Islamic Finance news

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Promising days ahead

Whether the global economy is heading for or in the middle of a double dip recession, the fact remains there is a general recovery in the state of individual economies. This is coupled with a raise in trust of Islamic banking and financial market instruments, as is seen by the number of Sukuk issuances in the past months.

There have been improvements in the overall Sukuk market, which we cover in two of our IFN reports this week. Prospects are bright in the second half of the year, and even Kazakhstan is planning to issue its first Sukuk, based on the government's bid to further encourage the public and private sector to subscribe to Islamic financial solutions.

We further delve into Sukuk in our Focus section, which analyzes the security of Sukuk deals in a time where the concept of such investment has been debatable, with the turbulent financial situations of Saudi conglomerates and the previous uncertainty of repayment from Nakheel. It is evident that the security of a Sukuk investment lies in the way a transaction is structured.

Our three country reports further evaluate the state of Islamic finance in Pakistan. The country's central bank has recently placed Islamic banking as a main priority. It aims to see the rigorous expansion of this sector and has provided regulatory support to aid this cause. Not only does Pakistan have a large unbanked population and an underserved agriculture sector, but challenges include a lack of qualified Islamic finance professionals and low levels of awareness in the concept of Islamic banking.

Pakistan is also featured via an IFN report which looks at Habib Metropolitan Bank's plans to aid the government in their efforts to swell the Islamic banking market share from 5.8% to 12% within the next 36 months, by innovating on their marketing strategy and product development.

We address its neighbor India in our market report where the government has begun on a project analyzing the future of interest free banking in the country that would support not only the interest of Muslims, but also provide an alternative means of banking to the rest of the population.

In efforts to ameliorate the plight of the Muslim poor, the Islamic Development Bank (IDB) has set an exemplary track record by providing financing to the countries of sub-saharan Africa. Most recently is IDB and the African Development Bank's pledge of US$5 billion to sort out Nigeria's electricity crisis as reported in our IFN report.

We look to Istisnah and Musharakah in our sector reports as Islamic financial instruments used to develop infrastructure, where there is ample opportunity for Islamic banks and their governments to use such financing.

Diverting to Takaful, this week's report looks at the growth of the sector that is set to reach US$25 billion in the next four years. Here the need for competitive products and pricing is crucial in ensuring the development of the industry is earmarked for rigorous growth.

We feature the recent Nomura Sukuk, the first Japanese Islamic fund in our termsheet. In our Meet the Head section we have Ken Eglinton, director of UK Islamic financial services at Ernst & Young who speaks candidly about the Islamic finance industry in the UK.

In this issue

Developments And Challenges in Islamic Banking in Pakistan

By Aishah Khalid

Islamic banking is one of the emerging fields in the global financial markets, with significant potential and fast paced growth. The progress of Islamic banking in Pakistan has likewise been commendable in the last few years. Islamic banking is also a priority area for the State Bank of Pakistan (SBP), the central bank.

Currently, there are six licensed full-fledged Islamic banks and 13 conventional banks are offering such services through standalone Islamic banking branches. The total Islamic banking network has 650 branches (including sub branches, as at the 31st December 2009), and is expanding at a good rate.

> "Independent Islamic banks have been an area of interest for the foreign investors as it provided them an easy avenue to enter Pakistan's banking industry"

Islamization of the financial system

Pakistan is among the first countries to build a financial system according to Shariah principles. The formal progress towards the Islamization of the financial system and banking in Pakistan began in late 1970s. However, as it was a massive task, the switchover plan was implemented in several phases.

The Islamization measures included the introduction of multiple regulations aimed at eliminating or, at least, reducing the element of interest (riba) from the operations of specialized financial institutions managed by the government and commercial banks during the early 1980s.

Meanwhile, the legal framework of Pakistan's financial and corporate system was amended to permit issuance of interest-free instruments of corporate financing. The most noticeable step was the permission to establish Mudarabah companies and floatation of Mudarabah certificates to raise risk-based capital. Amendments were also made to the banking regulations to include a provision for bank financing through profit and loss sharing accounts, leasing and hire purchase.

Meanwhile, separate counters were started in all the nationalized commercial banks and one foreign bank to mobilize deposits on a profit and loss sharing basis. Regarding investment of these funds, banks were instructed to provide financial accommodation for government commodity operations under Islamic principles.

First full-fledged Islamic commercial bank

During the same period, financing of import and inland bills for the government commodity corporations were shifted to mark-up basis. Simultaneously, necessary amendments were made to the related laws permitting the central bank to provide finance against Islamic instruments. Banks were allowed to provide finance to meet the working capital needs of trade and industry on a selective basis under the principles of Musharakah.

During the 1980s, almost all Pakistani rupee financing transactions conducted by the banking industry was Shariah compliant with a crude explanation of Islamic finance.

However, this was merely a change of nomenclature but, in essence, nothing really changed. Moreover, foreign currency deposits in Pakistan and on-lending of foreign loans continued as before. However, after a few years, the procedure adopted by the banks in Pakistan, based largely on 'mark-up' technique with or without 'buy-back arrangement', was declared unIslamic by the Federal Shariat Court.

Nevertheless, appeals were made in the Shariat Appellate Bench of the Supreme Court of Pakistan, which rejected the appeals and directed that laws involving interest be eliminated by 2001.

In the judgment, the court concluded that the present financial system had to be subjected to radical changes to bring it into conformity with the Shariah. It directed the government to set up, within a specified timeframe, a commission for transformation of the financial system and two task forces to plan and implement the transformation process. It was decided later that the shift to an interest-free economy would be made in a gradual and phased manner and without causing any disruptions.

Accordingly, the SBP issued detailed criteria for the establishment of full-fledged Islamic commercial banks in the private sector. SBP issued the first Islamic commercial banking license in 2002 to Meezan Bank, which started its operations in the same year. Since then, independent Islamic banks have been an area of interest for the foreign investors as it provided them an easy avenue to enter Pakistan's banking industry.

Regulatory support

SBP intends to develop a progressive and sound Islamic banking system that is compatible with the global financial sector, providing requisite Shariah compliant products and services to achieve equitable economic growth.

Its Islamic banking department, established in 2003, has been entrusted with promoting and developing Shariah compliant Islamic banking as a parallel and compatible banking system in the country. Currently, the Islamic banking department comprises four divisions:

i. Policy
ii. Shariah compliance
iii. Business support
iv. Shariah board secretariat

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Developments And Challenges in Islamic Banking in Pakistan (continued)

SBP has been making concerted efforts for the promotion of Islamic banking while largely focusing on providing the requisite financial infrastructure in the shape of Shariah compliance, legal, and supervisory frameworks. In this regard, SBP has taken several initiatives including:

i. Introduction of a three-tiered Shariah compliance mechanism comprising:
   a. SBP Shariah board to provide guidance to all stakeholders
   b. Shariah advisors of all banks providing Islamic financial services to assist these institutions must operate strictly within the Shariah compliance mechanism
   c. Shariah audit to monitor and restrict the activities of these institutions within specified boundaries
ii. Issuance of the essentials and model agreements of Islamic modes of financing
iii. Description of fit and proper criteria for Shariah advisors of Islamic banking institutions
iv. Introduction of risk management guidelines, instructions and guidelines for Shariah compliance, and essentials of Diminishing Musharakah to standardize the Islamic banking transactions
v. Development and issuance of short term statutory liquidity requirement eligible Shariah compliant government instrument, such as GoP Ijara Sukuk which provides an avenue for the liquidity management
vi. Apart from consumer and corporate banking, guidelines for Islamic microfinance businesses and Islamic agricultural finance have been issued

> "Currently, a big challenge being faced by the banking industry in Pakistan is to meet the minimum capital requirement (MCR)"

SBP's strategic plan for Islamic banking

Despite considerable growth of Islamic banks in the last few years, it is still in the initial phase of development and requires significant consideration to establish its presence in the wake of the increasingly competitive landscape of the banking industry.

Therefore, SBP, while aiming to increase the size of the Islamic banking industry to 12% (from the present ~6%) of the total banking industry by 2012, has developed a comprehensive strategic plan. This plan will focus on:

i. Expansion of the current outreach of Islamic banking products in existing consumer and corporate segments while inventing products for the untapped segments – microfinance, agriculture, and SME — to fulfill financial needs of these areas through Islamic banking.
ii. Making efforts to become part of the international Islamic banking community to attract foreign direct investment
iii. Capacity building of professional Islamic bankers
iv. Creating awareness about Islamic banking among the masses

Key challenges

Limited credit expansion

The prevailing growth potential in the Islamic banking industry is evident by its improving market share in the total banking industry. Nevertheless, the Islamic banking industry, due to lack of diversification in its financing portfolio is facing the challenge of limited credit expansion.

Its portfolio mix is mainly dominated by only three financing modes, that is, Murabahah, Diminishing Musharakah and Ijarah. Moreover, owing to limited liquidity deployment avenues available to the Islamic banking industry as compared to the conventional industry, its performance and profitability has also been subdued.

Liquidity management

Currently, a big challenge being faced by the banking industry in Pakistan is to meet the minimum capital requirement (MCR). This challenge is more pronounced for small banks — both conventional and Islamic.

The MCR for December 2009 was PKR6 billion (US$70.2 million), and this would be increased to PKR10 billion (US$117 million) by end 2013 with increment of PKR1 billion (US$11.7 million) each year. Moreover, this is relatively higher as compared to other regional countries. The Islamic banking industry, given its developing phase, faces financial constraints in meeting this requirement.

So far, only two (as of a total of six) Islamic banks — Meezan Bank and Dubai Islamic Bank — have raised their capital above PKR6 billion (US$70.2 million). Others, who have been granted extensions from the SBP, are working on different options including mergers. Recently, the merger of Al Baraka Islamic Bank and Emirates Global Islamic Bank has been announced. The deal is subject to necessary legal and regulatory approvals both in Pakistan and Bahrain and is expected to be completed within current year.

However, in contrast to MCR, the capital adequacy ratio (CAR) — regarded as a better measure of underlying risk — of Islamic banks is much stronger. Owing to relatively limited available deployment avenues, the average CAR of these banks is reasonably higher than the minimum regulatory requirement of 10%.

Recognizing the lower risk perspective of these institutions and overall subdued fundamentals — locally and internationally — for fresh equity injection, the apex regulator may consider relaxing MCR requirements. Or else this, while harming the growth of the Islamic banks, may not help in achieving the desired objectives.

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