

5 Islamic Banking

5.1 Overview

During FY17, the Islamic Banking Industry (IBI) continued its growth momentum, recording improvement in all key performance indicators. Assets and deposits of IBI reached Rs 2,035 billion and Rs 1,720 billion, with encouraging growth of 16.6 percent and 17.7 percent, respectively at end June 2017. The IBI share in overall banking assets and deposits also increased from 11.4 percent and 13.2 percent in FY16 to 11.6 percent and 13.7 percent respectively during FY17 (**Table 5.1**).

Islamic Banking Industry Progress	Islamic Banking Industry		Growth (YoY)		Share in Overall Banking Industry	
	Jun-16	Jun-17	Jun -16	Jun-17	Jun-16	Jun-17
Total Assets	1,745	2,035	16.8%	16.6%	11.4%	11.6%
Deposits	1,461	1,720	14.1%	17.7%	13.2%	13.7%
Total IBIs	22	21	-	-	-	-
Total Branches*	2,146	2,320	26.1	16.3	-	-

Source: Data/information submitted by banks under quarterly Reporting Charts of Accounts (RCOA)
*Number includes sub-branches

Another key area showing strengthening of the Islamic banking industry is improvement in the financing to deposit ratio (FDR). The FDR of IBI stood at 56.8 percent markedly surpassing the FDR of conventional banking industry, which stood at 48.7 percent as at end June 2017. This points to more focus of Islamic banking institutions on core banking business as compared to their conventional counterparts. The growth of the industry and its growing market share in overall banking industry seems promising in view of its shorter history as compared to the long established conventional banking.

In terms of outreach, the Islamic banking industry has further strengthened its presence across the country. During the year, 21 Islamic banking institutions (5 full-fledged Islamic banks and 16 conventional banks having Islamic banking branches) were operating in the country. During the period under review, Burj Bank Limited was merged into AlBaraka Bank (Pakistan) Limited, owing to which the number of IBIs adjusted at 21. Branch network of IBI reached to 2,320 branches spread across 110 districts of the country as of June 30, 2017.

5.2 Initiatives for Promotion of Islamic Banking

The consistent positive growth of the Islamic banking industry among others can also be attributed to the supportive policy and regulatory environment being promoted by SBP. The SBP efforts and initiatives for promotion and growth of Islamic banking have national and international recognition.

The following section highlights the key initiatives taken during FY17 for promotion of Islamic banking in the country.

5.2.1 Committees for Promotion of Islamic Banking

For development of Islamic banking and finance in the country, a high level Steering Committee was constituted by the Federal Government in December 2013. The Steering Committee comprised of renowned *Shari'ah* scholars, senior government officials, industry experts and business leaders. The committee submitted its report in March 2016 and gave several recommendations for development of the Islamic Banking Industry on sound footings. In order to implement the recommendations of the

Steering Committee, an Implementation Committee and its four Sub-Committees have been formed by the Government, namely:

- (1) Sub-Committee on Legal and Regulatory Framework
- (2) Sub-Committee on Taxation
- (3) Sub-Committee on Islamic Capital Market
- (4) Sub-Committee on Awareness and Capacity Building

These sub-committees are working diligently for smooth and efficient implementation of the Steering Committee's recommendations in their respective areas.

5.2.2 Exemption from KIBOR as Benchmark Rate

SBP, being aware of the significance of innovation, provides full support to the Islamic banking industry and aligns its regulatory and supervisory framework to the ongoing changes in the industry dynamics. To encourage participatory modes of financing, the Islamic banking institutions (IBIs), during the year were exempted from the requirement of using KIBOR as benchmark rate on *Musharakah*, *Mudarabah* and *Wakalah* (Agency) based financing. This will not only encourage IBIs to make more use of participatory modes of financing but will also increase confidence of masses in *Shari'ah* compliant financial system of the country.

5.2.3 External Shari'ah Audit Report - Shari'ah Governance Framework

For strengthening *Shari'ah* Governance Framework and to ensure transparency, necessary instructions were issued to IBIs during FY17 on the role and responsibilities of external *Shari'ah* auditors. The instructions cover important areas including avoidance of conflict of interest, training and capacity building of staff of external Audit firms in *Shari'ah* audit, Fit and Proper Criteria (FAPC) for *Shari'ah* scholars to be engaged for external *Shari'ah* audit of IBIs, verification of distribution of profit and loss to the depositors prior to its disbursement, submission of copy of external *Shari'ah* audit report to SBP.

5.2.4 Publication of Urdu Translation of Shari'ah Board Report

In order to enhance public understanding of IBIs' *Shari'ah* Boards' reports, IBIs were advised to publish the Urdu translation of their *Shari'ah* Board's report in their annual report with effect from December 31, 2016.

5.2.5 Tax Neutrality

The tax neutrality for *Shari'ah* compliant banking is an essential component of the overall policy environment for development of Islamic banking and finance. The Government on the SBP's recommendation provided the much needed and long awaited tax neutrality to Islamic banking industry through Finance Bill 2017. The major changes in the taxation laws and provisions made for the purpose include the following:

- Trade based Islamic modes of finance offered by Islamic financial institutions (IFIs) have been exempted from definition of "Supply" under Sales Tax Act 1990. This will exempt the purchases made by IFIs for onward sale to their clients under trade based modes of finance from the levy of sales tax.
- Customers availing financing under *Musharaka* and Diminishing *Musharaka* modes have been provided with equal tax treatment as available under conventional financing products.
- Turnover tax on *Murabaha* and *Commodity Murabaha* transactions to be levied on gross income instead of gross receipts.
- Allowing benefit of depreciation under *Ijarah* financing.

5.3 Liquidity Management Solutions for Islamic Banking Industry

Considering the importance of liquidity management solutions for Islamic banking industry, SBP has been conducting *Shari'ah* compliant Open Market Operations (OMOs) by utilizing *Ijara Sukuk (Bai Muajjal of Sukuk)* issued by the GOP. During FY17, the following transactions were carried out by GoP and SBP to offer such mechanism/product to the industry for its liquidity management:

- **GoP *Ijara Sukuk***-In support of the objective to provide the Islamic financial market an investment avenue amid rising liquidity levels, SBP, with consultation and consent of GoP, successfully conducted auction of Fixed Rental Rate-Government of Pakistan *Ijara Sukuk (FRR-GIS)* on June 29, 2017 to raise Rs 71.007 billion for the GoP.
- ***Bai-Muajjal of GIS by SBP***-Under this transaction, SBP purchased GoP *Ijara Sukuk (GIS-15)* worth Rs 7.15 billion and 17.492 billion from IBIs on *Bai-Muajjal* basis for a period of 6 months and one year respectively through competitive auction process.

5.4 Awareness and Capacity Building Programs

As per recommendations made by the high-powered Steering Committee, SBP is actively engaged in awareness creation among masses and capacity building of the industry. During FY17, SBP in collaboration with various reputed national and international institutions arranged following seminars, training programs and workshops on Islamic banking:

- Seven iterations of a training program titled “Fundamentals of Islamic Banking Operations (FIBO)” were completed in collaboration with National Institute of Banking and Finance (NIBAF) at Peshawar, Lahore, Sargodha, Hyderabad, Sialkot, Islamabad and Quetta. This is a special training program designed for branch managers, operation managers, and relationship managers of banks. The academia engaged with Islamic Banking and Finance and local *Shari'ah* scholars are also invited in these programs.
- A seminar on Islamic finance was organized in Lahore in collaboration with ‘Islamic Finance News – RED Money Group’, the world's leading Islamic finance news provider. The program was well represented by local Islamic finance industry. The special feature of this event was a ‘Closed-Door Dialogue’ wherein the think-tank had critical review of the current profile of the industry to make recommendations in setting its future direction.
- In order to broaden the talent pool of *Shari'ah* scholars for Islamic financial industry, a religious school was facilitated in designing and conducting a customized training program for those *Shari'ah* scholars who were not associated with Islamic financial industry. The initiative has been quite successful to provide *Shari'ah* scholars a platform wherein they could see the practical application of *Shari'ah* principles in developing banking solutions.
- SBP also facilitated COMSATS University to conduct awareness-cum-capacity building programs for bankers, *Shari'ah* scholars and academia in six cities of second tier category; Abbottabad, Attock, Sahiwal, Wah Cant, Vehari and Islamabad. The inaugural program of the series was conducted at Abbottabad during the year, which was well received by the participants.
- SBP supported Dunya Media Group in its Islamic Finance Awareness Drive 2017 for enhancing awareness about Islamic finance among the masses. Under the Drive, awareness

sessions were arranged for different stakeholders at Chambers of Commerce and Industries, and leading educational institutes.

5.5 Global Participation

Having developed and put in place a robust regulatory and *Shari'ah* governance system for Islamic banking industry, SBP is recognized as an active global partner. Its representation and active participation in various forums of international institutions dealing with Islamic finance is considered instrumental in crafting the future outlook of Islamic financial industry. SBP has been actively represented in various working groups, task forces, technical committee and Council of Islamic Financial Services Board (IFSB) and has actively contributed in the development of prudential standards for global Islamic finance industry. Further, SBP also participated in various senior level programs arranged by international institutions like IFSB, Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) Islamic Research and Training Institute (IRTI), and Islamic Development Bank (IDB).

5.5.1 Global Recognition

SBP was given an honorary award in recognition of contributions made to the global Islamic banking and finance industry at the Islamic Finance Forum of South Asia (IFFSA) Awards 2016, held in Colombo, Sri Lanka. Further, Global Islamic Finance Awards (GIFA) Committee gave Special Award (Advocacy Role) 2016 to Mr. Saeed Ahmed, the then SBP Deputy Governor for spearheading several key initiatives to promote and develop Islamic banking and finance industry of Pakistan.