed to a temporary phenomenon. The rising popularity of Islamic finance has also attracted Western and Far Eastern organizations, which recognize it as a useful alternative source of financing. Organizations have been using Shariah-compliant finance especially when doing business in Islamic countries or other countries with a sizable Muslim population, to attract affinity investors.

4.5.1 Local Developments

Al-Zamin Leasing Mudaraba's *Sukuk* issue of Rs.250 million in December 2003 was the first ever TFC to be issued by the Mudaraba sector on Islamic principles. This was a Musharaka-based Term Finance Certificates (TFC) and was rated B- by JCR-VIS. The oversubscription of the TFC reflected the confidence of the investors in the future prospects of the *Sukuk* industry.

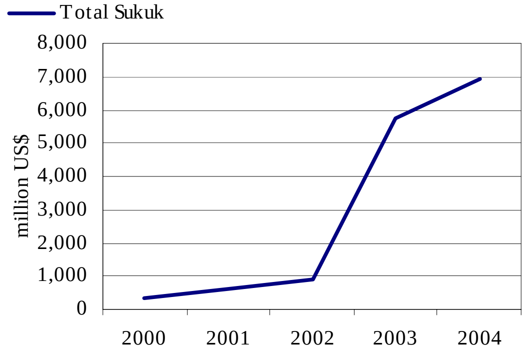
Following the international trend, the government of Pakistan for the first time launched a Shariah compliant International Ijara *Sukuk* of US$ 600 million in January 2005 with a five-year tenor. The issue was initially planned to raise US$ 500 million but the amount was increased in response to the overwhelming offerings by the investors, which went up to as high as US$1.2 billion. The *Sukuk* offers a return of 220 bps over the six-month LIBOR. The leading managers of the *Sukuk* issue were Citigroup and HSBC. Geographically, about 47 percent of the issue was placed with investors in Saudi Arabia and the Middle East, with 31 percent picked up by Asian investors, followed by Europe at 22 percent. By investor category, Islamic banks took 20 percent, government agencies 25 percent, asset managers 23 percent; private banks 11 percent, banks 18 percent and insurance/corporates 3 percent. For the purpose of compliance with Shariah**,** these bonds are fully backed by national assets including the 400-kilometer Islamabad-Lahore Motorway. The *Sukuk* has been rated as B+ by Standard and Poor's'. Oversubscription of the *Sukuk* shows great potential for raising long term capital finance from international capital markets, especially of Islamic countries, which ultimately helps in getting rid of short term costly loans of international agencies. The government intends to raise more funds through the issue of *Sukuks* and Euro bonds in FY06.

4.5.2 International Sukuk Issuances

Growth in *Sukuk* issuance and the increasing interest of conventional and Islamic investors in this area shows the enormous future prospects of the *Sukuk* market. Activities in the global *Sukuk* market started in the year 2000 when three different corporate *Sukuk* issues were initiated, while Bahrain issued the first sovereign *Sukuk* in 2001. During the last five years the *Sukuk* market has observed a massive growth of 170 percent. In 2004, the worth of total *Sukuk* issues, both corporate and sovereign, by different financial institutions was US$ 6.7 billion in different countries (see **Figure 4.2**); the share of Malaysia in this figure is $ 4.7 billion. A 5-year US$ 123 million issue was made in July 2004 by the central German state of Saxony-Anhalt, which was the first European Islamic Bond. The two biggest sovereign *Sukuk* issues during the year were of an amount of US$ 1.0 billion by the Department of Civil Aviation UAE and of US$ 250 million by the Government of Bahrain. Similarly, the biggest corporate *Sukuk* issue of the year was by Kapar Energy Ventures, Malaysia, of US$ 895 million, followed by Putrajaya Holdings with an issue of US$ 395 million.

Among all these institutions, Citigroup remained the largest player in the international *Sukuk* market, launching *Sukuk* issues in UAE, Bahrain and Germany. The bank also ensured that these issues, which also include the US$ 600 million issue for Pakistan, achieved an extended level of international distribution. Similarly, HSBC Amanah and Bank Muamalat, Malaysia are the other two financial institutions who initiated various *Sukuk* issues for different companies in Malaysia.

Figure 4.2: Sukuk Issues



Source: Capital Intelligence, Islamic Finance Information Service

4.6 *Takaful* - Islamic Mode of Insurance

Takaful is an Arabic phrase which means "guaranteeing each other" or mutual guarantee. Theoretically, *Takaful* is considered to be the Islamic mode of insurance based on the principle of cooperation, whereby the members/policy-holders contribute a certain amount of money to a common pool to protect each other from certain defined mishaps. Most of the Shariah scholars regard conventional insurance as non-shariah compliant as it contains elements of *Riba* (interest), *Gharar* (uncertainty) and *Maisir* (gambling). The main difference between *Takaful* and conventional insurance is that *Takaful* is free of these elements and based on *Tabarru* (donations) and investments (premiums) to be operated on Mudaraba basis, with the objective of improving solidarity and brotherhood in the society and to indemnify the burden of catastrophes and disasters to the affected people.

There are two types of *Takaful*, as discussed below.

4.6.1 General *Takaful*

In General *Takaful*, the company (operator) establishes a *Tabarru* Fund, called Participant Special Account (PSA), in which all the participants donate their contributions. After deducting the operational costs, the company then invests the fund on Mudaraba basis and any profit on the investment is added to the *Tabarru* fund. If any damage or loss takes place to participant's property or belongings, he would be compensated from the fund, in line with the extent of damage. General *Takaful* offers products related to fire, equipment/ motor breakdown or damage, accidents, marine losses etc.

4.6.2 Family *Takaful*

Family *Takaful*, an alternative to conventional life insurance, operates on the basis of two types of accounts namely, Participant Account (PA) and PSA. The sum of the *Tabarru* paid by the participants in the PSA constitutes the benevolent fund which provides certain benefits in the event of death of a participant. The major portion of contribution which represents the core savings of the participant goes to the PA. Both the PA and PSA can be invested in any interest-free Shariah compliant scheme on the basis of Mudaraba. Moreover, the whole procedure complies with Shariah guidelines and investment returns must not be obtained from any unethical commercial activities. *Takaful* contract specifies from the outset the term (e.g. 10, 15, 20 years etc.) of the policy and how the profits are to be shared between the operator and the participants, for instance at a ratio of 50:50 or 60:40 or 70:30 etc. The profits on both the accounts are credited into the PA and PSA accordingly.

On occurrence of any risk, the beneficiary has the right to make claims from the PSA, besides the accumulated amount from the PA. But if the participant survives until the maturity of the policy, his claim is confined only to the amount of the PA and to a certain portion of actuarial surplus, if any, out of the PSA. All the contributions (premiums) of the participant would be refunded to him along with the proportion of the profit made from the investment of his paid premium. There is no forfeiture of the premium amount in *Takaful*, whereas a person can lose his money if he has to cancel his policy in conventional insurance. The portion of total contributions allocated to the PSA depends upon the mortality table and other actuarial requirements. In Malaysia the rates range from 3 percent to 13 percent, depending upon the age of the participant at the inception as well as the term of the policy.

4.6.3 *Takaful* in Pakistan

The development of *Takaful* in modern times dates back to 1979 in Sudan and 1984 in Malaysia.[18] Contrary to Malaysia, Bahrain and other Gulf Cooperation Council (GCC) countries, the concept of *Takaful* is new in Pakistan. Pak-Kuwait Investment Company (PKIC), a joint venture between Pakistan and Kuwait, started its efforts in 2002 to introduce *Takaful* in the country. Eventually, in May 2005, PKIC signed a joint venture with a Malaysian based company 'Takaful National' to establish the first *Takaful* business in Pakistan named "Pak-Kuwait Takaful Company" (PKTC). Takaful National will hold 25 percent share of the company, while the remaining share will be held by PKIC (30 percent), Meezan Bank (10 percent) and other share-holders (35 percent). In the initial phase, the company will start operations in General *Takaful*, both in corporate and retail dealings, with particular emphasis on two special *Takaful* products related to motor and marine. Family *Takaful* is planned to be offered at a later stage.

Takaful Rules, 2005 have been notified by the Ministry of Commerce in September 2005, under Section 120 of the Insurance Ordinance 2000. These rules were developed by a task force constituted by the Securities and Exchange Commission of Pakistan.

Under the proposed Rules, a Wakala (agency) operational model has been introduced. This model is currently being practiced in a number of countries where *Takaful* products have been introduced. In this model, surplus (if any) in the *Takaful* fund is distributed to the policyholders. The operator charges *Wakalah* fee from contributions which covers most of the expenses of the business. The fee is fixed in advance in consultation with the Shariah committee of the company.

Takaful business shall not be carried on in Pakistan by any operator who is not eligible under Section 5 of the Insurance Ordinance 2000 and has not been granted a Certificate of Registration by the Commission under Section 6 of the said Ordinance. *Takaful* operators shall be required to invest their available funds in their Participations Takaful Fund (PTF) and Participants Investment Fund (PIF) in the products which adhere to the principles established by the Shariah and all such products shall be approved by the Shariah Board of the Takaful operator.

In the proposed model, composite *Takaful* has not been allowed which means that a *Takaful* operator shall not be allowed to undertake Family as well as General Takaful, both at the same time. This is in line with the directives of the Insurance Ordinance 2000. It has also been recommended that conventional insurance companies should not be allowed to offer Takaful products as their window operations.

[18] *Takaful* Performance 2004, Bank Negara Malaysia.

4.7 Future Prospects and Challenges

The future prospects of Shariah compliant banking products largely depend upon how efficiently and prudently the existing Islamic banking institutions perform in terms of profitability and growth in their asset and deposit base. Keeping in close touch with market requirements and responding to them promptly could enhance the potential growth of the Islamic Banking Industry. Introduction of innovative Shariah-compliant products is a crucial aspect of such growth.

Islamic scholars are of the view that the establishment of proper institutions to support the Islamic banking system, creation of rating agencies, development of chartered Shariah auditors and diversification of Shariah compliant products are the prerequisite conditions to make the sector grow at the desired speed.

At this point, a big challenge for SBP is to develop Shariah-compliant products to enable the monetary management of IBIs. Similarly, accounting standards for all modes of Islamic financing need to be developed, as in the case of Murabaha and Ijara.

Increase in the size and volume of Islamic capital markets also depends on the existence of a secondary market for trading in *Sukuk*, which is still to be developed even on an international level. Another challenge for the industry is the establishment of investment banks and liquidity management institutions exclusively for Islamic banking, following the models of Bahrain and Malaysia.

The unique distributive and facilitating nature of Islamic banking products can contribute extensively not only in the development of the economy but also to the reduction in poverty, unemployment and income inequalities. Products based on profit and loss sharing, with emphasis on financing production and not consumption, can have a favorable impact on savings and investments, if operated efficiently and transparently. In this respect, Musharaka can specially be used in short, medium and long term project financing, import and pre-shipment export financing and working capital requirements.

Providing finance to the SME sector has a great potential for the promotion of self-employment opportunities in the country. This sector can be financed on the basis of Musharaka / Diminishing Musharaka and Mudaraba. Good governance principles and the post investment role of the financier as required in Islamic finance can play a helpful role in the development of the SME sector.

In the early stages of development, IBIs are more inclined towards those Shariah compliant products which yield a fixed-return and which are of a low risk category, for instance Murabaha and Ijara. Alongside PLS, products they play a complementary role in financing projects and transactions of various natures.

Murabaha financing can also be effectively utilized in the finance of trade-related transactions like financing of automobiles, home appliances etc. In Murabaha goods are purchased and resold, either on the basis of cash or deferred payments, on mark-up.

Housing finance can be provided on the basis of Ijara (leasing), Murabaha and Diminishing Musharaka. In the case of Murabaha, the client negotiates the price with the vendor, the bank buys the house and then sells it to the client to earn mark-up.

Given the importance of the agriculture sector in Pakistan, Salam can be employed in financing the production of both major and minor crops. Consequently, this mode of financing can make a tremendous contribution in increasing employment and in the development of the rural sector. By the same token, projects related to manufacturing can be financed using Istasna', whereby an Islamic bank provides funds to pay for all input costs of the project and once the project is completed, the advances are paid back from the revenues of the project.

The derivatives market, which is still in its initial phase of development in the conventional banking industry, has a limited scope for Islamic banks. Some innovative products have been developed by banks in this field in different parts of the world with the approval of their Shariah Advisors.[19] However, further research on these instruments is still in progress.

[19] For details, please see the "International Journal of Islamic Financial Services", Volume 1, No. 1 and Volume 4, No.3 in addition to the "Swiss Derivatives Review", June 25, 2004.