

# Pakistan's Islamic Banking Sector Review

2003 to 2007



**ISLAMIC BANKING DEPARTMENT  
STATE BANK OF PAKISTAN**

## Table of Contents

<b>1. Vision &amp; Mission Statements of State Bank of Pakistan (SBP)</b> .....	<b>III</b>
<b>2. Vision &amp; Mission Statements of Islamic Banking Department of SBP</b> .....	<b>III</b>
<b>3. Governor’s Message</b> .....	<b>IV</b>
<b>4. Foreword</b> .....	<b>VI</b>
<b>5. Executive Summary</b> .....	<b>VII</b>
<b>6. Future Outlook</b> .....	<b>IX</b>
<b>7. Brief Historical Perspective on Islamic Banking Initiatives in Pakistan</b> .....	<b>1</b>
7.1 Steps for Islamization of Banking and Financial System in 1980s .....	1
7.2 Brief Evaluation .....	2
7.3 Post Judgment Measures.....	3
7.4 Policy Decision .....	4
<b>8. Regulatory, Supervisory &amp; Shariah Compliance Developments</b> .....	<b>6</b>
8.1 Regulatory & Supervisory Framework.....	6
8.1.1 The Three Pronged Strategy .....	7
8.1.2 Guidelines for Conventional Banks having dedicated Islamic Banking Branches for....	7
Segregation of Funds and System & Control .....	7
8.1.3 Schedule of Service Charges: .....	9
8.1.4 Off-Site Surveillance for Shariah Compliance through Introduction of Questionnaires in Institutional Risk Assessment Framework (IRAF).....	10
8.1.5 Development of Enforcement Framework.....	10
8.1.6 Guidelines for Islamic Microfinance Business .....	10
8.1.7 Rolling Out IFSB Standards / Guidelines .....	11
8.1.8 Other Initiatives .....	14
8.2 Shariah Compliance Framework.....	15
8.2.1 Shariah Board of State Bank of Pakistan.....	15
8.2.2 Shariah Advisor .....	17
Essentials & Model Agreements of Islamic Modes of Financing .....	18
8.2.4 Instructions and Guidelines for Shariah Compliance in Islamic Banking Institutions..	19
8.2.5 Shariah Advisors Forum (SAF) .....	21
8.2.6 Shariah Compliance Inspection .....	21
8.2.7 Standardization of Shariah Practices- Adoption/Adaptation of AAOIFI Shariah Standards.....	22
<b>9. Islamic Banking Industry Review in Terms of:</b> .....	<b>23</b>
9.1 Industry Progress and Market Share in Brief.....	24
9.2 Year Wise Entry of Players.....	26
9.3 Islamic Banking (Balance Sheet) Market Share-December 2007 .....	27
9.4 Growth in the Branch Network of Islamic Banking Industry .....	28
9.5 Province & City-Wise Breakup of Islamic Banking Branch Network .....	29
9.6 Bank-Wise Position of Islamic Banking Branches .....	31
9.7 Total Assets & Bank Wise Share.....	32
9.8 Deposits & Bank Wise Share.....	33
9.9 Deposit Structure .....	34
9.10 Financing & Bank Wise Share.....	35
9.11 Mode and Sector Wise Break-up of Financing.....	36
9.12 Investments & Bank Wise Share .....	37
9.13 Sources and Uses of Funds .....	38
9.14 Financing to Deposits Ratio.....	39
9.15 Capital Adequacy Ratio .....	40
9.17 Non Performing Financing .....	41

9.18 Earning Assets as Percentage of Total Assets .....	41
9.19 Income Statement.....	41
9.20 Product Offering of the Islamic Banking Industry in Pakistan .....	42
<b>10. Issues Faced by the Industry and Efforts of SBP .....</b>	<b>48</b>
10.1 Taxation Issues.....	48
10.2 Financial Reporting and Accounting Standards .....	48
10.3 Islamic Export Refinance Scheme .....	49
10.4 Capacity Building .....	50
10.5 Liquidity Management.....	52
10.6 Limited Outreach of Islamic Banking Institutions.....	52
10.7 Awareness Creation .....	53
<b>11. Strengthening Internal &amp; External Linkages.....</b>	<b>55</b>
11.1 Strengthening Links with International Islamic Infrastructure Institutions (IIIs) .....	55
11.1.1 Islamic Financial Services Board (IFSB) .....	55
11.1.2 International Islamic Financial Market (IIFM).....	56
11.1.3 Islamic Research and Training Institute (IRTI).....	56
11.1.4 Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) .....	57
11.1.5 Other Initiatives .....	57
11.2 Internal Linkages .....	58
11.2.1 Joint Forum of SBP and Securities & Exchange Commission of Pakistan on Islamic Financial Industry .....	58
11.2.2 Coordination with ICAP, FBR, MoF etc. ....	58
<b>12. Chronology of Policy Announcements.....</b>	<b>59</b>
<b>13. List of Tables &amp; Figures.....</b>	<b>66</b>
<b>14. Glossary of Islamic Finance Terms.....</b>	<b>67</b>
<b>ANNEXURE-A: Brief Background of the Full Fledged Islamic Banks .....</b>	<b>70</b>
<b>ANNEXURE-B: Fifteen Principles of Best Practice for Establishing and Implementing Effective Risk Management in IBIs.....</b>	<b>72</b>
<b>ANNEXURE-C: Salient Features of the Islamic Export Refinance Scheme .....</b>	<b>74</b>
<b>ANNEXURE-D: Tentative Roll out Plan of IFSB Standards/Guidelines .....</b>	<b>75</b>

## Acronyms

1.	AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
2.	BCBS	Basel Committee for Banking Supervision
3.	GCC	Gulf Cooperation Council
4.	HEC	Higher Education Commission
5.	IBBs	Islamic Banking Branches
6.	IBDs	Islamic Banking Divisions of Conventional Banks having IBBs.
7.	IBIs	Islamic Banking Institutions (Full Fledged Islamic Banks, Islamic Banking Subsidiaries* and Islamic Banking Branches )
8.	IBs	Full Fledged Islamic Banks
9.	IFSB	Islamic Financial Services Board
10.	IIFM	International Islamic Financial Market
11.	IIIs	Islamic International Infrastructure Institutions
12.	INCEIF	International Centre for Education in Islamic Finance
13.	IRTI	Islamic Research Training Institute
14.	IFS	Islamic Financial Services
15.	IFSI	Islamic Financial Services Industry
16.	IsDB	Islamic Development Bank
17.	MFB	Micro Finance Banks
18.	MOF	Ministry of Finance
19.	NIBAF	National Institute of Banking and Finance
20.	SAF	Shariah Advisors Forum
21.	SBP	State Bank of Pakistan
22.	SECP	Securities and Exchange Commission of Pakistan
23.	SME	Small and Medium Enterprises

\* No Islamic banking subsidiary exists currently.

## Abbreviations for Bank Names

No.	Abbreviation	Bank
1	RBS	Royal Bank of Scotland*
2	AIB	Albaraka Islamic Bank B.S.C. (E.C.)
3	ASK	Askari Commercial Bank Limited
4	BAF	Bank Alfalah Limited
5	BAH	Bank AL Habib Limited
6	BIP	BankIslami Pakistan Limited
7	BOK	The Bank of Khyber
8	DIB	Dubai Islamic Bank Pakistan Limited
9	DWD	Dawood Islamic Bank Limited
10	EGI	Emirates Global Islamic Bank Limited
11	HLB	Habib Bank Limited
12	HMB	Habib Metropolitan Bank Limited
13	MBL	Meezan Bank Limited
14	MCB	MCB Bank Limited
15	NBP	National Bank of Pakistan
16	SCB	Standard Chartered Bank(Pakistan)
17	SNR	Soneri Bank Limited
18	UBL	United Bank Limited- Ameen Islamic Banking

\* Previously ABN Amro (ABN)

## Abbreviations for some Variables and Islamic Modes of Finance

S. No	Abbreviation	Variables / Modes
1	CDP	Customers Deposits
2	FDP	Fixed deposits
3	SDP	Savings deposits
4	CAN	Current accounts -Remunerative
5	OTH	Others
6	FID	Financial Institutions Deposits
7	FRU	Remunerative deposits
8	FNR	Non Remunerative deposits
9	MRH	Murabaha
10	IJR	Ijarah
11	MUS	Musharaka
12	MUD	Mudaraba
13	DMU	Diminishing Musharaka
14	SLM	Salam
15	IST	Istisna
16	QRD	Qarz/Qarz-e-Hasna

## 1. Vision & Mission Statements of State Bank of Pakistan (SBP)

### Vision

To Transform SBP into a modern and dynamic central bank, highly professional and efficient, fully equipped to play a meaningful role, on sustainable basis, in the economic and social development of Pakistan

### Mission

To promote monetary and financial stability and foster a sound and dynamic financial system, so as to achieve sustained and equitable economic growth and prosperity in Pakistan

## 2. Vision & Mission Statements of Islamic Banking Department of SBP

### Vision

To make Islamic banking the banking of first choice for the providers and users of financial services

### Mission

To promote and develop Islamic Banking industry in line with best international practices, ensuring Shariah compliance and transparency.

### 3. Governor's Message

Islamic finance (IF) is assuming growing significance worldwide. Demand for this sector is driven by multiple factors: its faith base appeal from one quarter of world's Muslim population, its potential to augment financial engineering blended with socially and ethically responsive financing, its potential to service high net worth clients (whether Muslim or non-Muslim) and its potential to attract cross border oil revenue surpluses. Globally Islamic Financial Institutions (IFIs) together is likely to be now a one trillion dollar industry –with the setting up of over 250 IFIs that have managed to mobilize \$400 billion and remaining from Islamic capital markets across over 60 countries including non Muslim countries.

The initiative to introduce Islamic Banking in Pakistan was launched back in 2001 when the government decided to promote Islamic banking in a gradual manner and as a parallel and compatible system that is in line with best international practices. Meezan Bank Limited (MBL), which was granted a license on 31st January, 2002, commenced operations from March 20, 2002, as the first Islamic bank of the country. Since then the industry has been continuously showing impressive growth, surpassing the growth rates recorded by the conventional banks during the past five years. Being primarily a religiously conservative society the ever expanding Islamic finance industry of Pakistan provides opportunities to a fairly large segment of the populace that are outside the conventional banking system. This, in turn, will lead to financial deepening in the country and hence contribute towards one of the overall national economic goals, i.e. expansion of financial sector.

The industry over the years has managed to offer a wide array of products encompassing almost the entire range of Islamic modes of financing that are able to cater to the needs of majority of the sectors of the economy. Pakistani-IBs have managed to attract foreign stakes which gives industry an edge and a diverse look with scope for successful cross fertilization and transfer of experiences for the development of the local industry. Rapid growth of the industry has been accompanied by good financial performance and specific industry niche. The capital to risk-weighted ratio has invariably remained significantly above the 8 percent required level, and NPLs ratios have been considerably low. Through SBP's proactive policy action a number of developments have taken place on the Regulatory, Supervisory & Shariah Compliance Framework front. Moreover SBP has through its linkages with internal and external stakeholders (such as AAOIFI & IFSB) attempted to resolve some critical issues faced by the industry and also to capitalize on the opportunities available in the local and international context.

The Islamic financial services industry, despite its remarkable growth during the last few years, is still in its infancy and needs careful nurturing and development to make a significant impact on the financial landscape of the country. While charting its way forward this industry has to safeguard and maximize the interests of major stakeholders so that there is growth in market share of Islamic financial service industry from the existing insignificant level. Standards and codes, Principles of Corporate Governance, internal controls, disclosure and transparency have to be separated and made distinct from conventional banking to reflect the peculiar characteristics of Islamic Financial Sector. Some progress has been made but still there are a lot of knotty issues to be settled. There are conflicting pronouncements and continuing debate as to what is and what is not permissible under Shariah. These controversies in the interpretation of Shariah precepts among scholars from different fiqhs create a lot of uncertainties among the potential investors who then shy away from taking a plunge in the Islamic products keeping the overall size of the market small.

Positioning itself effectively the State Bank of Pakistan has established a dedicated Islamic Banking Department (IBD) which works as a focal point for all the efforts regarding Islamic banking in the country. The publication of Islamic Banking Sector Review 2003-07 will contribute significantly in projecting the progress made and issues faced by our Islamic Banking Sector.

*Dr. Shamshad Akhtar,*  
*Governor, State Bank of Pakistan*



## 4. Foreword

In the last thirty years, Islamic finance industry has made considerable progress at the global front. Especially, during the last decade the Islamic Financial Sector (IFS) has registered a robust growth (between 15 to 20 percent per annum); making it one of the fastest growing segments of the overall financial system. As a result, today the Islamic financial industry is comprised of across-the-board financial institutions and markets. Moreover, there are dedicated regulatory, legal and academic institutions at the international level that are providing support in establishing the IFS. With the passage of time the international Islamic financial market is becoming increasingly dynamic and diversified. Once looked at as a patchwork of niches in the Arabian Gulf region and Malaysia, the market is evolving into a global one. In this milieu, the stakeholders are implementing important market harmonization measures as proposed by the international standard setting bodies like AAOIFI and IFSB.

Pakistan is no exception to this phenomenon and Islamic banking here too is witnessing unprecedented growth. SBP has been playing a leading role towards promotion and development of Islamic banking in the country. The establishment of a full-fledged Islamic Banking Department at SBP to focus on all Islamic Banking issues provided the industry the necessary impetus to grow and gradually emerge as a preferred choice of the public. SBP's drive to promote Islamic banking as a parallel system, operating at a level playing field with commercial banking, is aimed at building a broad based financial system in the country to enable all segments of the population to access financial services and play their due role in the overall economic development.

Given the need to share with the stakeholders and public at large about the developments that have taken place in this important area it was felt imperative that dedicated publications be issued by SBP with focus on the Islamic Banking Sector of the country. The first attempt in this regard was issuance of quarterly Islamic Banking Bulletin which has been widely appreciated by a number of quarters. Moving into next phase we are pleased to publish "**Islamic Banking Sector Review**" (**BSR**) 2003-2007 which is relatively wider in scope and period of coverage. The said publication mainly covers the developments in the sector during the period from Year 2003 to 2007 in terms of growth dynamics, composition of the players and product offering, regulatory initiatives, financial performance, resolution of issues faced by the industry and creation & strengthening of internal and external linkages.

Though, we have strived to enrich contents of the publication and make it more comprehensive in all respects; feedback and suggestions to bring further improvement in the document are always welcomed and appreciated.

**PERVEZ SAID**  
**Director Islamic Banking Department**  
**State Bank of Pakistan**

## 5. Executive Summary

In Pakistan Islamic banking emerged as a response to both religious and economic needs. Efforts for economy wide elimination of Riba started during 1970s and most of the significant and practical steps were taken in 1980s. The mid-80s attempt was a significant step in the evolution of Islamic banking system in the country. In a technical sense it was the most advanced model compared to any other model being practiced anywhere in the world at that time. However that system fell apart as it did not adequately address issues such as putting in place an effective Shariah compliance mechanism, giving emphasis to capacity building, and opting for a flexible and evolutionary approach. In any case this effort provided a valuable experience that has been taken into account while formulation of SBP's current strategy to re-launch Islamic Banking in Pakistan .

The initiative to re-introduce Islamic Banking in Pakistan was launched back in 2001 when the government decided to promote Islamic banking in a gradual manner and as a parallel and compatible system that is in line with best international practices. Following the decision of the government to shift to interest free economy in a phased manner without causing any disruptions the effort was envisaged to be based on a market driven and flexible approach. Furthermore it aims at building a broad based financial system in the country to enable all segments of the population to access financial services

In this context SBP worked on a three pronged strategy for promotion of Islamic Banking i.e.

- Allow new full fledged Islamic banks in the private sector,
- Allow the conventional banks to set up Islamic banking subsidiaries
- Allow the existing conventional banks to open Stand-alone Islamic banking branches.

This time there has been a shift in the approach from the legal & regulatory perspective to that of dealing with the whole affair of introducing Islamic banking in Pakistan as a change management issue. As compared to our past experience our new approach provides flexibility to the IBIs as regard to products, instruments and Shariah compliance methodology. This new initiative has witnessed a very encouraging response. As at end of the year 2003 only one bank operated as a full-fledged Islamic bank and three conventional banks were operating Islamic banking branches. Currently there are 6 full fledged licensed Islamic banks (IBs) and 12 conventional banks have licenses to operate dedicated Islamic banking branches (IBBs). All of the five big banks in Pakistan are providing Islamic banking services. The total assets of the Islamic banking industry are over Rs. 225 billion as of 30th June, 2008 which accounts for a market share of 4.5% of total banking industry assets. The market share of deposits stands at 4.2%. Total branch network of the industry comprises of more than 358<sup>1</sup> branches with presence in over 50 cities & towns covering all the four provinces of the country and AJK.

The industry over the years has managed to offer a wide array of products encompassing almost the entire range of Islamic modes of financing that are able to cater to the needs of majority of the sectors of the economy. Also it has been noticed that the industry has a good financial performance. Foreign investment<sup>2</sup> in Pakistani Islamic banking industry is giving the industry a unique look through which success transfer is taking place as experiences are being shared leading to the development of the local industry.

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<sup>1</sup> As on September, 01, 2008

<sup>2</sup> Brief background about the full fledged Islamic banks is given in **Annexure- A**

SBP has over the years attempted to develop a supportive Regulatory and Supervisory Framework having special emphasis on Shariah Compliance that is in line with the best international practices. The aim is to align our industry with the international best practices so as to enhance the credibility and international stakeholders' confidence in Islamic banking efforts of SBP. This will in turn not only boost the image of our country but will also be instrumental in attracting foreign investment.

Pakistan has adopted a three tiered, somewhat unique, Shariah Compliance Mechanism and process to ensure a deeper and extensive Shariah compliance supervision on an on-going basis. The Shariah supervision mechanism consists of three basic elements. Shariah Advisors for banks undertaking Islamic Banking, a Shariah Compliance Inspection and a centralized Shariah Board for the country at SBP. The recently issued Instructions and Guidelines for Shariah Compliance aim to further augment this Shariah compliance regime. Similarly adoption/adaptation of AAOIFI Standards/Guidelines will help bring our industry at par with the international standards and also achieve standardization of Shariah practices locally.

Provision of level playing field to this industry passing through infancy stage is another important area which has been addressed by the central bank. SBP through interaction/coordination with relevant stakeholders has taken a number of steps for resolution of various issues faced by the industry such as Liquidity Management and Accounting & Taxation Issues etc. Similarly SBP also took initiatives like launch of Islamic Export Refinance Scheme (under Part-1 and Part-2) and 3 weeks' Islamic Banking and Finance Certificate Course through the National Institute of Banking and Finance (NIBAF-a subsidiary of SBP).

At the international level SBP has been actively pursuing the goal of strengthening links with International Islamic Infrastructure Institutions and also with central banks and other multilateral developmental institutions. Being one of its founding members, SBP is already playing an active role in the working of the Islamic Financial Services Board (IFSB). It is also a permanent member of the Bahrain based International Islamic Financial Market (IIFM) and is being represented through active participation in meetings of Board of Directors, Working Groups etc of IIFM. SBP is also a trustee of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).

The Islamic Financial Services segment is an increasingly important constituent of the financial sector in Pakistan and has grown in size and diversity in just a few years. The participants of the Islamic Banking Industry are all strong players with a sound capital base, compliant with SBP's MCR requirements uniformly applied to both conventional and Islamic Banks, which restricts entry into the sector without the requisite sound financials. The industry is still in a development phase and it is expected that with time, not only will the practice of Islamic financial intermediation converge with the conceptual foundations on which it is based, but will also increase the level of financial depth and penetration by providing financial services to the unbanked segment.

## 6. Future Outlook

Based on the factors like unmet demand, geographical coverage, product development, new segments and data collected by different Islamic banks, it is estimated that total assets of Islamic banking industry will reach over one trillion rupees up to year 2012. All banks expect to expand the branch network to over 1200 branches in 5 years. Deposits are expected to reach at about Rs.1 trillion. This in combination with the introduction of new sectors into the fold of Islamic banking i.e. Islamic microfinance and agriculture services it is projected that Islamic banking industry will capture 12% share of total banking industry in year 2012.

In addition to this, there will be a strong need of trained human resources in the field of Islamic banking. Based on the information collected, it is expected that within next 5 years expertise of over 15,000 people will be required to serve the Islamic banking industry.

The challenge for Islamic banks is to sustain the expected growth in a still-developing industry infrastructure environment and in an increasingly competitive banking industry. Specifically, the Islamic banking industry is faced with the following opportunities / challenges:

- Strong demand for Shariah compliant financial services driven by a large and upwardly-mobile domestic Muslim population
- Bankers of Pakistani origin are well positioned in major Islamic financial markets and regional Islamic financial intuitions
- Increased interest from GCC investors in Shariah compliant investment opportunities in Pakistan
- Expectation to see a more active role of Islamic banking players in developmental sectors like SME, Microfinance, Agribusiness, etc.
- Increased competition from conventional banks that are now bigger and better capitalized as a result of consolidation and mergers.
- Conventional banking segment is also highly profitable, putting pressure on Islamic banks to demonstrate growth with profitability
- Demanding consumers expect differentiated products (credibility and reputation risk)
- “Islamic banking” is an increasingly popular subject with the domestic print and electronic media (need for media management)

Keeping in view the successful launch and steady growth of the Islamic banking system in the country that was supported by provision of requisite Regulatory, Supervisory & Shariah Compliance framework the State Bank of Pakistan plans to continue with its approach of dealing with Islamic banking as a change management issue. This approach also ensures that there will be no disruption in the current system. The roll out is market lead rather than through legal means or as a religious dictate.

This approach dictates adoption of policies based on a sound regulatory framework yet offering the market to grow in a Shariah compliant manner while catering to the ever changing needs of the users. This is also in line with the direction and approach being adopted internationally. SBP is focused on providing the users of Islamic banking with the solutions they seek for managing their financial relationships. These solutions will be as functional and cost effective as those being provided by the conventional banking system yet these will be strictly Shariah compliant. To ensure

this SBP will focus upon two key elements. Firstly, a sound regulatory framework, flexible, market driven and in line with international best practices. Second a sound Shariah Compliance Mechanism, comprehensive, flexible, multi layered and acceptable locally and internationally. It is worth mentioning here that based on the successful launch of the industry SBP has now developed a strategic plan<sup>3</sup> which envisages a 12% market share by 2012 and is based on five pillars namely Extension of Outreach, Shariah Compliance Mechanism, Strengthening of Regulatory Framework, Capacity Building and Internal and External Relations.

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<sup>3</sup> For viewing the Strategic Plan please visit  
<http://www.sbp.org.pk/departments/pdf/StrategicPlanPDF/Strategy%20Paper-Final.pdf>

## 7. Brief Historical Perspective on Islamic Banking Initiatives in Pakistan

Islam was the basis of creation of an independent state within the undivided Indo-Pak Sub-Continent. All Constitutions of Pakistan have incorporated, within the principles of policy, the elimination of Riba as an important objective of the State policy. Quaid-e-Azam, the father of the nation, in his speech at the occasion of the inauguration of State Bank of Pakistan, had expressed the desire for evolving an Islamic system of banking.

Article 38(f) of the Constitution of the Islamic Republic of Pakistan provides: "The State shall .... Eliminate *riba* as early as possible." The Objectives Resolution, now a part of the Constitution, as well as principles of policy enunciated in the Constitution also require to establish an order in Pakistan "[w]herein the Muslims shall be enabled to order their lives in the individual and collective spheres in accordance with the teachings and requirements of Islam as set out in the Holy Quran and Sunnah".

In Pakistan Islamic banking emerged as a response to both religious and economic needs. The earliest efforts for finding an alternative to the interest-based system could be found in a number of reports submitted by the Council of Islamic Ideology (CII).

### *7.1 Steps for Islamization of Banking and Financial System in 1980s*

Efforts for economy wide elimination of Riba started during 1970s and most of the significant and practical steps were taken in early 1980s. It was a very bold and comprehensive exercise. Pakistan was among the three countries in the world that had been trying to implement interest free banking at comprehensive / national level

Numerous measures were taken to introduce interest free banking in Pakistan. Banking and other relevant laws viz. SBP Act, BCO, Companies Ordinance, recovery laws, negotiable instruments act, etc. were amended to facilitate interest free banking system and the industry was given a specific timeline to convert to the Islamic banking system.

State Bank Pakistan also gave the industry the products which it was allowed to use without any change or exception. Islamic banking was rolled out country-wide. New regulations were prepared prescribing the modes of financing, profit distribution mechanism for deposits, financing facilities by SBP, etc. which constituted ground work for Islamization of financial system.

#### *The Islamization measures among others entailed*

- Elimination of interest from the operations of specialized financial institutions in 1979 and from commercial banks during 1981 to 1985.
- The legal framework of Pakistan's financial and corporate system was amended on June 26, 1980 to permit issuance of a new interest free instrument of corporate financing named Participation Term Certificate (PTC).
- An Ordinance was promulgated to allow the establishment of Modaraba companies and floatation of Mudaraba certificates for raising risk capital. Amendments were also made in

the Banking Companies Ordinance, 1962 (The BCO, 1962) to include provision of bank finance through PLS, mark-up in prices, leasing and hire purchase.

- On January 1, 1981 Separate Interest-free counters started operating in all the nationalized commercial banks, and one foreign bank (Bank of Oman) to mobilize deposits on profit and loss sharing basis. Regarding investment of these funds, bankers were instructed to provide financial accommodation for Government commodity operations on the basis of sale on deferred payment with a mark-up on purchase price. Export bills were to be accommodated on exchange rate differential basis.
- In March, 1981 financing of import and inland bills and that of the then Rice Export Corporation of Pakistan, Cotton Export Corporation and the Trading Corporation of Pakistan were shifted to mark-up basis. Simultaneously, necessary amendments were made in the related laws permitting the State Bank to provide finance against Participation Term Certificates and also extend advances against promissory notes supported by PTCs and Mudaraba Certificates.
- From July 1, 1982 banks were allowed to provide finance for meeting the working capital needs of trade and industry on a selective basis under the technique of Musharaka.
- As from April 1, 1985 all finances to all entities including individuals began to be made in one of the specified interest-free modes. From July 1, 1985, all commercial banking in Pak Rupees was made interest-free. From that date, no bank in Pakistan was allowed to accept any interest-bearing deposits and all existing deposits in a bank were treated to be on the basis of profit and loss sharing.
- Deposits in current accounts continued to be accepted but no interest or share in profit or loss was allowed to these accounts. However, foreign currency deposits in Pakistan and on-lending of foreign loans continued as before. The State Bank of Pakistan had specified 12 modes of non-interest financing classified in three broad categories. However, in any particular case, the mode of financing to be adopted was left to the mutual option of the banks and their clients.
- At that time two important areas were kept outside the purview of interest free banking system mainly due to lack of research in these fields, viz. Government borrowings (both local and foreign) and foreign exchange.

## ***7.2 Brief Evaluation***

The mid-80s attempt was a significant step in the evolution of Islamic banking system in the country. In a technical sense it was the most advanced model compared to any other model being practiced anywhere in the world at that time. The efforts and practical steps undertaken in the 1980's to Islamize the economy at national level are considered as pioneering work in the Muslim world as this became important reference material for other countries which undertook the path towards introduction and establishment of an Islamic banking system.

This model was a winner in every sense except for four basic issues.

- **First** it failed to recognize the process as *evolutionary*, it took the *revolutionary* approach.

- **Second** the system was too *rigid* and did not offer the flexibility to cater to the ever changing needs in a dynamic market.
- **Third**, there was no appropriate mechanism to ensure *Shariah Compliance*.
- **Last** but not the least, all the stakeholders involved, were *not ready* to roll when the time came to launch.

Unfortunately these issues could not be addressed adequately and therefore the system fell apart. In any case this effort provided a valuable experience that has been taken into account while formulation of SBP's current strategy to re- launch Islamic Banking in Pakistan<sup>4</sup>.

In early 90s the whole exercise was challenged in the Federal Shariat Court and the procedure adopted by banks in Pakistan since July 1, 1985 was declared un-Islamic by the Federal Shariat Court (FSC) in November 1991. The system was based largely on 'mark-up' technique with or without 'buy-back arrangement'. The FSC declared that various provisions of the laws held repugnant to the injunctions of Islam in its Judgment dated November 14, 1991 would cease to have effect as from July 1, 1992.

However, the Government and some banks/DFIs preferred appeals to the Shariat Appellate Bench (SAB) of the Supreme Court of Pakistan. The SAB delivered its judgment on December 23, 1999 rejecting the appeals and directing that laws involving interest would cease to have effect finally by June 30, 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 also directed the Government to set up, within specified time frame, a Commission for Transformation of the financial system and two Task Forces to plan and implement the process of the transformation. The Court indicated some measures, which needed to be taken, and the infrastructure and legal framework to be provided in order to have an economy conforming to the injunctions of Islam.

Later, the decision regarding transformation of the whole system was set aside in a review petition by the Supreme Court and has been sent to the Federal Shariat Court to start fresh hearings. However, the deferment in the final decision has not dampened the efforts to lay the groundwork for the emerging sector. The Government/State Bank proceeded ahead for promoting Islamic Banking practices parallel with the conventional banking.

### ***7.3 Post Judgment Measures***

- In January 2000 the Commission for Transformation of Financial System (CTFS) was constituted in the State Bank of Pakistan under the Chairmanship of Mr. I.A. Hanfi, a former Governor of State Bank of Pakistan.
- A Task Force was set up in the Ministry of Finance to suggest the ways to eliminate interest from government financial transactions.
- Another Task Force was set up in the Ministry of Law to suggest amendments in legal framework to implement the Court's Judgment. The CTFS constituted a Committee for Development of Financial Instruments and Standardized Documents in the State Bank to prepare model agreements and financial instruments for new system.

<sup>4</sup> For Summary of Reports of various Commissions / Committees etc. please visit <http://www.sbp.org.pk/departments/pdf/StrategicPlanPDF/Appendix-D%20Summary%20of%20Reports.pdf>

<sup>5</sup> Supreme Court's Judgment dated December 23, 1999



- Moreover consultations and exchanges were undertaken with brotherly Islamic countries and renowned institutions of Islamic learning such as Middle Eastern countries and Al-Azhar University of Egypt, to learn more about their experiences and practices;
- An important conclusion made was that the introduction of Islamic Banking System is a long process requiring development of legal and regulatory framework, institutions, markets, and efficient and appropriate practices. This process requires constant monitoring and fine-tuning. It was suggested that Pakistan should follow the example of Malaysia, Egypt and Saudi Arabia and adopt a dual/parallel banking system. The government's intention was to promote Islamic banking in the country while keeping in view its linkages with the global economy and existing commitments to local and foreign investors.

## ***7.4 Policy Decision***

In a meeting held on September 4, 2001 under the Chairmanship of the President of Pakistan, attended by officials of the Ministries of Finance and Law, Governor State Bank of Pakistan, Chairman and some members of the Council of Islamic Ideology and the Chairmen of the CTFS and the two Task Forces it was decided that the shift to interest free economy would be made in a gradual and phased manner and without causing any disruptions. It was also agreed that State Bank of Pakistan would offer three institutional options:

- 1) Setting up subsidiaries by the commercial banks for the purpose of conducting Shariah compliant transactions;
- 2) Specifying branches by the commercial banks exclusively dealing in Islamic products with all safeguards to ensure integrity and purity of Islamic banking operations , and
- 3) Setting up a new full-fledged commercial bank to carry out exclusively banking business based on proposed Islamic products.

As a result of these efforts, in 2001, an Islamic Banking Division was established in the Banking Policy Department at SBP. This time around, concerted efforts were made by SBP to undertake Islamic Banking in its true spirit and also keeping in view the lessons learnt from the experience of Bahrain, Malaysia and Saudi Arabia etc. in this area. Accordingly, steps have been taken to set up a parallel banking system, so that an enabling environment is ensured for the sector, avoiding any serious repercussions of entire transformation of financial sector.

As part of this process, the State Bank has introduced various policies.

- In December 2001, criterion for the establishment of Islamic banks was announced. Al-Meezan Investment Bank Limited applied under the criteria issued by SBP to convert itself into Islamic commercial bank. They were issued a license in the name of Meezan Bank Limited to operate as full-fledged Islamic bank in January, 2002. The bank acquired the business of Societe Generale Bank branches operating in Pakistan and has started commercial operations in March, 2002 as a model Islamic bank in Pakistan.
- In September 2002, an amendment in the Sec 23 of BCO 1962 was promulgated in order to promote Islamic banking through establishment of Islamic banking subsidiaries.

- Cognizant of the fact that detailed guidelines on the issue were needed, the State Bank issued Policies for the Promotion of the Islamic Banking on January 1, 2003 defining criteria for establishment of Islamic banks in the private sector, Islamic banking subsidiaries and stand alone branches by conventional banks. The policies encompass the eligibility conditions, licensing requirements, and guidelines on the physical set up along with Shariah compliance and other operational matters of the banks<sup>6</sup>.
- In recognition of the need for a separate department to look after the regulation and promotion of the Islamic banking sector, the Islamic Banking Department (IBD) was established in the State Bank in September, 2003. The department has been staffed with personnel having rich experience in regulating the banking industry and with in depth knowledge of all aspects of Islamic banking, including conceptual as well as business.

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<sup>6</sup> For detailed set of criteria/guidelines (updated version announced vide IBD Circular N0. 2 of 2004) please visit <http://www.sbp.org.pk/ibd/2004/cir02.htm>

## 8. Regulatory, Supervisory & Shariah Compliance Developments

The present re-launch of Islamic Banking in Pakistan by the State Bank of Pakistan has been based not only on the lessons learnt from the history of Islamic Banking efforts in Pakistan but also on the experiences of other countries in the world that are currently known for their leadership role in this banking sector. The basic difference, in SBP's current policies regarding Islamic banking and the previous efforts, is the approach adopted by SBP wherein the introduction of Islamic Banking is being viewed more as a change management issue rather than as a religious or a legal issue.

This basic difference in approach defines the policies on Islamic Banking and is primarily responsible for the success achieved so far. It was decided to promote Islamic banking in a gradual manner and as a parallel and compatible system that is in line with best international practices. Following the pronouncement of the government to shift to interest free economy in a phased manner without causing any disruptions the effort was envisaged to be based on a market driven and flexible approach. Furthermore this approach is also helping build a broad based financial system in the country to enable all segments of the population to access financial services

SBP is focused on providing the users of Islamic banking with the solutions they seek for managing their financial relationships. These solutions are as functional and cost effective as those being provided by the conventional banking system yet these are Shariah compliant. To ensure this the focus is upon two key elements. Firstly, a sound regulatory framework, flexible, market driven and in line with international best practices. Second a sound Shariah Compliance Mechanism, comprehensive, flexible, multi layered and acceptable locally and internationally. In this report we have dealt with the two elements in separate sections.

### *8.1 Regulatory & Supervisory Framework*

While charting the regulatory framework for the industry attempt is being made to build onto the existing regulatory framework to accommodate Islamic banking transactions by retaining the elements that are common to both systems and adding on those elements that are not currently available to accommodate the unique differences of Islamic banking. This is the pragmatic approach that avoids the tendency to reinvent the wheel and at the same time give Islamic banking a tremendous advantage by allowing it to leverage, to the maximum extent, the conventional banking regulatory system that has developed over a long period of time and has a built in process of getting continuously developed and adjusted to meet the needs of a dynamic and robust financial markets.

Broadly, the regulatory and supervisory framework governing the Islamic Banking System comprises the following:

- 8.1.1 Three Pronged Strategy
- 8.1.2 Guidelines for Conventional Banks having IBBs for Segregation of Funds and Systems & Controls
- 8.1.3 Schedule of Service Charges
- 8.1.4 Off-site Surveillance for Shariah Compliance through Introduction of Questionnaires in Institutional Risk Assessment Framework (IRAF).
- 8.1.5 Development of Enforcement Framework
- 8.1.6 Guidelines for Islamic Microfinance Businesses

- 8.1.7 Rolling Out of IFSB Standards / Guidelines
- 8.1.8 Other Initiatives

### **8.1.1 The Three Pronged Strategy**

While SBP's Islamic banking strategy allows the people to manage their financial relationships in line with their Islamic beliefs, it at the same time provides choice to the banks to choose the structure that suits them the most in terms of their current structure, business prospects, and the cost structure in the competitive environment.

In this context SBP worked on a three pronged strategy for promotion of Islamic Banking i.e.

1. Allow new full fledged Islamic banks in the private sector,
2. Allow the conventional banks to set up Islamic banking subsidiaries
3. Allow the existing conventional banks to open Stand-alone Islamic banking branches.

In line with Part-I of the strategy, on 1st December, 2001, State Bank of Pakistan issued detailed criteria for setting up of Scheduled Islamic Commercial banks based on Shariah Principles in the Private Sector.

As regards Part-II of the strategy, in November 2002, in order to allow the scheduled commercial banks to open subsidiaries for Islamic banking operations, a new clause was inserted in sub-section (1) of section 23 of the Banking Companies Ordinance 1962 as follows:

“(aa) the carrying on of banking business strictly in conformity with the Injunctions of Islam as laid down in the Holy Quran and Sunnah”.

Therefore, the scheduled commercial banks were allowed to open subsidiaries for Islamic Banking operations. Accordingly, a Detailed Criteria for setting up of Islamic Banking Subsidiaries by existing Commercial Banks was formulated.

For Part-III of the strategy, Guidelines for opening of Stand-alone branches for Islamic banking by existing commercial banks were formulated.

### **8.1.2 Guidelines for Conventional Banks having dedicated Islamic Banking Branches for Segregation of Funds and System & Control**

In addition to complying with the overall requirements prescribed in the Shariah compliance regime the State Bank of Pakistan has put in place necessary regulatory framework which aims at ensuring the segregation of funds in conventional banks having dedicated Islamic Banking Branches.

Salient features of this framework are as follows:

#### *a) Before Commencement of Business*

- A Shariah Advisor has to be appointed in the light of SBP Shariah Board's "Fit and Proper Criteria" and the approval of SBP. However, Banks are free to appoint a Shariah Committee at their own discretion and not as part of SBP regulation.
- The bank will ensure that all the Documents and agreements pertaining to each type

of products and services alongwith Risk management guidelines, Plans for Internal control and Information Technology systems are in place. All relevant documents/agreements and guidelines have to be duly certified by their Shariah Adviser and a certificate in this regard has to be submitted to the State Bank alongwith the Application Form. All these documents are also to be made readily available to the SBP Inspection Team during inspection of the bank.

*b) While Approaching for License*

- At the time of seeking license the Working Paper/Proposal should also include method of segregating the funds of the IBB from the funds of commercial banking of the applying bank.
- Moreover every licensed branch of a bank shall carry a name, and shall invariably be required to prominently display the name of the branch as stipulated in the license.

*c) Systems and Controls*

- The bank shall ensure that proper systems and controls are in place in order to ensure segregation of funds and protect the interest of depositors, including but not limited to the followings:-
- Islamic Banking Division of the conventional bank has the responsibility to ensure that all funds pooled into the Islamic Banking Fund are channeled into Shariah compliant financing and investment activities.
- The bank shall be required to prepare procedure manuals for the Islamic Banking Division and Islamic Banking Branch (IBB) operations duly approved by their Shariah Adviser/Shariah Supervisory Committee as well as the Board of Directors or in case of branches of foreign banks operating in Pakistan, by their Head Office.
- The bank shall prepare a full set of documents pertaining to the deposit, investment and financing products pertaining to IBB operations.
- The full set of the documents duly vetted by their Shariah Adviser shall be maintained by the IBD. Similarly, all documents in respect of new schemes offered by IBB(s) shall also be prepared and maintained by IBD before launching of the scheme.
- All documents (including ledgers, registers, pay-in-slips, cheques, receipts, passbooks, etc.) used in the IBD and IBB(s) shall be appropriately marked, so as to easily distinguish them from the documents pertaining to commercial banking.
- In order to efficiently utilize the existing branch network, the bank may authorize some of its branches to sell the Islamic banking deposit schemes. However, in such cases proper systems and control should be in place to ensure that the fund transfer takes place on the same day to/from the IBB. The authorized branches shall not, in any manner whatsoever, receive/pay interest on such services. The authorized branches may charge a reasonable fee/commission on sale of such deposit schemes under a policy to be approved by the Board of Directors or in case of branches of foreign banks, their Head Office. Proper training in Islamic banking should also be provided to the staff of authorized branches dealing with such deposit schemes.

- The bank shall be required to undertake comprehensive internal audit including internal Shariah Review on the operations of the IBB(s) and IBF at least once in a year.

*d) Accounting Records / Reporting and Disclosure:*

- The banks shall keep separate book of accounts in respect of Islamic banking operations and ensure proper maintenance of records for all transactions for segregation of funds.
- The banks shall prepare a separate daily trial balance of the operations arising from the IBB(s).
- Based on the balances of all the items (assets, liabilities, expenses and income) relating to the operations of the IBB(s), the bank shall prepare and submit separate annual as well as quarterly financial statements for its IBB operations alongwith its periodical financial statements on the format prescribed by State Bank from time to time.

e) It is worth mentioning here that SBP has put in place an eligibility criteria for conventional banks intending to undertake Islamic banking operations. This criteria has been set to ensure soundness of Islamic banking system through which banks with weak systems and controls or having adverse rating have been debarred from starting Islamic banking operations. The eligibility of a bank to open Islamic banking branch(es) is considered by the State Bank keeping in view, among others, the financial strength of the bank as evident from its capital base(net capital free of actual and potential losses), adequacy of its capital structure, record of earning capabilities, future earning prospects of the bank, managerial capabilities, bank's liquidity position, track record of the bank's adherence to prudential regulations, credit discipline, quality of customer services etc. In addition, the following considerations are also taken in the grant of the license:-

- (i) Banks having CAMELS rating of 1, 2 and 3 in the last ON-SITE inspection are eligible for opening Islamic Banking Branches.
- (ii) There should not be major adverse inspection findings against the bank.
- (iii) The bank shall identify experienced and trained key staff to handle the IBB operations.

### **8.1.3 Schedule of Service Charges:**

The Islamic Banking Institutions have been required by SBP to provide copy of the printed schedule of charges at least seven days before the commencement of the related half-year. In this regard they have been advised to ensure meticulous compliance of the following instructions while submitting schedule of charges to SBP:

- Islamic Banking Branches of Conventional banks shall have a separate set of Schedule of Charges for their business.
- The Schedule of Charges submitted by the IBIs shall be signed by the bank's Shariah Advisor as an endorsement of Shariah compliance.
- If IBIs want to fix different rate of charges for various categories of clients (e.g. according to volume of business etc.), then such categories should be clearly defined by the IBI.

#### **8.1.4 Off-Site Surveillance for Shariah Compliance through Introduction of Questionnaires in Institutional Risk Assessment Framework (IRAF)**

The system of Institutional Risk Assessment Framework (IRAF) was introduced by SBP in 2004 for continued monitoring and evaluation of banks and DFIs. The review of banks/DFIs under IRAF is based on inputs relating to four areas namely compliance with standards, codes & guidelines; supervisory & regulatory information; financial performance & condition and market information & intelligence.

For the Islamic Banking Institutions the State Bank has now developed detailed Shariah Compliance Questionnaires (applicable from December 2008) drawn from the overall Shariah compliance framework put in place by SBP for incorporation in the Self Assessment Institutional Risk Assessment Framework.

#### **8.1.5 Development of Enforcement Framework**

Following the development of Shariah Inspection regime SBP is now also focusing on another relevant and important area i.e. of putting in place an enforcement framework for Shariah compliance in the Islamic Banking Institutions. The framework is accordingly being developed by the Islamic Banking Department in consultation with other relevant departments of SBP.

#### **8.1.6 Guidelines for Islamic Microfinance Business**

Pakistan is among the few countries in the world, which has a separate comprehensive legal and regulatory framework for Microfinance Banks. The framework allows microfinance and commercial banks to extend range of microfinance services to poor and low income people through various arrangements. With the growing popularity of Islamic Banking in the country, it was deemed necessary to provide options for provision of Islamic microfinance services by microfinance and commercial banks as well as allowing full fledged Islamic microfinance banks in the country.

Consequently, State Bank of Pakistan formulated guidelines<sup>7</sup> for provision of Islamic microfinance products and services by financial institutions. These guidelines are aimed at providing enabling environment for introduction of microfinance products and services on Shariah compliant basis in the country through various channels mentioned therein. They will help in broadening the coverage of microfinance products and services to low income segments of the society in a Shariah compliant manner.

Based on their type, organization structure, capacity and overall objectives the commercial and microfinance banks interested in building Islamic microfinance portfolio have been allowed to review the different institutional/organizational arrangements and select, one or the combination of more than one mode. The said guidelines stipulate four types of institutional arrangements for offering Islamic microfinance viz:

*a. Establishing Full Fledged Islamic Microfinance Banks (IMFBs)*

These cover:

- Licensing Requirements
- Application Forms.

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<sup>7</sup> For detail information on the said guidelines please visit <http://www.sbp.org.pk/ibd/2007/C5.htm>

- Compliance with Legal Framework & Prudential Regulations for IMFBS

*b. Islamic Microfinance Services by Full-fledged Islamic Banks*

These cover:

- Mode I- Islamic Microfinance Counters at Existing Branches
- Mode II- Stand-alone Islamic Microfinance Branches & Mobile Banking
- Mode III- Establishing Independent IMFBS as Subsidiaries of Banks
- Mode IV- Developing Linkages with Islamic MFBs/MFIs

*c. Islamic Microfinance Services by Conventional Banks*

These cover:

- Mode I- Islamic Microfinance Counters at Existing Branches
- Mode II- Stand-alone Islamic Microfinance Branches & Mobile Banking
- Mode III- Establishing Independent IMFBS as Subsidiaries of Banks
- Mode IV- Developing Linkages with Islamic MFBs/MFIs

*d. Islamic Microfinance Services by Conventional Microfinance Banks (MFBs)*

These cover:

- Eligibility Criteria.
- Islamic Microfinance Division
- Islamic Microfinance Fund
- Systems and Control
- Utilizing Conventional Branch Network.
- Internal Audit.
- Accounting Records and Disclosure
- Statutory Liquidity and Cash Reserve Requirements

Furthermore for all the microfinance arrangements additional guidelines prescribed for facilitating the customers include:

- Preparation of FAQs and brochures (to be prominently placed in the branch and on the websites of the institutions) in local/national languages to address the commonly asked questions regarding the products and services offered as well as general introduction of the same.
- Allocation of a separate page on website of the institutions for Islamic microfinance products offered by the bank and also the postal and email address, phone and fax numbers.

### **8.1.7 Rolling Out IFSB Standards / Guidelines**

Islamic Financial Services Board is an international-standard setting body of regulatory and supervisory agencies that have vested interest in ensuring the soundness and stability of the Islamic financial services industry. In advancing this mission, the IFSB promotes the development of a prudent and transparent Islamic financial services industry through introducing new, or adapting existing international standards consistent with Islamic Shariah principles, and recommend them for adoption. To this end, the work of the IFSB complements that of the Basel Committee on



Banking Supervision, International Organization of Securities Commissions and the International Association of Insurance Supervisors.

Currently the IFSB has published the following standards:

- Guiding Principles of Risk Management for Institutions (other than Insurance Institutions) offering only Islamic Financial Services (IIFS).
- Capital Adequacy Standard for Institutions (other than Insurance Institutions) offering only Islamic Financial Services (IIFS).
- Guidance Note in Connection with The Capital Adequacy Standard: Recognition of Ratings by External Credit Assessment Institutions (ECAIs) on Shariah-Compliant Financial Instruments
- Guiding Principles on Corporate Governance for Institutions Offering Only Islamic Financial Services (Excluding Islamic Insurance (Takaful) Institutions and Islamic Mutual Funds).
- Disclosures to Promote Transparency and Market Discipline
- Guidance on Key Elements in the Supervisory Review Process of Institutions offering Islamic Financial Services (excluding Islamic Insurance (Takaful) Institutions and Islamic Mutual Funds).

State Bank of Pakistan is the full member of Islamic Financial Services Board (IFSB) since its inception. Being a full member, it is its responsibility to support & adopt /adapt standards issued by IFSB in the Islamic banking industry. To introduce the world class regulations and be part of the global Islamic Banking industry a process has been put in place to introduce these standards in Pakistan. This process includes public exposure to draft regulations and an exposure and buy in of the stakeholders of this industry. After necessary adjustments, based on the feedback, laws and other regulatory considerations these standards are being rolled out<sup>8</sup>. The rolling out of these standards is helping Pakistan in not only building a robust Islamic Banking regulatory framework but also helping in addressing some critical areas.

*a) Risk Management Guidelines for Islamic Banking Institutions*

The State Bank of Pakistan in January 2008 formulated Risk Management (RM) Guidelines<sup>9</sup> for Islamic Banking Institutions (IBIs) with a view to further strengthening the regulatory framework in the area of risk management for IBIs.

These RM Guidelines are based on a 'Guiding Principles of Risk Management for Institutions offering Islamic Financial Services' issued by Islamic Financial Services Board (IFSB), and the same have been tailored keeping in view the regulatory regime of State Bank of Pakistan. These guidelines aim to further complement and enhance the current Risk Management regime of SBP by identifying and suggesting techniques to manage various types of risks unique to Islamic Banking Institutions.

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<sup>8</sup> A tentative Roll Out Plan for the IFSB Standards in Pakistan is Given as **Annexure-D**

<sup>9</sup> For detailed information on the said guidelines please visit <http://www.sbp.org.pk/ibd/2008/C2.htm>

These guidelines provide a set of fifteen principles<sup>10</sup> of best practice for establishing and implementing effective risk management in IBIs and provide guidance for each category of risk, drawn from discussion on Islamic Financial Industry practices. The principles contained in these Guidelines are designed to complement the current risk management principles issued by the 'Basel Committee on Banking Supervision' (BCBS) and other international standard-setting bodies.

Further, these set of principles are applicable to the six categories of risks viz:

1. Credit risk
2. Market risk
3. Liquidity risk
4. Operational risk
5. Equity investment risk and
6. Rate of return risk.

For each type of risk, Risk management practices have been discussed giving examples of specific Islamic banking modes of financing and according to various roles that an Islamic Banking Institution may perform.

Moreover:

- The IBIs have been expected to recognize and evaluate the overlapping nature and transformation of risks that exist between and among the categories of the above-mentioned risks.
- Since IBIs may face consequential business risks (relating to developments in the external marketplace) such as adverse changes in IBIs' markets, counterparties, or products as well as changes in the economic and political environments in which IBI operate and the effects of different Shariah rulings etc. the business plans, supporting systems and financial position of IBI's may be affected.
- IBIs are also exposed to reputational risk arising from failures in governance, business strategy and process. Negative publicity about the IBIs' business practices, particularly relating to Shariah non-compliance in their products and services, could have an impact upon their market position, profitability and liquidity.

In this regard, IBIs are expected to view the management of these risks from a holistic perspective.

Since most of the IBIs in Pakistan are new entrants in the market, they have been encouraged to put in place an effective risk management strategy right from the start based on the said guidelines as well as other guidelines issued by SBP. These guidelines are flexible in the sense that IBIs can adapt them in line with the size and complexity of their business.

#### *b) Impact Study on IFSB Capital Adequacy Standard*

SBP is in the process of implementing capital adequacy standard issued by IFSB in Pakistan and for the purpose it is carrying out an 'impact study'. The aim of the study is to identify issues in the implementation of IFSB capital adequacy standard and to finalize a reporting format for collection of data from IBIs. The implementation of IFSB capital adequacy standard

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<sup>10</sup> The set of fifteen principles covering the six categories of risks have been given as **Annexure-B**

in Pakistan will be another milestone in ensuring proper risk management in IBIs in line with international standards recognizing the peculiar risk profile of Islamic banking products and services.

### 8.1.8 Other Initiatives

#### *a) Draft Guidelines for Islamic Financing for Agriculture*

Pakistan is an agricultural country. Agriculture constitutes almost one-fourth of the country's GDP, contributes around 60% of exports and employs 42% of the labor force. SBP, in collaboration with banks has taken several initiatives that paid dividend in the form of significant increase in meeting the financing needs of this sector. Most of the banks have established separate agri / rural credit departments and are eager to adopt agri / rural credit as viable business line.

There has always been a great demand from agricultural customers to have Islamic financing products for agriculture sector. The Islamic banks and IBBs have also shown great interest in adopting Shariah Compliant agriculture finance as a viable business line.

However, there was lack of awareness of Islamic Modes of Financing among traditional agri financing bankers and Islamic Banks were naive to the requirements and business cycles of farm and non-farm sectors in the country. Therefore, a Task Force for Agri Financing was constituted comprising of SBP officials, experts in agriculture & Islamic banking, and Shariah Advisers of banks to prepare guidelines to facilitate banks to develop their own Shariah compliant products for financing to agriculture sector.

Task Force has prepared Draft Guidelines<sup>11</sup> for Islamic Financing for Agriculture which among others, cover the following areas:

- Suggested Islamic Modes of Financing for Working Capital and Term Financing
- Implementation of Islamic Modes of Financing into Agriculture Sector: Some Illustrations of their application and procedure.
- Eligibility of Customer
- Profits & Incomes
- Security and Collateral
- Insurance and other Documentation
- Monitoring & Recovery System
- Compliance with SBP Regulations

These guidelines will be given final shape after receiving feedback from the stakeholders.

#### *b) Business Review Meetings*

In order to keep itself well informed of the developments taking place in the Islamic banking industry, Islamic Banking Department of SBP conducts occasional "Business Review Meetings" with selected Islamic Banking Institutions (IBIs).

In such meetings, the IBIs gave presentation on

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<sup>11</sup> For detailed information on the said draft guidelines please visit <http://www.sbp.org.pk/Guidelines/IslamicAgriculture/Guidelines-Islamic-Financing-Agriculture-01-09-2008.pdf>

- Products being offered by them,
- Financial performance / position,
- Capacity building measures,
- Marketing Plan,
- Service Standards,
- Charity fund Policy and
- Future plans as well as problems (if any) being faced by them & related suggestions for possible solutions.

## ***8.2 Shariah Compliance Framework***

Shariah compliance is the most important aspect of Islamic finance. The credibility of Islamic Banking Institutions (IBIs) not only depends on the financial health of the institution but also on its adherence to the Shariah. Under the current strategy for promotion and development of Islamic Banking as a parallel, viable and compatible system, State Bank of Pakistan has put in place a comprehensive Shariah Compliance Structure.

The Shariah Compliance Framework established by State Bank of Pakistan consists of:

- 8.2.1 Shariah Board at SBP
- 8.2.2 Shariah Advisor
- 8.2.3 Essentials & Model Agreements of Islamic Modes of Financing
- 8.2.4 Instructions and Guidelines for Shariah Compliance in Islamic Banking Institutions
- 8.2.5 Shariah Advisors Forum
- 8.2.6 Shariah Compliance Inspection
- 8.2.7 Standardization of Shariah Practices- Adoption/Adaptation of AAOIFI Shariah Standards

### **8.2.1 Shariah Board of State Bank of Pakistan**

#### *a) Rationale*

In view of having a central Shariah body to guide State Bank of Pakistan (SBP) and the Islamic banking industry, a Shariah Board was formed in the State Bank on 24th October, 2003. SBP Shariah Board is a Shariah body at national level which advises SBP on the procedures, laws and regulations pertaining to Islamic Banking in the light of Shariah principles.

#### *b) Composition*

The Shariah Board consists of members drawn from among Islamic scholars, bankers, accountants, lawyers and other relevant fields. It has a minimum of five members. At least two members are Shariah scholars, one member a Chartered accountant, one a lawyer and one representing the bankers and the State Bank to be the Director of Islamic Banking Department of SBP, who also serves as the secretary of the Shariah Board. The Chairman of the Shariah Board is from among the Shariah scholars. The technical members, i.e. the lawyer, the accountant and the banker give their opinion in the relevant areas of their expertise to the Shariah scholars, who consider their views while giving a Shariah ruling on issues under consideration.

SBP Shariah Board is an ideal Shariah supervisory body due to its unique composition. This distinctive composition of the board provides SBP with enormous benefits. While reviewing the Shariah compliance mechanisms in other countries we find that structures of national Shariah Boards comprises only of Shariah scholars. Complexity of issues faced by Islamic Financial Institutions requires that while giving a Shariah ruling the associated technical aspects such as those pertaining to legal, accounting and banking etc. also need to be considered on simultaneous basis. The composition of SBP's Shariah Board helps to cover and understand almost all aspects of any issue discussed in the meetings which gives comprehensiveness to its decisions.

The rulings given by the Board are not only Shariah compliant but are also workable as they take into consideration the legal and financial infrastructure of the country and the business needs.

#### *c) Role and Responsibilities*

The role and responsibilities of Shariah Board are given as follows:

- Review and approve for Shariah compliance the products/instruments developed by State Bank of Pakistan for conducting its central banking and monetary management functions under the Islamic modes.
- Advise State Bank of Pakistan on Prudential regulations developed for Islamic banking sector.
- Approve the fit and proper criteria for appointment of Shariah advisors of institutions conducting Islamic banking activities.
- Advise State Bank of the Shariah ruling in case of a conflict arising from the Shariah audit of the Islamic banking activities of the banks under the supervisory control of State Bank.
- Advise State Bank on the Shariah rulings in case of a conflicting Shariah opinion on the Islamic banking products.
- Perform such other functions as may be assigned from time to time, by the State Bank for conducting of smooth functioning of Islamic financial system.

#### *d) Existing Members*

- Dr. Mahmood Ahmed Ghazi (Shariah Scholar).
- Mr. Ebrahim Sidat (Chartered Accountant),
- Syed Riaz-ul-Hasan Gillani (Lawyer),
- Mr. Pervez Said (Banker, Director IBD, SBP) and
- Dr. M. Imran Usmani (Shariah Scholar)

#### *e) Performance*

The performance of the Shariah Board has been quite satisfactory and despite the teething and bonding problems, which they have overcome quickly, their advice and output have been

very helpful in promoting the Islamic banking industry and building confidence among the stakeholders.

The Shariah Board members are well versed with local & international practices both in the field of banking as well as Shariah and are thus instrumental in ensuring that the advice given to SBP is in line with international practices. SBP's Shariah Board has been visited by international scholars who appreciated its composition and working and felt the same should be repeated in other jurisdictions. Overall the role of SBP Shariah Board has been quite instrumental in SBP's drive to promote Islamic Banking in Pakistan.

Shariah Board has held 22 meetings so far. Some important contributions of the Board include:

- Recommendations for development of Islamic banking on sound footing.
- Approval of Essentials and Model Agreements for Islamic Modes of Financing after a due consultation process
- Approval and revision of Fit and Proper Criteria for Shariah Advisors of Islamic Banking institutions
- Approval of Term Sheet of Ijara Sukuk
- Approval of WAPDA, KSEW and PIA Sukuk as Shariah compliant security
- Guidance on Shariah Compliance Inspection of an Islamic bank
- Development of Essentials of Diminishing Musharaka
- Approval of Shariah Compliance Inspection Manual
- Review and approval of Instructions and Guidelines for Shariah compliance in Islamic Banking Institutions
- Review of AAOIFI Shariah Standards on Murabaha & Ijara for adoption/ adaptation in Pakistan's Islamic banking industry.

### **8.2.2 Shariah Advisor**

Each Islamic Banking Institution (IBI) is required to work under the guidance of a Shariah advisor. To keep this process more objective, broad based and responsive to the market conditions SBP Shariah Board has approved Fit & Proper Criteria for Shariah advisors of IBIs.

According to this Criteria, minimum required Shariah and contemporary educational qualification as well as experience and exposure for becoming a Shariah Advisor has been defined. Moreover, to minimize conflict of interest, it has been specified that a person cannot work as Shariah Advisor for more than one IBI in Pakistan. Further, it has been specified that a Shariah Advisor shall not hold any executive/non-executive position in any other financial institution, except working as Shariah Advisor of Islamic mutual funds of the same IBI. In addition to that, Shariah Advisors of IBIs have been barred from having any substantial interest in or becoming employee of some types of organizations like exchange Companies, corporate brokerage houses or stock exchange. These provisions in Fit and Proper Criteria for Shariah Advisors has ensured objectivity in evaluation criteria, minimization in conflict of interest and induction of new lot of Shariah advisors in the market.

#### *Duties and Responsibilities*

Shariah Advisor (SA) is required to ensure that all products and services and related policies and agreements of IBIs are in compliance with Shariah rules and principles. Before launching any new products and services, the related policies and agreements are required to be duly vetted by the SA. SA, in coordination with management, is also mandated to conduct/arrange Shariah training

programs for the IBI's staff. Based on the periodic review of operations of the IBI SA is required to prepare a report (to be published in the IBI's annual report) in respect of its Shariah compliance. The decisions and rulings of SA are subject to instructions, guidelines and directives issued by SBP Shariah Board from time to time.

The fatawa and rulings of the Shariah Advisor in all financial matters are binding on the IBI. He can, however, advise/issue guidelines on any matter referred to him by BoD/management.

## **Essentials & Model Agreements of Islamic Modes of Financing**

### *a) Essentials of Islamic Modes of Financing*

All IBIs are required to follow essentials of Islamic modes of financing in the course of their operations as minimum requirements for Shariah compliance in respect of products developed on the basis of such modes. Furthermore, these essentials are considered to be minimum requirements for Shariah compliance and IBIs can include additional conditions and controls in their procedures for the sake of more effective Shariah Compliance and prudence. The essentials prescribed by SBP till date relates to the following modes of finance:

1. Mudaraba
2. Musharaka
3. Diminishing Musharaka
4. Ijarah
5. Murabaha
6. Musawamah
7. Salam
8. Istisna

For the Islamic modes for which essentials have not been prescribed, AAOIFI Shariah standards can be used as guidelines by IBIs in consultation with their Shariah Advisor.

### *b) Model Agreements for Islamic Modes of Financing<sup>12</sup>*

Similarly, in order to facilitate the existing Islamic banks and the potential market players the following Model Agreements for the respective modes have also been developed:

1. Murabaha Facility Agreement
2. Musawamah Facility Agreement
3. Lease Agreement
4. Salam Agreement
5. Musharaka Investment Agreement
6. Istisna Agreement
7. Agreement for Interest free Loan

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<sup>12</sup> The model agreements can be visited at <http://www.sbp.org.pk/press/Essentials/Essentials-Mod-Agreement.htm>

8. Mudaraba Financing Agreement
9. Syndication Mudaraba Agreement

It is to mention here that these are model agreements, and can be modified according to the products designed by the banks conducting Islamic banking business, with the approval of banks' Shariah Adviser to ensure that such changes are consistent with the principles of Shariah.

## **8.2.4 Instructions and Guidelines for Shariah Compliance in Islamic Banking Institutions**

To cater to the unique aspects of Islamic banking and in pursuance of its goal to strengthen the Shariah compliance framework in the Islamic banking industry, 'Instructions and Guidelines for Shariah Compliance' were issued by the State Bank of Pakistan after consultation with various stakeholders and which were also been reviewed and approved by the SBP Shariah Board<sup>13</sup>. These Instructions and Guidelines for Islamic Banking Institutions (IBIs) are in addition to current Prudential Regulations, guidelines and other circulars and directives issued by SBP.

### **a) Instructions for Shariah Compliance**

The 'Instructions for Shariah compliance in IBIs' cover the following areas:

#### *1. Appointment of Shariah Advisor*

This section deals with areas like approval authority for appointment & termination/removal and the ToRs of the Shariah advisor, and also the tenure and functional reporting line etc.

#### *2. Duties and Responsibilities of Shariah Advisor*

These have already been covered in the section relating to Shariah advisor. Moreover the management of IBI has been made responsible to provide him all information relating to the IBI's compliance with Shariah. The legal counsel, auditor or consultant of an IBI has been allowed to seek advice on the Shariah matters from the SA who is required to provide such advice to them.

#### *3. Report of Shariah Advisor*

Based on the periodic review of operations of the IBI SA is required to prepare a report (to be published in the IBI's annual report) in respect of its Shariah compliance. The Shariah Advisor is required to report about whether or not, in his opinion, the affairs of IBI have been carried out in accordance with rules and principles of Shariah, SBP regulations and guidelines related to Shariah compliance and other rules as well as with specific fatawa and rulings issued by the Shariah Advisor from time to time.

#### *4. Conflict Resolution in Shariah Rulings*

In case any difference of opinion arises regarding Islamic Banking practices between:

- a) Shariah Advisor of the IBI and the State Bank's Inspection staff or other SBP departments

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<sup>13</sup> For detailed version of the Instructions and Guidelines please visit <http://www.sbp.org.pk/ibd/2008/C2.htm>



b) Management of any IBI and their Shariah Advisor (and the matter remains unresolved even after its referral to the concerned bank's Board's audit committee or BoD)

Then the case can be referred to SBP Shariah Board for consideration and final decision. IBIs and the Shariah Advisor of any IBI (with the concurrence of management) can also refer issues relating to Shariah compliance to State Bank for consideration of SBP Shariah Board.

### 5. *Shariah Compliant Modes of Banking and Finance*

Islamic Banking Institutions in Pakistan can offer products based on the following Shariah-compliant modes of banking and finance.

**Table 8.1 Shariah Compliant Modes of Banking and Finance**

Trading Modes	Participatory Modes	Debt Based Modes	Other Modes
Ijarah or Ijarah wa Iqtina	Mudaraba	Qard	Wakalah
Murabaha	Musharaka		Assignment of Debt
Musawamah	Diminishing Musharaka		Kafalah
Salam	Equity Participation in the form of shares in a corporate entity		
Istisna			
Tawarruq <sup>14</sup>			

However the modes identified above does not preclude the possibility of developing new products by the IBIs with prior approval of their Shariah Advisor.

### 6. *Use of Charity Fund*

IBIs are required to create a Charity fund in which income of the IBI from non-Shariah compliant sources or penalties and late payment charges received from clients in default or overdue cases etc. are credited. The amount in this fund will be utilized for charitable and social welfare purposes.

### 7. *Introduction of New Products and Services*

The IBIs are required to prepare a full set of documents including agreements, process flows, checklists and manuals pertaining to the deposit, investment and financing products being offered by them, duly vetted by the Shariah Advisor. Moreover before launching new

<sup>14</sup> Tawarruq may be used in exceptional cases requiring specific prior approval of Islamic Banking Department of SBP

products and services, IBIs have to submit salient features of the products (as per format prescribed by SBP) along with Certificate from their Shariah Advisor to the SBP.

#### *8. Schedule of Service Charges*

The Schedule of Charges submitted by the IBIs are signed by the bank's Shariah Advisor as an endorsement of Shariah compliance and the Islamic Banking Branches of Conventional banks are required to have a separate set of Schedule of Charges for their business.

#### *9. Essentials of Islamic Modes Of Financing*

### **b) Guidelines for Shariah Compliance in Islamic Banking Institutions (IBIs)**

The 'Guidelines for Shariah compliance in IBIs' are meant for providing guidance in areas like Shariah Compliance, Internal Shariah Audit, Investment in Shares, Policy for Profit Distribution with PLS Depositors and Financial Reporting and General Disclosure.

Necessary flexibility has been provided in these guidelines and IBIs can set up the suggested systems and procedures keeping in view the size and scope of their operations. These guidelines are being issued on "comply or explain basis" and IBIs are required to record reasons in writing for non-compliance with any of these guidelines.

#### **8.2.5 Shariah Advisors Forum (SAF)**

When Shariah opinion is required regarding an Islamic banking issue of mutual/collective interest, the same is taken up in the meetings of Shariah advisors for discussion and possible resolution if so required. In case the issue requires detailed study/clarification, a sub-committee is formed from the panel of Shariah Advisors to do some research and submit/present their findings to SBP.

In case of need the matter under consideration may be taken to the SBP Shariah Board for its final resolution. Since some of the learned Shariah Advisors are based in other parts of the globe like Middle East, SBP also get feedback/views based on their global perspective/experience through their representatives.

#### **8.2.6 Shariah Compliance Inspection**

Commencement of Shariah Inspection of IBIs is a major initiative of SBP for ensuring Shariah compliance as it would enhance credibility of the system. Introduction of Shariah Inspection is among the first attempts by a regulator to start regulatory Shariah inspection of Islamic commercial banks. A leading international firm Ernst & Young from Bahrain and a locally based renowned & internationally acclaimed consultancy firm-Ford Rhodes Sidat Hyder & Co. was engaged to prepare the Shariah Inspection Manual. Before finalizing the inspection parameters and procedures a test case Shariah Audit Inspection of an Islamic Bank was carried out and the observations made by the auditors and SBP Shariah Board were considered.

The Shariah Compliance Inspection covers a review of the Islamic financial arrangements, general banking services and operations, financial statements and accounting records of the Islamic banks so as to ensure that all their transactions and operations are being carried out in accordance with the injunctions of Islamic Shariah, in their substance and their form.

Training to SBP Inspection staff for conducting Shariah inspection on the basis of the manual has also been provided through the same consultants. This will help in paving the way for carrying out a qualitative Shariah compliance inspection of the Islamic banking industry.

### **8.2.7 Standardization of Shariah Practices- Adoption/Adaptation of AAOIFI Shariah Standards**

The Shariah compliance framework outlined above effectively contributes towards bringing in harmony and standardization of Shariah practices in the Islamic banking industry of Pakistan. However, it is to mention here that a flexible approach has been adopted while achieving the desired objectives. This has been done to avoid revisiting the experience of 1980's where a rigid model was applied that resulted in a stalled process of product innovation and development. The aim this time is not to standardize each and every practice just for the sake of standardization only. Rather emphasis has been on a market based approach wherein the industry can on an on going basis provide Shariah compliant banking services through a parallel and compatible system.

The introduction of international players in our Islamic banking industry has further necessitated the need to bring our industry at par with the global Shariah standards. One of the most important and effective tool available for achieving the expected level of standardization is the Shariah Standards developed by Accounting and Auditing Organization for the Islamic Financial Institutions (AAOIFI).

In order to bring our industry at par with the international standards and also achieve standardization of Shariah practices locally, a mechanism for adoption/adaptation of these Shariah standards has been developed by SBP. According to this mechanism the meetings of Shariah Advisors of all IBIs are being held with a view to thoroughly study the AAOIFI Shariah Standards one by one. SBP invites comments on a particular Standard, discusses it in SAF or SAF Sub-Committee and then prepares recommendations for submission to the SBP Shariah Board for approval and their possible adoption / adaptation in our market. Till date the standards on Murabaha, Ijara and Mudaraba have been finalized and the same are expected to be notified soon.

## 9. Islamic Banking Industry Review in Terms of:

- 9.1 Industry Progress and Market Share in Brief
- 9.2 Year-Wise Entry of Players
- 9.3 Islamic Banking (Balance Sheet) Market Share-December 2007
- 9.4 Growth in the Branch Network of Islamic Banking Industry
- 9.5 Province & City-wise Breakup of Islamic Banking Branch Network
- 9.6 Bank-wise Position of Islamic Banking Branches
- 9.7 Assets – Bank-Wise Share of Assets
- 9.8 Deposits – Bank-Wise Share of Deposits
- 9.9 Deposit Structure
- 9.10 Financing – Bank Wise Share of Financing
- 9.11 Mode & Sector Wise Breakup of Financing
- 9.12 Investments – Bank Wise Share of Investments
- 9.13 Sources and Uses of Funds
- 9.14 Financing to Deposit Ratio
- 9.15 Capital Adequacy Ratio
- 9.16 Capital to Total Assets Ratio
- 9.17 Non Performing Financing
- 9.18 Earning Assets as Percentage of Total Assets
- 9.19 Income Statement
- 9.20 Product Offering of the Islamic Banking Industry in Pakistan

## ***9.1 Industry Progress and Market Share in Brief***

As mentioned earlier SBP worked on a three pronged strategy for promotion of Islamic Banking i.e.

1. Allow new full fledged Islamic banks in the private sector,
2. Allow the conventional banks to set up Islamic banking subsidiaries
3. Allow the existing conventional banks to open Stand-alone Islamic banking branches.

The first and third options have been exercised so far and none of the commercial banks have so far set up a subsidiary for Islamic banking.

The change in policy approach from the legal & regulatory perspective to that of dealing with the whole affair of introducing Islamic banking in Pakistan as a change management issue has received a very encouraging response. Under the current policy first Islamic banking license was granted on 31st January, 2002. Since then the industry has been continuously showing impressive growth. In 2003 only one bank operated as the full fledged Islamic bank and two conventional banks were operating Islamic banking branches. The total assets of the Islamic banking industry accounted for a market share of about 0.5% and the total branch network comprised of 17 branches. Today we have 6 full fledged Islamic banks and 12 conventional banks are operating dedicated Islamic banking branches. As on 30<sup>th</sup> June 2008, the total assets of the Islamic banking industry were around *Rs. 229 billion* which accounts for a market share of about 4.5%. The total branch network of the industry comprises of over *358 branches* with presence in over *50 cities & towns* and covering all the four provinces of the country and AJK.

It is also important to compare progress of Islamic Banking in Pakistan with the progress in other countries<sup>15</sup>. Malaysia's first Islamic Bank commenced operations in 1983 and the market share of the Malaysian Islamic banking system today stands at approximately 13%. Bahrain's Islamic banking system is said to have gained a share of around 8% in over 30 years. Similarly in Indonesia Islamic banking was introduced somewhere in mid 90's. According to Bank Indonesia, Islamic banking assets reached in March, 2007 to 1.67 percent of total assets as compared with 0.7 percent in 2003 and currently the deposits stand at 1.69% and financing at 2.60% of the total banking sector.<sup>16</sup>

On the other hand, Pakistan has shown much better performance than other global players. At certain point of time, 6 full-fledged Islamic banks and 14 conventional banks with Islamic banking branches were operating. Due to merger of Habib Bank AG Zurich Pakistan Operations with Metropolitan Bank Limited and Prime Commercial Bank Limited with ABN Amro Bank N.V. Pakistan (now RBS Bank), the total number of conventional banks having Islamic banking branches today stands at 12.

The industry progress, during the period 2003-07, in terms of growth in number of institutions, branches, total assets, deposits and financing & investment along with the market share is given in Table below:

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<sup>15</sup> For brief profile of Islamic banking sectors in some selected countries please visit <http://www.sbp.org.pk/departments/pdf/StrategicPlanPDF/Appendix-B%20Islamic%20Banking%20in%20some%20selected%20countries1.pdf>

<sup>16</sup> Bank Indonesia, "Islamic Banking Statistics", (April, 2007)

Table 9.1 Industry Progress and Market Share

(Rs. in Billion)

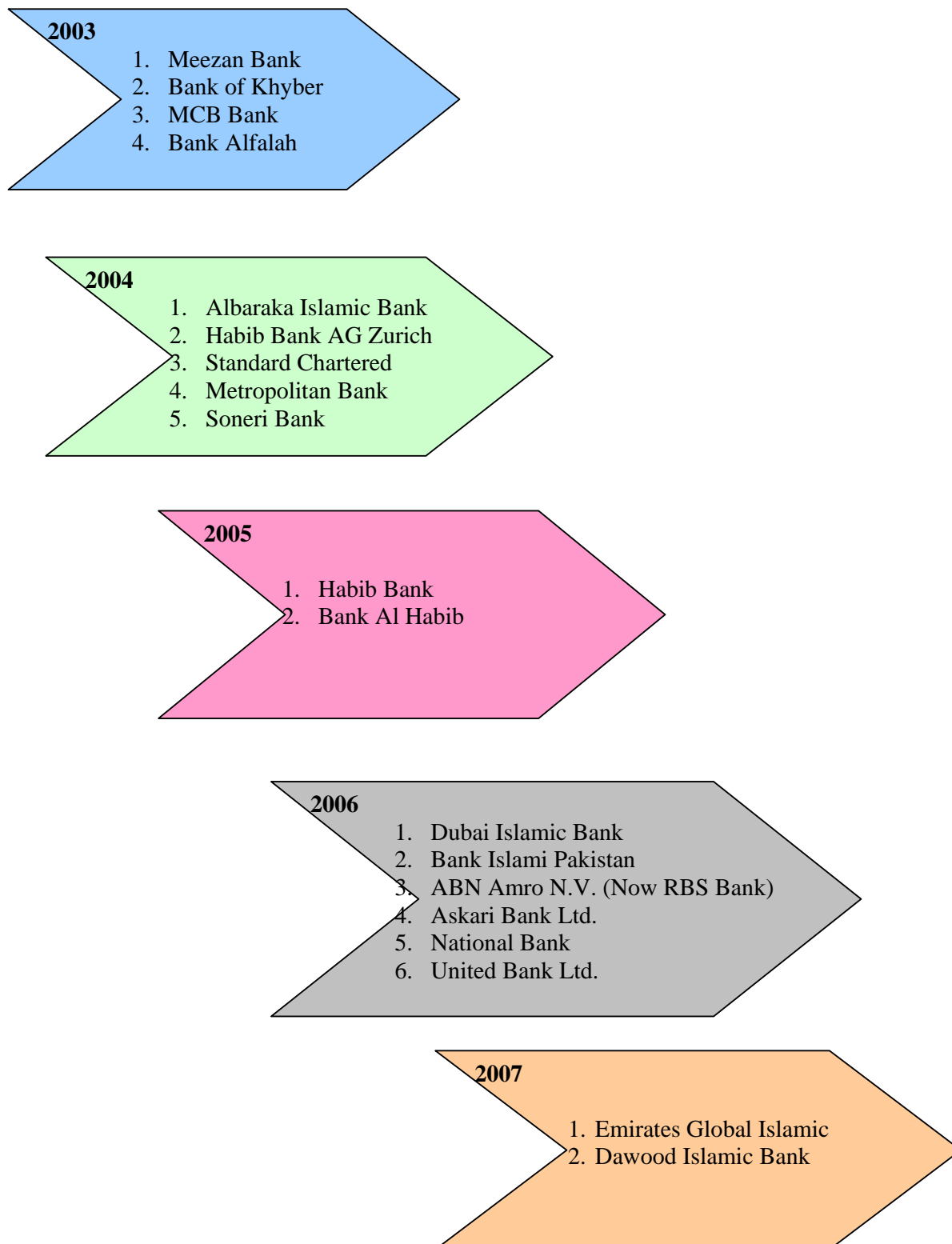
Description	Dec.03	Dec.04	Dec.05	Dec.06	Dec.07
Total Assets	13	44	71	119	206
% of Banking Industry	0.5%	1.5%	2.0%	2.8%	4.0%
Deposits	8	30	50	84	147
% of Banking Industry	0.4%	1.3%	1.8%	2.6%	3.8%
Financing & Investment	10	30	48	73	138
% of Banking Industry	0.5%	1.3%	1.7%	2.3%	3.5%
A) Full fledged Islamic Banks (IBs)	1	2	2	4	6
B) Branches of IBs	10	23	37	93	186
C) Conventional Banks with IBBs*	3	9	9	12	12
D) Branches of Conventional Banks	7	25	33	57	103
Total Islamic Banking Institutions (A+C)	4	11	11	16	18
Total No. of Branches (B+D)	17	48	70	150	289

\*IBBs= Islamic Banking Branches

Source: Annual Accounts for Years Ending Dec. 2003 to 2007.

## 9.2 Year Wise Entry of Players

Figure 9.1 Year Wise Entry of Players



### 9.3 Islamic Banking (Balance Sheet) Market Share-December 2007

Table 9.2 Islamic Banking (Balance Sheet) Market Share-December 2007

(Rs. in Million)

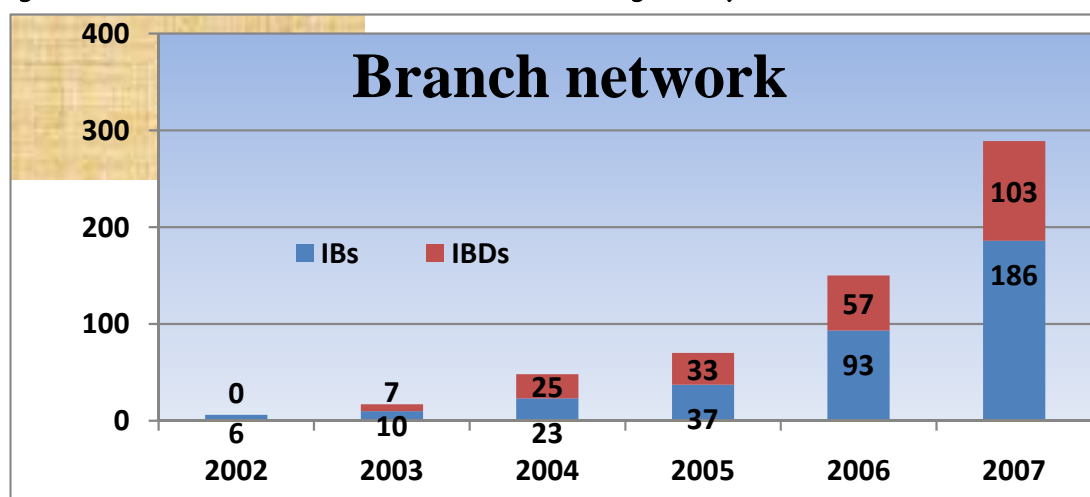
	Banking Industry of Pakistan	Islamic Banking Industry	Market Share of IBIs %age
<b>ASSETS</b>			
Cash & Balances With Treasury Banks	469,267.8	20,463.4	4.4%
Balances With Other Banks	147,400.3	18,532.7	12.6%
Due from Financial Institutions	190,577.4	11,850.1	6.2%
<i>Investments - Net</i>	<i>1,275,325.8</i>	<i>30,961.0</i>	<i>2.4%</i>
<i>Financing - Net</i>	<i>2,688,979.4</i>	<i>106,848.0</i>	<i>4.0%</i>
Other Assets	211,628.8	6,870.7	3.2%
Operating Fixed Assets	168,542.6	6,966.5	4.1%
Deferred Tax Assets	19,634.9	3,454.0	17.6%
<b>TOTAL ASSETS</b>	<b>5,171,357.1</b>	<b>205,946.3</b>	<b>4.0%</b>
<b>LIABILITIES</b>			
Bills Payable	82,075.1	2,596.5	3.2%
Due to Financial Institution	452,050.2	15,041.6	3.3%
<i>Deposits And Other Accounts</i>	<i>3,854,712</i>	<i>147,361</i>	<i>3.8%</i>
Sub-ordinated Loans	30,107.1	-	0.0%
Liabilities Against Assets Subject To Finance Lease	896.0	52.6	5.9%
Other Liabilities	189,797.9	10,535.3	5.6%
Deferred Tax Liabilities	17,127.5	832.9	4.9%
<b>TOTAL LIABILITIES</b>	<b>4,626,765.4</b>	<b>176,420.0</b>	<b>3.8%</b>
<b>NET ASSETS</b>	<b>544,591.6</b>	<b>29,526.3</b>	<b>5.4%</b>
<b>REPRESENTED BY:</b>			
Share Capital	247,246	25,658	10.4%
Reserves	119,862	1,422.7	1.2%
Un-appropriated Profit	85,508	1,952.7	2.3%
	<b>452,616</b>	<b>29,033</b>	<b>6.4%</b>
Surplus/Deficit on Revaluation of Assets	91,976	493	0.5%
<b>TOTAL</b>	<b>544,592</b>	<b>29,526</b>	<b>5.4%</b>
Source: Annual Audited Accounts , 2007			



## 9.4 Growth in the Branch Network of Islamic Banking Industry

The Figure 10.2 given below clearly demonstrates that share of full fledged Islamic banks in overall branch network of the industry has increased over period of time. Furthermore, the table shows that during the year 2006 highest growth rates in overall branch expansion were experienced wherein two new full fledged Islamic banks (Dubai Islamic Bank & BankIslami) and four conventional banks having IBBs commenced operations. As the full fledged banks consolidate themselves it is expected that the rate of growth in network expansion will increase at a much higher pace.

Figure 9.2 Growth in the Branch Network of Islamic Banking Industry



## 9.5 Province & City-Wise Breakup of Islamic Banking Branch Network

Table 9.3 Province-wise Breakup of Islamic Banking Branch Network<sup>17</sup>

	Bank Name	Azad Kashmir	Balochistan	Federal Capital	NWFP	Punjab	Sindh	Grand Total
Islamic Banks	Albaraka Islamic Bank B.S.C. (E.C.)	1		1	3	10	5	20
	BankIslami Pakistan Limited	1	5	1	1	10	19	37
	Dawood Islamic Bank Limited			1		6	7	14
	Dubai Islamic Bank Pakistan Limited			1	1	11	7	20
	Emirates Global Islamic Bank Limited		1	2	2	11	8	24
	Meezan Bank Limited	1	3	6	12	52	39	113
	<b>Sub Total</b>	<b>3</b>	<b>9</b>	<b>12</b>	<b>19</b>	<b>100</b>	<b>85</b>	<b>228</b>
Standalone Islamic Banking	Askari Bank Limited		1	1	1	8	3	14
	Bank AL Habib Limited		1			2	1	4
	Bank Alfalah Limited			2	2	19	9	32
	Habib Bank Limited						1	1
	Habib Metropolitan Bank Limited					1	3	4
	MCB Bank Limited			1		4	3	8
	National Bank of Pakistan				1	1	1	3
	Soneri Bank Limited			1		1	2	4
	Standard Chartered Bank(Pakistan)			1	1	3	3	8
	The Bank of Khyber		1		11	3	2	17
	The Royal Bank of Scotland					1	2	3
United Bank Limited				1	3	1	5	
	<b>Sub Total</b>		<b>3</b>	<b>6</b>	<b>17</b>	<b>46</b>	<b>31</b>	<b>103</b>
Sub	Dawood Islamic Bank Limited						1	1
	Dubai Islamic Bank Pakistan Limited				1		1	2
	Meezan Bank Limited				2	1	4	7
	<b>Sub Total</b>				<b>3</b>	<b>1</b>	<b>6</b>	<b>10</b>
	<b>Grand Total</b>	<b>3</b>	<b>12</b>	<b>18</b>	<b>39</b>	<b>147</b>	<b>122</b>	<b>341</b>

<sup>17</sup> Position as on 11<sup>th</sup> August, 2008

Table 9.4 City-Wise Breakup of Branch Network<sup>18</sup>

S. No	Cities covered by Islamic Banking Institutions	Total No of Branches
1	Abottabad	4
2	Bahawalpur	1
3	Banu	1
4	Batkhela	1
5	Chaman	1
6	Charsadda	1
7	Dera Ghazi Khan	1
8	Dera Ismail Khan	2
9	Faisalabad	18
10	Gujar Khan	1
11	Gujranwala	7
12	Gujrat	2
13	Hangu	1
14	Haripur	1
15	Hyderabad	7
16	Islamabad	18
17	Kamoki	1
18	Karachi City	107
19	Kasur	1
20	Khushab	1
21	Kohat	1
22	Lahore City	67
23	Larkana	1
24	Mandi Bahauddin	1
25	Mansehra	3
26	Mardan	1
27	Mingora	1
28	Mirpur AJK	2
29	Mirpur Khas	1
30	Multan	12
31	Muslim Bagh	1
32	Muzaffarabad	1
33	Nawabshah	2
34	Nowshera	1
35	Okara	1
36	Peshawar	19
37	Pishin	1
38	Qilla Saifullah	1

39	Quetta	8
40	Rahim Yar Khan	4
41	Rawalpindi	16
42	Sadiqabad	1
43	Sahiwal	1
44	Sargodha	2
45	Sheikhupuar	1
46	Sialkot	7
47	Sukkur	2
48	Tando Allahyar	2
49	Tank	1
50	Timergara	1
51	Wah Cantt	1
	<b>Grand Total</b>	<b>341</b>

<sup>18</sup> Position as on August 11, 2008

## 9.6 Bank-Wise Position of Islamic Banking Branches

Table 9.5 Bank-Wise Position of Islamic Banking Branches<sup>19</sup>

	Sr. No.	Name of Bank	Branches
Full Fledged Islamic Banks	1	Meezan Bank Ltd	113
	2	AlBaraka Islamic Bank BSC (EC)	20
	3	Dubai Islamic Bank Pakistan Limited	20
	4	BankIslami Pakistan Limited	37
	5	Emirates Global Islamic Bank Limited	24
	6	Dawood Islamic Bank Limited	14
		<b>Sub Total</b>	<b>228</b>
Standalone Islamic Banking Branches	7	Bank Alfalah Ltd	32
	8	MCB Bank Ltd	8
	9	Bank of Khyber	17
	10	Habib Metropolitan Bank	4
	11	Habib Bank Ltd	1
	12	Standard Chartered Bank	8
	13	Bank Al Habib	4
	14	Soneri Bank Ltd	4
	15	Askari Bank Limited	14
	16	National Bank of Pakistan	3
	17	United Bank Ltd	5
	18	The Royal Bank of Scotland	3
		<b>Sub Total</b>	<b>103</b>
Sub Branches	A	Dawood Islamic Bank Limited	1
	B	Dubai Islamic Bank Pakistan Limited	2
	C	Meezan Bank Ltd	7
		<b>Sub Total</b>	<b>10</b>
		<b>Grand Total</b>	<b>341</b>

<sup>19</sup> Position as on August 11, 2008

## 9.7 Total Assets & Bank Wise Share

During the period 2002 to 2007 the total assets of the industry registered the Annual Compound Growth Rate (ACGR) of 96.8%. The growth rates for Total Assets of the industry for the respective years (i.e. 2003 to 2007) are 85.2%, 241.8%, 62%, 66.9% & 72.6%. Supported by larger branch network the full fledged Islamic banks have had the major share in total assets of the industry however a steady growth in the assets of conventional banks having IBBs has also been witnessed which is one of the indicators of fact that Islamic banking system is gradually proving its potential as an alternate to the conventional system.

Figure 9.3 Assets of Islamic Banking Industry

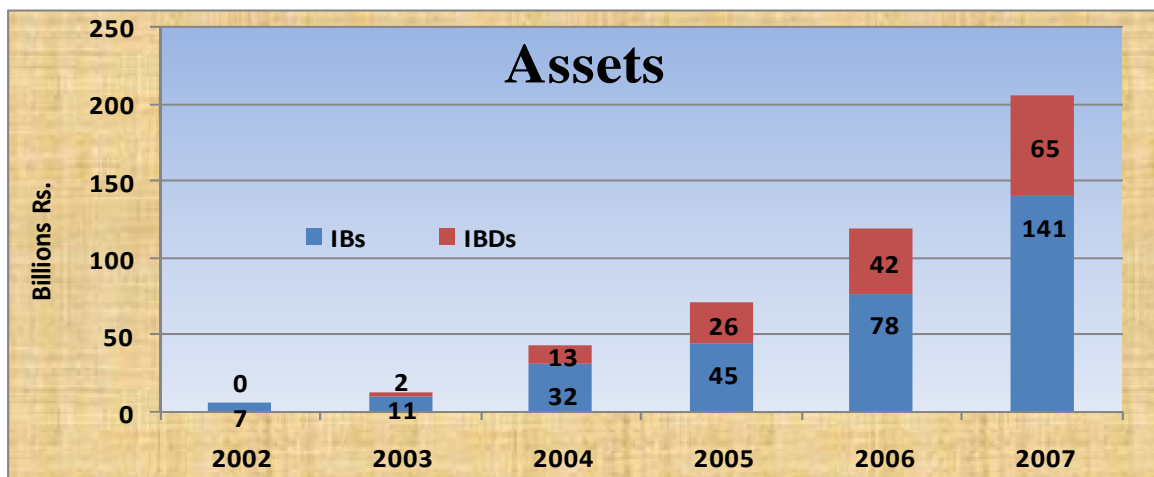
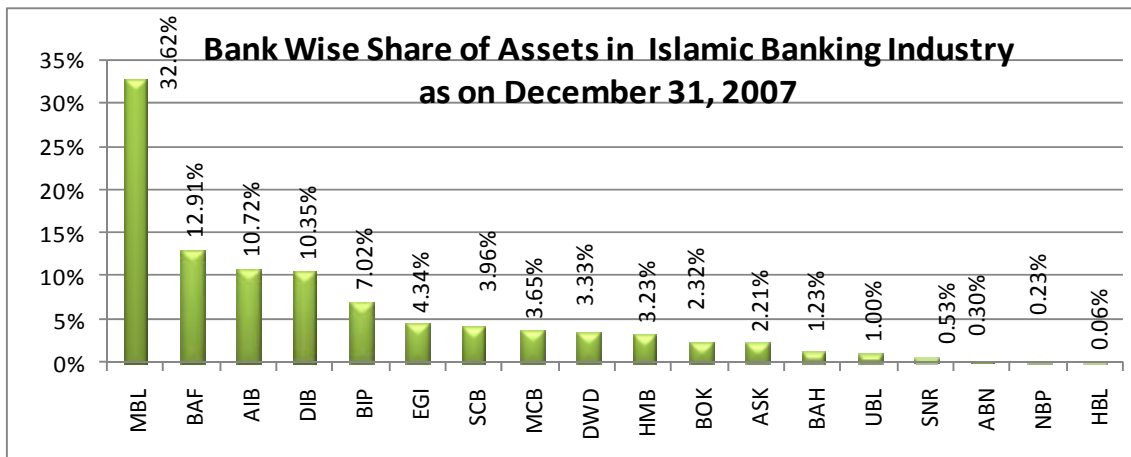


Figure 9.4 Bank wise Share of Assets of Islamic Banking Industry as on December 31, 2007

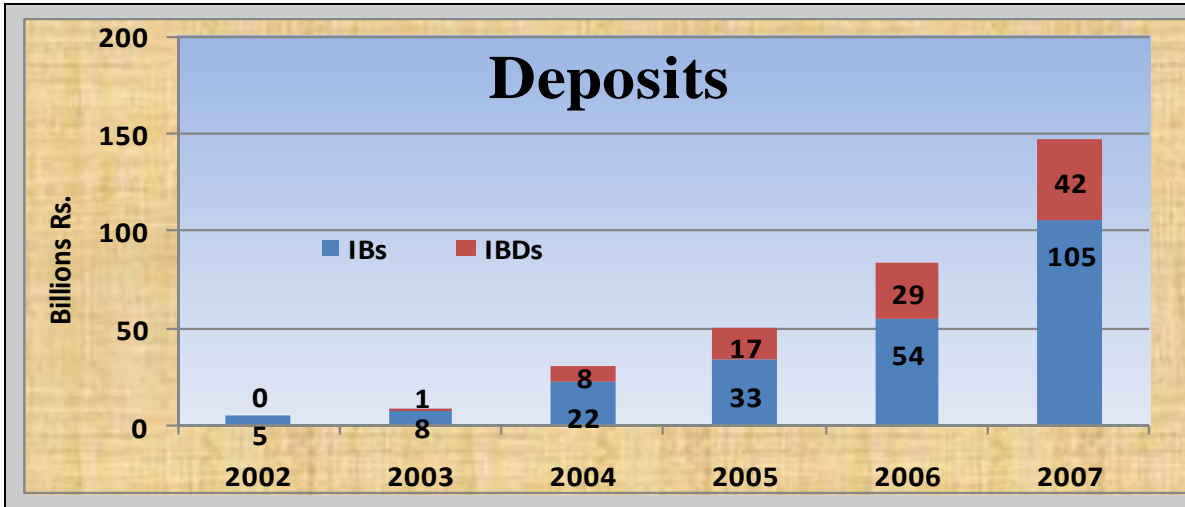


It is interesting to note that the Islamic banking balance sheets of three big commercial banks in Pakistan (i.e. UBL, HBL and NBP) have not yet shown signs of gaining a noticeable share of the overall Islamic banking system.

### 9.8 Deposits & Bank Wise Share

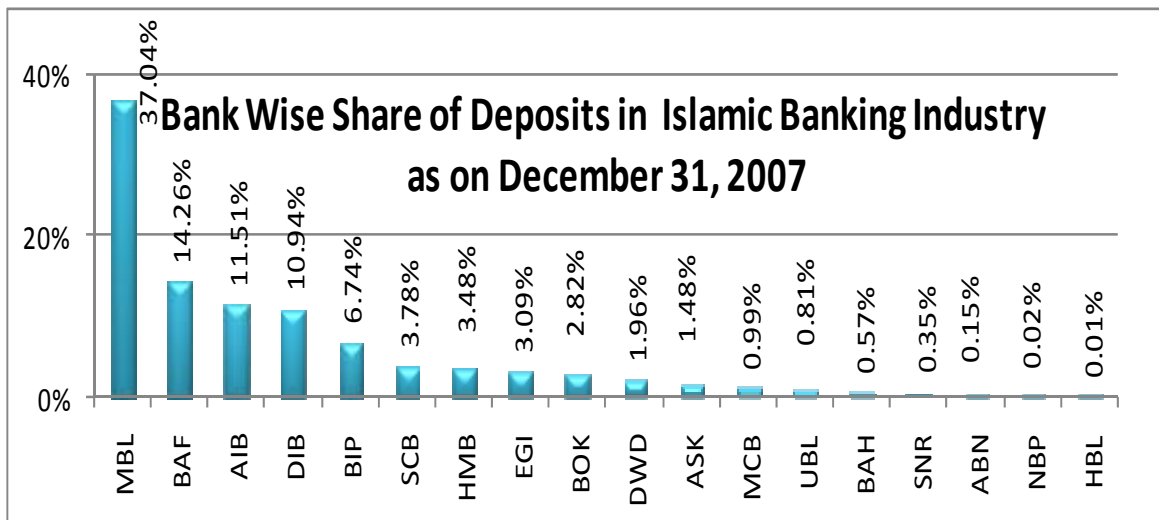
For the period under review the ACGR of deposits was 96.1% whereas the growth rates for respective years (i.e. for 2003 to 2007 were 65.3%, 259.5%, 65.4%, 67.7% & 76.0%. Both IBs and IBDs contributed towards overall increase however just like total assets the full fledged banks contributed more towards this growth. A relatively restricted branch network coupled with the preferred policy of some conventional banks having IBBs to borrowing funds from their head offices has partly contributed to this skewed distribution.

Figure 9.5 Deposits of Islamic Banking Industry



The rapid growth experienced during the year 2004 was primarily due to the entry of Albaraka Islamic bank and an aggressive strategy adopted by Bank Alfalah. Similarly the entry of four new full fledged Islamic banks i.e. Dubai Islamic, Emirates Global, Dawood Islamic & BankIslami during 2006 and 2007 contributed towards the healthy growth in overall deposits position during these years.

Figure 9.6 Bank wise share of Deposits of Islamic Banking Industry as on December 31, 2007



The bank wise share of deposits as on December 31, 2007 is presented in the Figure 9.6. Over all the share of Meezan Bank's deposits is dominant while among IBDs of conventional banks Bank Alfalah is

leading the group. However the new entrants like Dubai Islamic and BankIslami have also managed to capture good share in relatively shorter period of time. Going forward the remaining two full fledged players i.e. Dawood Islamic and Emirates Global are also expected to catch up with other competitors.

## 9.9 Deposit Structure

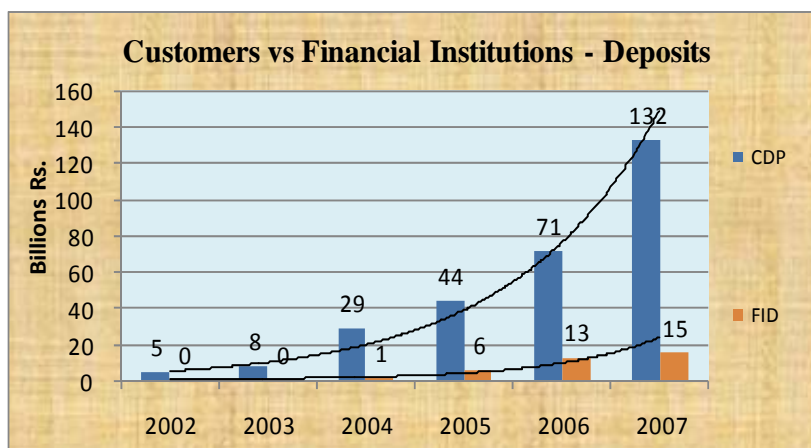
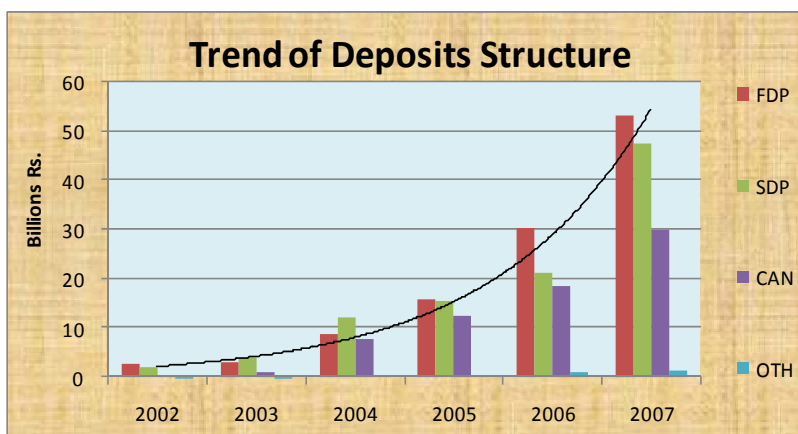
Deposits structure consists of Fixed Deposits, Saving Deposits, Current Accounts non-remunerative and other deposits. Savings, Fixed and Current account (non remunerative) of customers deposits are 32%, 36% and 20% respectively of Overall Deposits and Other accounts.

**Table 9.6 Deposits and Other Accounts of IBIs ( Rs. in 000') as on 31<sup>st</sup> December 2007**

Deposits and Other Accounts of IBIs ( Rs. in 000')		
<b>Deposits and Other Accounts of IBIs ( Rs. in 000') as on 31<sup>st</sup> December 2007</b>	<b>147, 361, 124</b>	<b>100.00%</b>
<b>A) Customers</b>	<b>132, 218, 830</b>	<b>89.72%</b>
Fixed Deposits	53,328, 431	36.19%
Savings Deposits	47, 656,938	32.34
Current Accounts- Remunerative	-	-
Current Accounts- Non Remunerative	29,882,882	20.28%
Others	1,350,579	0.92%
<b>B) Financial Institutions</b>	<b>15,142,294</b>	<b>10.28%</b>
Remunerative Deposits	15, 076,714	10.23%
Non -Remunerative Deposits	65,580	0.04%

**Figure 9.7 Trend of Deposit Structure**

As shown in Figure 9.7 the savings deposits initially grew at a higher rate but later on the Fixed deposits category experienced a relatively better growth rate. As a result an increase in the share of fixed deposits vis a vis the savings and current accounts took place. This represents the growing interest of the customers in entering into long term relationships with the industry that is gradually building its reputation as a credible Shariah compliant offering.



## 9.10 Financing & Bank Wise Share

During the period under review ( i.e. from 2002 to 2007) the ACGR of gross financing of Islamic banking institutions (IBIs) was 97.8% whereas the respective years' growth ( i.e. for 2003 to 2007) was 135.1%, 218.4%, 66.4%, 43.4% & 63.5%. The distribution of financing in terms of its offering through full-fledged banks and IBBs of conventional banks is relatively less skewed when compared to that of Deposits.

Figure 9.8 Islamic Banking Industry Financing

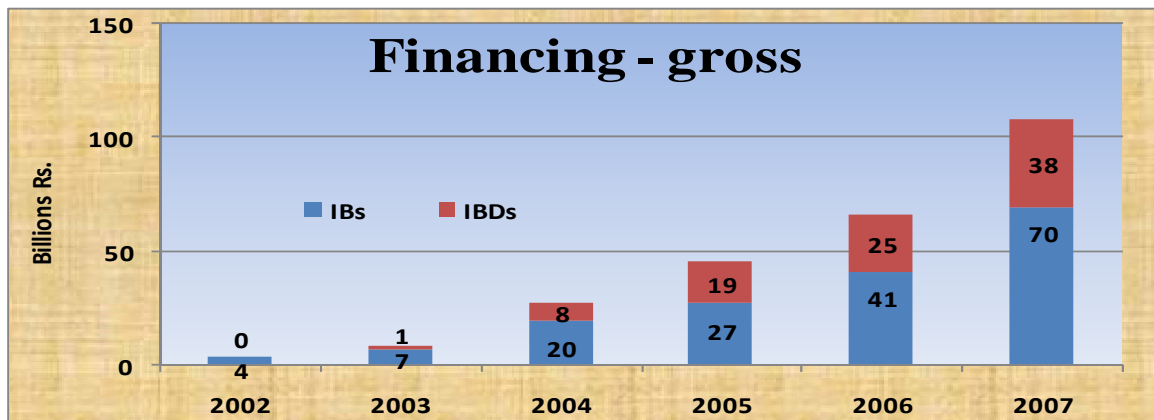
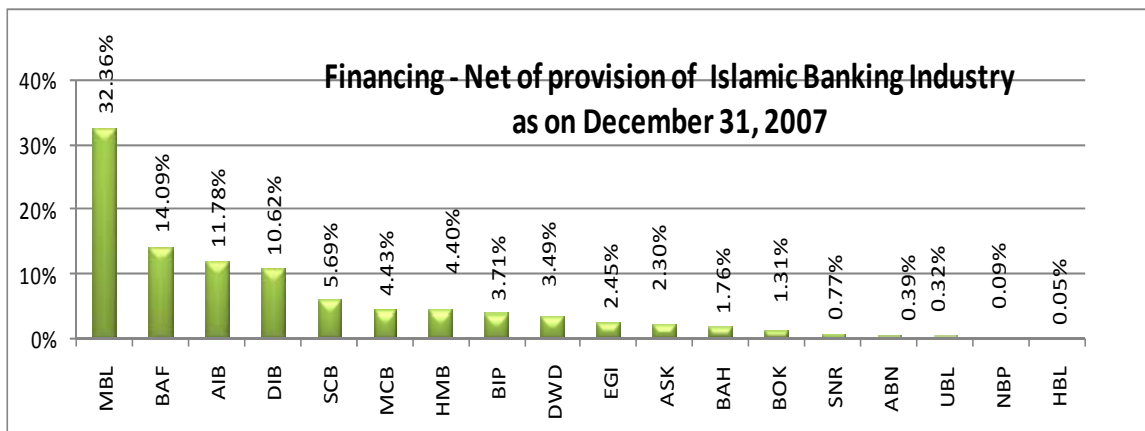


Figure 9.9 Bank Wise Share of Financing of Islamic Banking Industry as on December 31, 2007

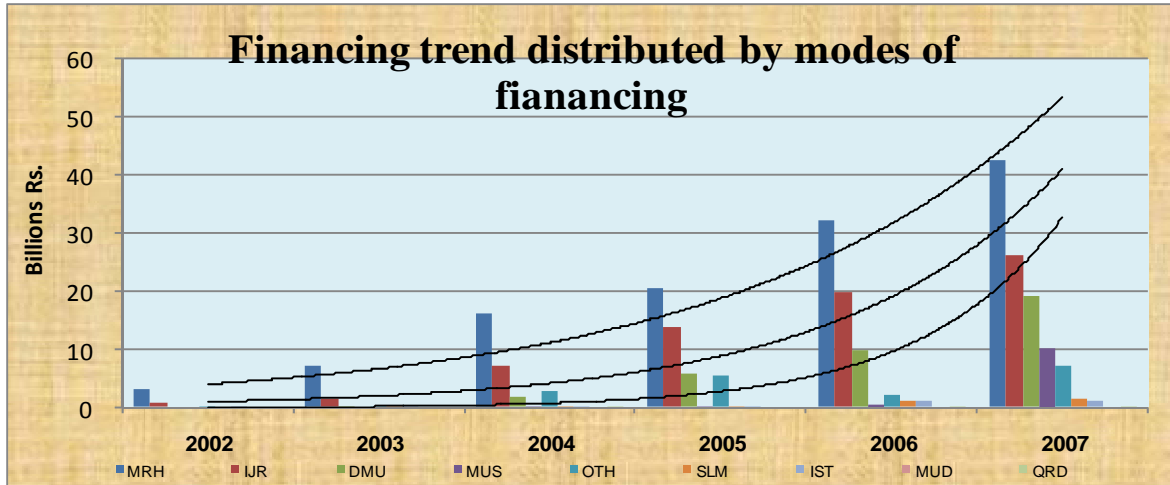


The bank wise share of financing (net of provisions) as on December 31, 2007 as presented in the Figure 9.9 shows the dominant position of Meezan Bank i.e. capturing almost one third of financing being provided by the industry. Bank Alfalah again leads the category of conventional banks having Islamic banking branches. Also Standard Chartered Bank and Habib Metropolitan Bank with relatively fewer numbers of branches have managed to capture a noticeable amount of the financing. However with the entry of BankIslami, Emirates Global, Dubai Islamic and Dawood Islamic the full fledged players will continue to capture a dominant share in the overall financing offered by the industry.



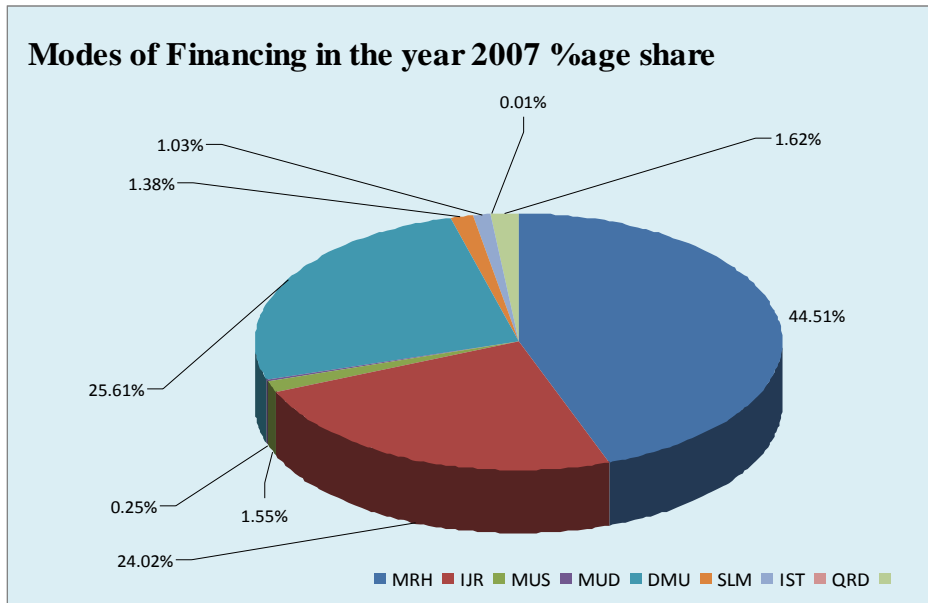
## 9.11 Mode and Sector Wise Break-up of Financing

Figure 9.10 Trend of Mode Wise Breakup of Financing



For the Islamic Banking Institutions preferred modes of financing belong 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) are the most attractive and popular modes of financing. However, lately the share of Diminishing Musharaka has also grown at a rapid pace leading towards diversification of the Islamic banks' financing portfolio.

Figure 9.11 Mode Wise Break –up of Financing as on December 31, 2007



80% plus share in financing represent the three modes of financing i.e. Murabaha (44%), Ijarah (24%) and Diminishing Musharaka (25%) respectively.

Table 9.7 Sector Wise Break up of Financing and Share in Total

Sector	Banking Industry of Pakistan		Islamic Banking (IB) Ind.		Mkt. Share of IB (Percentage)	
	No. of Borrowers	Amount (Rs.Mn)	No. of Borrowers	Amount (Rs. Mn)	No. of Borrowers	Amount
Corporate	26,061	1,520,130	1,959	62,784	7.5%	4.1%
SMEs sector	185,039	437,351	2,685	12,535	1.5%	2.9%
Agriculture	1,415,353	150,777	159	13	0.0%	0.0%
Consumer sector (other than Staff loans)	3,025,463	371,421	36,533	28,843	1.2%	7.8%
Commodity financing	2,616	148,447	31	1,118	1.2%	0.8%
Others	126,021	72,758	11,48	2,459	0.9%	3.3%
<b>Total</b>	<b>4,780,553</b>	<b>2,700,883</b>	<b>42,515</b>	<b>107,752</b>	<b>0.9%</b>	<b>4.0%</b>

Source: Quarterly Reports of Condition for Quarter Ending 31st December 2007

### 9.12 Investments & Bank Wise Share

From 2002 to 2007 the ACGR for Investments has been 105.0% with respective years' growth (i.e. for 2003 to 2007) being 45.2%, 61.6%, -7.6%, 295.2% & 322.5%. Initially due to non availability of Shariah compliant instruments the Islamic banking institutions suffered from a relative disadvantageous position. Specifically, until the issuance of WAPDA Sukuk in November 2005, there was no approved security for meeting the Statutory Liquidity Requirement. Subsequently KSEW Sukuk has also been categorized as SLR eligible instrument. Meanwhile SBP has provided the industry with a level playing field through a separate SLR regime and limit on investment in shares. Currently for meeting the SLR requirements Islamic Banking Institutions have been allowed to maintain SLR at 9% of their TDL on an overall basis, with investment in SLR eligible Sukuk not exceeding 7% of their TDL (however, individual holding in Sukuk of one issuer shall be limited to 5 percent of total TDL) and remaining in the shape of cash in hand, balance with NBP in current account, and balance with State Bank of Pakistan in Special Deposit Account.

Figure 9.12 Islamic Banking Industry Investment

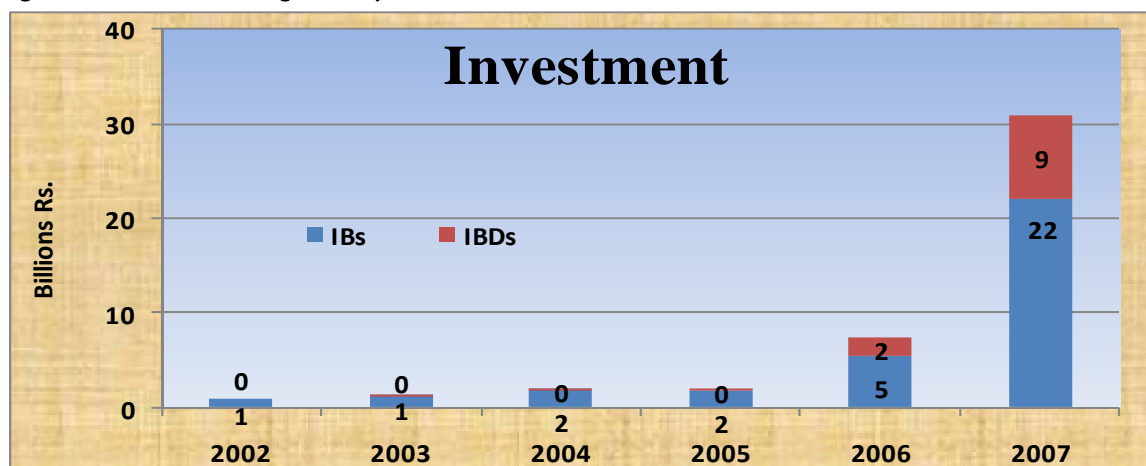
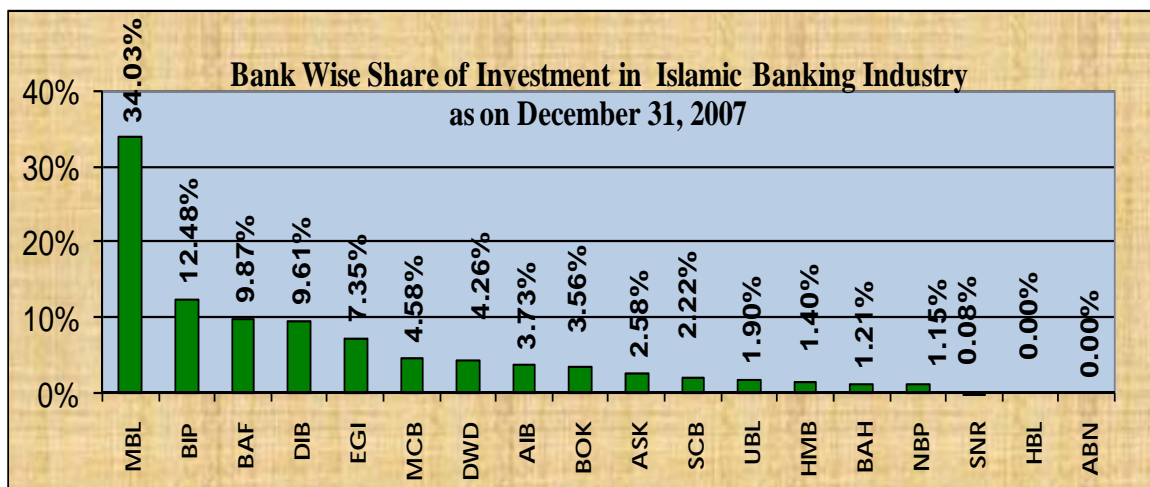


Figure 9.13 Bank Wise Share of Investment in Islamic Banking Industry as on December 31, 2007



At the end of year 2007 Meezan Bank continued to enjoy the highest share in overall investments made by the industry and Bank Alfalah in line with the size of its balance sheet leads the category of conventional banks having IBBs.

### 9.13 Sources and Uses of Funds

Consolidated table of sources and uses of funds in Islamic Banking Sector is as follows:

Table 9.8 Sources and Uses of Funds in Islamic Banking Industry (Rs. in Million)

	2003	2004	2005	2006	2007
Deposits	8,397	30,185	49,932	83,740	147,361
Borrowings	1,899	6,559	9,006	10,843	15,042
Capital & other funds	1,994	5,123	7,811	16,348	29,526
Other liabilities	625	2,276	4,745	8,363	14,017
<b>TOTAL</b>	<b>12,915</b>	<b>44,143</b>	<b>71,493</b>	<b>119,294</b>	<b>205,946</b>
Financing-Net	8,652	27,535	45,786	65,613	106,848
Investments	1,242	2,007	1,854	7,328	30,961
Cash, bank balance, placements	1,979	11,900	19,314	31,358	38,996
Other assets	1,042	2,701	4,539	14,996	29,141
<b>TOTAL</b>	<b>12,915</b>	<b>44,143</b>	<b>71,493</b>	<b>119,294</b>	<b>205,946</b>

Figure 9.14 Sources of Funds in Islamic Banking Industry as on December 31, 2007

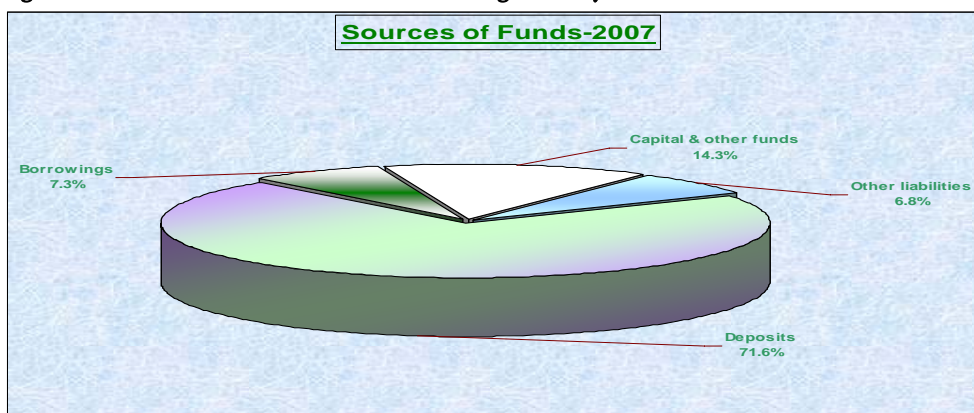
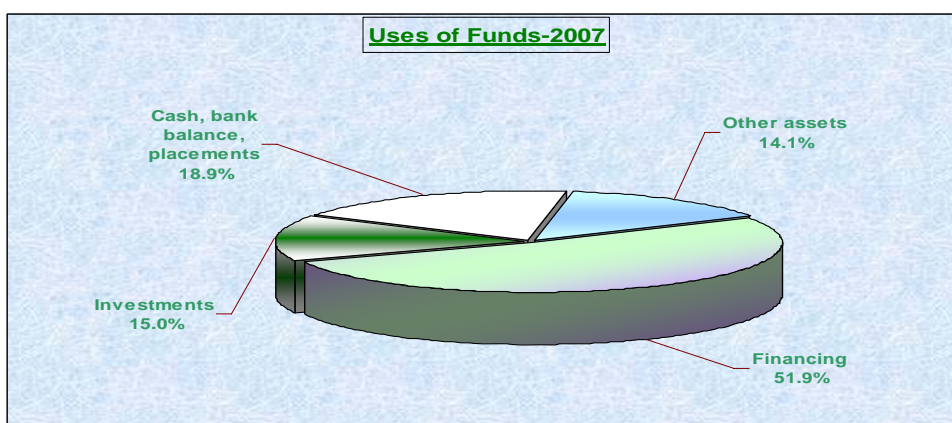


Figure 9.15 Uses of Funds in Islamic Banking Industry as on December 31, 2007



A look at the sources and uses of funds (for end Dec. 2007) shows that the deposits and financing continue to dominate the balance sheet of the Islamic Banking Institutions in Pakistan.

Financing has constituted the major share of the asset portfolio, though the share has decreased over the years from 67% as at end December 2003 to 51% as at end December 2007. While this decline can partly be attributed to monetary tightening, the share of investments in total assets has increased from 9% as at end December 2003 to 15% as at end December 2007. This asset structure generally indicates a lack of investment avenues for Islamic Banks. Moreover the dearth of Shariah compliant liquidity management instruments has compelled the banks to rely on less preferable modes such as Commodity Murabaha.

As in conventional banks, deposits continue to form the largest share of the total liabilities of Islamic banks. Their share among the sources of funds has increased from 65% in 2003 to 72% in 2007. This trend is partly due to the tendency shown on part of some Islamic banking divisions of conventional banks to rely less on borrowings from their head office and concentrate on seeking deposits.

### 9.14 Financing to Deposits Ratio

The financing to deposits ratio has constantly been declining since the industry is coming out of its formative phase; this depicts the increasing diversification of operations as well as availability of

other opportunities for deployment of earning assets. As for example the Financing to Deposits Ratio declined marginally from 71 percent in Jun-07 to 70 percent in Sep-07, which was 78.4 percent in CY06.

### 9.15 Capital Adequacy Ratio

The capital adequacy ratios for the Islamic banking branches (IBBs) and Islamic banks have remained well above the regulatory benchmark of 8 percent. As four new full fledged banks have entered the market during the years 2006 & 2007 the capital adequacy ratio for the full fledged bank category has gone upto 20.8%. However as the financing and investment portfolios of these banks keep on expanding this situation will change accordingly.

**Table 9.9 Capital Adequacy Ratio**

	As on			
	31-12-2004	31-12-2005	31-12-2006	31-12-2007
	Capital Adequacy Ratio	Capital Adequacy Ratio	Capital Adequacy Ratio	Capital Adequacy Ratio
Total-IBDs	12.5%	12.4 %	12.8%	12.4%
Total-IBs	13.1%	20.1%	20.9%	20.8%
Consolidated	13.0%	17.5%	18.3%	18.4%

**9.16 Capital to Total Assets Ratio** With the continued entry of new players the capital of the Islamic banking system has grown at a healthy rate with the capital to total assets ratio being 14.3% as at end December 2007. The ratio currently being comfortably more than the generally accepted benchmark of 5 percent is expected to decline as the industry is in its early years of progression, where the efforts on part of participants to increase financial intermediation are quite pronounced hence the expansion in asset and deposit base is rather obvious.

**Table 9.10 Some Key Indicators**

Indicators	2003	2004	2005	2006	2007
NPFs to Total Financing	0.7%	0.9%	1.0%	1.3%	1.2%
Net NPFs to Net Financing	0.0%	0.2%	0.2%	0.4%	-0.1%
Provisions to NPFs	100.0%	82.3%	80.6%	72.0%	109.5%
Net Mark up Income to Total Assets	1.7%	1.4%	2.3%	2.4%	2.9%
Non Mark up Income to Total Assets	2.2%	1.4%	1.7%	0.9%	1.2%
Operating Expense to Gross Income	54.6%	65.3%	49.9%	72.8%	70.2%
ROA ( Average Assets)	2.2%	1.2%	1.7%	0.9%	1.0%

### ***9.17 Non Performing Financing***

With the growing operations and fast expanding financing portfolio, the occurrence of non performing financing is inevitable. The ratio of non-performing financing to total financing was 0.7% in 2003 that touched 1.3% in 2006. However, as at end of 2007 the ratio has slightly declined to 1.2%. These ratios are still very low and do not carry significant threat to the financial soundness of IBIs.

The peculiar nature of the Islamic banking and the Shariah based modes of financing, whereby any late payment penalty recovered from the borrowers shall be spent for charitable purposes, serves as a sufficient condition for the banks to observe extra vigilance in credit appraisals and ensure timely and effective recovery. While observing the situation minutely it will come to notice that the non performing financing to total financing ratio which was very low at 0.7 percent in CY03 slightly went up in 2004 as the NPFs primarily belonged to the operations of Albaraka Islamic Bank before conversion and those of Societe Generale inherited by Meezan Bank. The slight increase in ratios of NPFs to total financing and net NPFs to net financing in the ensuing year is mainly attributable to the inherited infections of some of the branches of conventional banks.

### ***9.18 Earning Assets as Percentage of Total Assets***

Table 9. 11 Earning Assets as Percentage of Total Assets

Description	(Rs. in Million)				
	2003	2004	2005	2006	2007
Earning Assets (A)	10,578	33,543	56,670	95,114	168,191
Total Assets (B)	12,914	44,143	71,493	119,294	205,946
A/B	81.9%	76.0%	79.3%	79.7%	81.7%

A gradual improvement in the ratio of earning assets to total assets can be observed which shows that the industry despite being in its nascent stage and faced with some critical issues is managing to consolidate itself so as to offer an effective alternate system to the users of banking services.

### ***9.19 Income Statement***

The common sized income statement points at the growing financial intermediation in Islamic banking institutions and increased focus on the income from core activities. Over the years with the increasing percentage of markup expenses net markup income has been declining as a percentage of Mark up income. However in absolute terms net mark up income has grown at a healthy rate.

The Islamic banking industry has produced very healthy profits. In view of higher volume of Business over the years, profitability indicators have also improved markedly. In fact, the rate of growth in profits, 185.1 percent in CY05, outstripped the high growth witnessed in total assets. However in the ensuing year as some new full fledged banks had entered the market a higher growth in operating expense resulted in negative growth in the profits. In the year 2006, significant increase in the operating expenses reduced the before tax profits to Rs832 million from Rs.1,243 million in CY05. Resultantly ROA also decreased from 1.7 percent in CY 05 to 0.9 percent in CY06.

In the year 2007 however a very healthy growth in the profits was experienced as most of the players in the industry had either crossed the break even stage or were close to do so. It must be appreciated that initially the Islamic banking was growing at an accelerated rate; therefore the growth in assets far exceeded the income growth resulting in a decline in profitability indicators when measured in terms of total assets. This is reflected in the return on average assets that had dipped to 1.2 percent in CY04 from 2.2 percent in the previous year. The impact of operating expenses and changes in profitability can accordingly be observed on the ROA during the period under review. Increase in asset base and increase in provisioning are also some of reasons for declining profitability ratios.

**Table 9.12 Income Statement (Rs. in Million)**

	2003		2004		2005		2006		2007	
	Amt.	%	Amt.	%	Amt.	%	Amt.	%	Amt.	%
<b>Markup Income</b>	406.4	100	1,081.0	100	3,164.3	100	6,383.1	100	1,2706.7	100
<b>Markup Expense</b>	188.5	46.3	483.7	44.8	1,542.3	48.7	3,515.3	55.1	6785.3	53.4
<b>Net Markup Inc.</b>	217.9	53.6	597.2	55.2	1,622.0	51.3	2,867.9	44.9	5921.4	46.6
<b>Provision Expense</b>	(15.8)	(3.9)	36.0	3.3	175.6	5.5	238.7	3.7	807.9	6.4
<b>Non Markup Inc.</b>	287.4	70.7	596.0	55.1	1,206.6	38.1	1,067.4	16.7	2476.8	19.5
<b>Operating Expense</b>	276.0	67.9	779.0	72.1	1,410.5	44.6	2,864.5	44.9	5895.9	46.4
<b>Profit Before Tax</b>	245.0	60.2	378.2	35.0	1,242.6	39.3	832.2	13.0	1694.4	13.3
<b>Tax</b>	27.0	6.6	36.2	3.4	265.2	8.4	(34.4)	(0.5)	67.7	0.5
<b>Profit After Tax</b>	218.0	53.6	342.0	31.6	977.4	30.9	866.6	13.6	1626.7	12.8

## ***9.20 Product Offering of the Islamic Banking Industry in Pakistan***

The industry over the years has managed to offer a wide array of products encompassing almost the entire range of Islamic modes of financing that are able to cater to the needs of majority of the sectors of the economy.

### ***Asset Side***

The segments covered by the industry through various Shariah compliant modes such as Murabaha, Mudaraba, Musharaka, Ijarah, Diminishing Musharaka, Salam, Istisna, Wakala and Islamic Export Refinance etc. (Please See Table. 10.13) include

- Corporate / Commercial,
- Agriculture,
- Consumer,
- Commodity Financing,
- SME sector,
- Treasury & Financial Institutions.

Also with the increased issuance of Sukuk by corporates investments of IBIs in these Shariah compliant instruments is on the rise.

### ***Liability Side***

On the Liability side, Islamic Banking Industry offers various Shariah compliant deposit schemes that are available for customers to invest their funds. These include

- Current Accounts,
- Basic Banking Account,
- Savings Accounts,
- Term Deposits of various maturities, and
- Certificates of Investment etc.

Current Account is mostly being offered on Qard basis whereas Mudaraba is the preferred mode used by Islamic banks for offering savings accounts, term deposits & certificates of investment. (Please see Table. 10.14 )

### ***Others***

Some full fledged banks are also offering investment banking products and services including Sukuk Arrangement, Financial Advisory, Private Placement, Syndication, Trusteeship, Underwriting, Structured Finance, Listing on Capital Markets, Project Financing, Mergers & Acquisitions etc. Further, a variety of other ancillary services are also being offered in a Shariah compliant manner such as

- Bonds & Guarantees,
- Letters of Credit
- Remittances ( local & International),
- Online banking,
- ATM/debit card ( including Visa),
- Safe deposit lockers and
- Utility bill payments etc.
- Collection of export bills, assignment of export / local bills
- Inter-Bank funds transfer facility through ATM,
- E-Statement facility,
- Lockers,
- Phone Banking and 24 /7 Call Centre service.
- Deposit accepting ATMs



Table 9.13 Islamic Mode Wise Asset Side Offerings of the Islamic Banking Industry of Pakistan

Islamic Mode	Target Customers	Sectors	Purpose
<b>Diminishing Musharaka</b>	<ul style="list-style-type: none"> <li>• Multinational Companies</li> <li>• Large local corporates</li> <li>• Public sector entities</li> <li>• Sole proprietor</li> <li>• Private limited companies.</li> <li>• Manufacturing industries.</li> <li>• Salaried Individuals</li> <li>• Self Employed Professionals</li> <li>• Business Individuals</li> </ul>	<ul style="list-style-type: none"> <li>• Consumer</li> <li>• Corporate</li> <li>• Commercial</li> <li>• SME</li> </ul>	<ul style="list-style-type: none"> <li>• Plant</li> <li>• Machinery</li> <li>• Equipment</li> <li>• Commercial Property</li> <li>• House Finance – (Buy, Build, Renovate, Replace)</li> <li>• Auto Finance</li> </ul>
<b>Musharaka</b>	<ul style="list-style-type: none"> <li>• Real Estate Developers</li> <li>• Industrialist etc.</li> </ul>	Corporate	<ul style="list-style-type: none"> <li>• Running Finance/Islamic Overdraft</li> <li>• Export Finance</li> <li>• Treasury (Interbank Money Market)</li> </ul>
<b>Mudaraba</b>	<ul style="list-style-type: none"> <li>• NGOs,</li> <li>• Businessmen</li> </ul>		<ul style="list-style-type: none"> <li>• IERS</li> <li>• Bill Discounting</li> <li>• Treasury (Interbank Money Market)</li> </ul>
<b>Service &amp; Reverse services Ijara (Ijara-tul-Ashkhas)</b>			<ul style="list-style-type: none"> <li>• Financing for Services</li> <li>• Locker Services</li> </ul>

Islamic Mode	Target Customers	Sectors	Purpose
<b>Sale &amp; Lease Back Ijarah Financing</b>		<ul style="list-style-type: none"> <li>Corporate, Commercial, SME, Investment Banking</li> </ul>	
<b>Ijarah</b>	<ul style="list-style-type: none"> <li>Multinational Companies</li> <li>Large local corporates</li> <li>Public sector entities</li> <li>Sole proprietor</li> <li>Private limited companies.</li> <li>Manufacturing industries</li> <li>Construction Industries</li> <li>Transportation Industries</li> <li>Salaried Individuals</li> <li>Self Employed Professionals</li> <li>Business Individuals</li> <li>Govt. Employees</li> </ul>	<ul style="list-style-type: none"> <li>Consumer</li> <li>Corporate</li> <li>Commercial</li> <li>SME</li> <li>Investment Banking</li> </ul>	<ul style="list-style-type: none"> <li>Plant</li> <li>Machinery</li> <li>Equipment</li> <li>Auto Finance</li> <li>LCs</li> </ul>
<b>Murabaha</b>	<ul style="list-style-type: none"> <li>Multinational Companies</li> <li>Large local corporates</li> <li>Public sector entities</li> <li>Sole proprietor</li> <li>Private limited companies</li> <li>Manufacturing industries</li> <li>Construction Industries</li> <li>Traders</li> </ul>	<ul style="list-style-type: none"> <li>Corporate, Commercial</li> <li>SME,</li> <li>Agriculture</li> <li>Investment Banking</li> </ul>	<ul style="list-style-type: none"> <li>Working Capital</li> <li>Islamic Export Refinance Scheme (IERS)</li> <li>Treasury</li> <li>Import &amp; Export</li> <li>Bill Purchase /Discounting (Usance)</li> <li>Finance Against Trust Receipt</li> </ul>
<b>Musawama</b>			<ul style="list-style-type: none"> <li>Islamic Finance Against Foreign Bills</li> </ul>

			<ul style="list-style-type: none"> <li>• Islamic Export Bills Finance(under LC)</li> <li>• Islamic Export Refinance Scheme (IERS)</li> </ul>
<b>Commodity Murabaha</b>	Commercial Banks		Treasury
<b>Murabaha Cum Wakala</b>	Import oriented industries	<ul style="list-style-type: none"> <li>• Corporate</li> <li>• Commercial</li> <li>• SME</li> </ul>	Murabaha Import (Funded)
<b>Islamic Mode</b>	<b>Target Customers</b>	<b>Sectors</b>	<b>Purpose</b>
<b>Wakala</b>	<ul style="list-style-type: none"> <li>• Export oriented industries</li> <li>• Commercial Banks</li> </ul>		<ul style="list-style-type: none"> <li>• Export Finance</li> <li>• Inter-bank placements</li> </ul>
<b>Wakala &amp; Sale</b>		<ul style="list-style-type: none"> <li>• Corporate</li> <li>• Commercial</li> <li>• SME</li> </ul>	Financing for Corporate, Commercial and SME
<b>Istisna's Cum Wakala</b>	Manufacturing Industries, Construction Industry.	<ul style="list-style-type: none"> <li>• Corporate</li> <li>• Commercial</li> <li>• SME</li> </ul>	Manufacturing & Construction
<b>Istisna/Parallel Istisna</b>		<ul style="list-style-type: none"> <li>• Corporate, Commercial</li> <li>• SME</li> <li>• Consumer</li> </ul>	<ul style="list-style-type: none"> <li>• IERS,</li> <li>• Construction projects</li> <li>• House finance</li> <li>• Manufacturer of machinery etc.</li> </ul>
<b>Salam/Parallel Salam</b>		<ul style="list-style-type: none"> <li>• SME</li> <li>• Consumer</li> <li>• Agriculture</li> <li>• Commercial</li> <li>• Corporate</li> </ul>	<ul style="list-style-type: none"> <li>• Commodity Financing</li> <li>• Bill Discounting</li> <li>• Bill Purchase (Sight)</li> </ul>
<b>Kafalah</b>			<ul style="list-style-type: none"> <li>• Letters of Credit</li> <li>• Bonds &amp; Guarantees</li> </ul>
<b>Dayn</b>	Salaried Persons	Consumer Finance	Travel Services
<b>Bai Surf</b>			Sight Bills Purchase
<b>Amanah</b>			Lockers
<b>Ujrah</b>			Credit Card

**Table 9.14 Islamic Mode Wise Liability Side Offerings of the Islamic Banking Industry of Pakistan**

Generic Name	Islamic Mode Used
<b>Current Account</b>	Wadiah Mudaraba Qard
<b>Savings Account</b>	Hybrid of Mudaraba and Musharaka Musharaka Mudaraba
<b>Term Deposit</b>	Hybrid of Mudaraba and Musharaka Musharaka Mudaraba Wakala

## 10. Issues Faced by the Industry and Efforts of SBP

### *10.1 Taxation Issues*

SBP has put in place a process that is comprehensive and provides the necessary groundwork to all the government departments concerned to enable them executing their part of the change in rules. This process consists of forming a committee at ICAP that determines the accounting treatment of Islamic transaction modes. Based on the accounting treatment, changes needed in the tax rules to provide same effective taxation treatment to Islamic transactions as that provided to conventional transactions are made.

SBP initially took up the issue of double taxation on Murabaha transactions with the Central Board of Revenue (CBR) and proposed amendments in the taxation laws in consultation with market players so as to provide a level playing field to the IBIs. Consequently, in the budget for the year 2004-2005, an amendment was made (Statutory Regulatory Order 445(1) / 2004) 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 approved by the SBP or the SECP, as the case may be, were not to be treated as Supply. Also amendments in Income Tax Ordinance in areas like minimum turnover tax etc. have been introduced.

However lately in the Finance Bill 2007 it has now been ensured that taxation of Shariah compliant Islamic banking would be treated at par with conventional banking.

### *10.2 Financial Reporting and Accounting Standards*

In Pakistan, the regulatory financial reporting framework for the Islamic Banks (IBs) and the Islamic Banking Divisions of Conventional Banks consist of:

- The International Financial Reporting Standards (IFRS);
- the Banking Companies Ordinance (BCO), 1962;
- the Companies Ordinance (CO), 1984; and
- various rules and regulations devised by the State Bank of Pakistan (SBP) and the Securities and Exchange Commission of Pakistan (SECP) particularly including the SBP Prudential Regulations and Banking Supervision Department-Circular-4 of 2006.

According to the SBP's recently issued Guidelines for Shariah Compliance in Islamic Banking Institutions following are the Financial Reporting and General Disclosure requirements:

- IBIs shall follow financial reporting standards for Islamic modes of financing issued by the Securities and Exchange Commission of Pakistan (SECP) under the Companies Ordinance, 1984. For modes/areas not covered by these standards, IBIs are encouraged to use AAOIFI Accounting Standards.

- Moreover in the annual report, IBIs are encouraged to disclose a) overall basis of working of profit distributed to depositors; b) break up of their financing by Islamic modes of finance; and c) remuneration of Shariah advisor. In addition, the annual report of conventional banks having Islamic Banking Branches shall include separate balance sheet and profit and loss statement of their Islamic banking operations. Additional disclosure in the form of cash flow statement of Islamic banking operations is also encouraged.

It is to mention here that Institute of Chartered Accountants of Pakistan has appointed a Committee on Accounting and Auditing Standards for Interest Free Modes of Financing and Investments. The Committee comprises experienced Chartered Accountants and experts from all relevant fields including Bankers, Lawyers, Shariah Scholars and the representatives from the regulators. The Committee is reviewing the accounting standards prepared by Accounting and Auditing Organization for Islamic Financial Institutions, Bahrain (AAOIFI) with a view to adapt them to Pakistani circumstances and if considered necessary to propose new accounting standards.

So far, the Committee has issued two Islamic Financial Accounting Standards (IFASs).

- **IFAS – 1 Murabaha** has been notified by the SECP through SRO 865 (I) / 2005 in August 2005 under section 234 of the Companies Ordinance, 1984 and accordingly it has now become a part of law for the purpose of preparation of financial statements of Banks and similar financial institutions. It was made applicable on financial statements beginning on or after January 01, 2006.
- **IFAS – 2 Ijarah** has been notified through SRO 431 (I) / 2007 dated May 22, 2007 by the Securities and Exchange Commission of Pakistan (SECP). It was made applicable on the financial statements for the periods beginning on or after July 01, 2007. It is applicable on companies, i.e. the lessees, also.
- In addition, work is in progress on standards for Profit Distribution to PLS depositors, Diminishing Musharaka followed by Musharaka.

### ***10.3 Islamic Export Refinance Scheme<sup>20</sup>***

Similar to the export refinance facility available to conventional banks, in 2002 SBP started a Musharaka based Islamic export refinance scheme (IERS) for Islamic banks and stand-alone Islamic branches operating in the country.

Islamic Banking Institutions (IBIs) are availing this facility under both parts of SBP's Export Finance Scheme (EFS). The framework of the IERS is based on the concept of Profit & Loss Sharing. The State Bank shares the actual profit of the Musharakah pool of the Islamic Bank. However, in case the actual profit of the pool is more than ongoing rates under conventional EFS, the excess profit so received by SBP is credited to the Takaful fund, (a reserve fund to be maintained by SBP under Islamic modes) for risk mitigation that would be used to meet future losses arising during implementation of IERS. It is interesting to observe that up till 2005 only Meezan Bank Limited was availing this facility for their clients, whereas in the FY 2007-08 four full fledged Islamic banks and two conventional banks having IBBs have availed the said facility.

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<sup>20</sup> Salient Features of the Islamic Export Refinance Scheme are given as **Annexure-C**

## *10.4 Capacity Building*

Capacity Building is another major challenge being faced by Islamic financial Industry. Proper understanding of Islamic banking services and their equal treatment vis-à-vis conventional products is vital for the practitioners in Islamic Finance Industry for product innovation and differentiation. It is, therefore, extremely important to have the people with the right kind of skills and commitment to run Islamic financial institutions.

- In the wake of high growth rate experienced by IBI SBP is putting special emphasis on ensuring that adequately trained human resource is employed by the Islamic Banking Institutions. Banks are asked to provide appropriate training to the staff before getting a license from SBP.
- In order to give the relevant local and international exposure to employees of Islamic Banking Department and also other departments of SBP (that are dealing with Islamic banking industry) it is ensured that appropriate training opportunities are utilized. Moreover occasionally the Islamic Banking Department of SBP conducts an internal Awareness/Training Program on Islamic Banking which helps in educating the SBP staff on Islamic Banking and Finance concepts and issues.
- Also a Memorandum of Understanding has been signed between State Bank and International Centre for Education in Islamic Finance (INCEIF), Malaysia which envisages creating a strategic alliance between the two for promoting educational excellence in this field in the respective countries. Under this Memorandum of Understanding 10 scholarships for “Certified Islamic Finance Professional (CIFP)”, a distance learning program developed by INCEIF were offered to Pakistan. The candidates for the said Program were nominated by SBP from its own staff, NIBAF and Islamic banks.
- Workshops like those on IFSB “Capital Adequacy Standard” and “Transparency and Market Discipline” have been organized in which participants from the local industry participate as they provide the much needed facilitation on the implementation of the said Standards in our local market.
- Avenues like arranging / sponsoring International Conferences, Video-Conferencing etc. have been utilized so as to contribute towards achieving the task of capacity building of the industry.
- Taking advantage of visits of dignitaries, and experts in Islamic finance, special sessions are organized for the stakeholders.

### *National Institute of Banking and Finance*

- Initially the National Institute of Banking and Finance (NIBAF) (training wing of the State Bank) included a Module on Islamic banking and finance in its training courses designed for State Bank Officers Training Scheme and other fresh inductees.
- In view of the increasing demand for trainings in Islamic banking and finance, NIBAF designed a 3-week Intermediate to Advance level Certification Course keeping in view the practical requirements of stakeholders. The course, comprising 16 modules, was designed in

consultation with Islamic banking experts and Shariah scholars from within the country and also outside. The target group comprises staff from Islamic banks, commercial banks and the Islamic Banking Branches of commercial banks operating in Pakistan. The training sessions also include group work on product development, deposit management, process of Murabaha & Ijarah pricing beside case studies regarding Securitization, Sukuk, Diminishing Musharaka (Housing finance), Murabaha and Ijarah etc.

- Till date<sup>21</sup> eleven (11) courses have been conducted at NIBAF Karachi & Islamabad in which 421 out of 446 officers were awarded certificates for successful completion. The Course has registered success in terms of coverage, training delivery, coordination and administration. This course, in the short run is proving to be very beneficial for the rapidly growing Islamic Banking Industry requirements. The participants are evaluated for each module and at the end there is a comprehensive test. Only participants scoring above the threshold level i.e. 60percent in each of the modules and the comprehensive test with 65percent overall weighted score are awarded certificates.
- Further, customized one-week training programs on Islamic Banking are also arranged by NIBAFI for Islamic banks.
- Also an international course on Monetary and Fiscal Policies with a focus on Islamic Economics has been conducted in collaboration with Islamic Research and Training Institute (IRTI) of Islamic Development Bank (IDB). The course participants were invited from the member countries of the IDB. In the same context, to share knowledge and expertise seminars on Awqaf and Retakaful have also been held at NIBAF in collaboration with the International Islamic University Islamabad and IRTI.

#### *Other Initiatives*

- Institute of Bankers Pakistan conducts seminars, training courses etc. for creating wider awareness among bankers about the conceptual and operational framework of Islamic banking. The subject of Islamic Banking and Finance has also been included in its Banking Diploma courses. The curriculum of IBP's Banking Diploma Examination has been revised and updated. They have also revised the syllabus on the subject of Islamic Banking and Finance.
- A number of other educational institutions like International Institute of Islamic Economics, International Islamic University Islamabad, and Centre for Islamic Economics, Karachi, etc are also offering academic and training courses on Islamic banking and finance.
- SBP has developed a standardized curriculum for certification, post-graduate and master level programs in Islamic Banking. The curriculum has been sent to the Higher Education Commission (HEC). HEC's Curriculum Review/Revision Committee would in due course consider the curriculum for possible adoption in Pakistani educational institutions. This attempt will hopefully ensure up to a certain extent the quality of the offerings by education, training and research institutions offering Islamic Banking courses.

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<sup>21</sup> As of November, 2008.



## ***10.5 Liquidity Management***

Development of Shariah compliant liquidity management instruments, interbank market etc. is a very important area for orderly development of the industry. Dearth of Shariah compliant liquidity management instruments has remained a major cause of concern for the Islamic banking industry of Pakistan. Due to non availability of requisite quantity of Shariah compliant instruments the Islamic banking institutions have relied on products like Commodity Murabaha for managing their liquidity related problems. WAPDA Sukuk (1st and 2nd Issue) and Karachi Shipyard & Engineering Works Limited (KSEW) Sukuk (1st and 2nd Issue) are SLR eligible instruments that are currently available to the Islamic banking industry.

For providing level playing field to the IBIs they have been asked to meet lower SLR requirements both for Pak Rupee Demand and Time Liabilities and Foreign Currency FE-25 deposits. For meeting the SLR requirements Islamic Banking Institutions have been allowed to maintain SLR at 9% of their TDL on an overall basis, with investment in SLR eligible Sukuk not exceeding 7% of their TDL (however, individual holding in Sukuk of one issuer shall be limited to 5 percent of total TDL) and remaining in the shape of cash in hand, balance with NBP in current account, and balance with State Bank of Pakistan in Special Deposit Account. Moreover, IBIs have been given enhanced limit by SBP for investment in shares.

State Bank of Pakistan has formed a Task Force to map out a plan for introducing short term and medium term liquidity management products based on innovative Islamic Structures. It had prepared a structure for short term SLR eligible Shariah compliant government instrument (i.e. GoP Ijara Sukuk) which was sent for Government approval and the same have now been issued (i.e. in the second week of September, 2008). This issuance will go a long way in resolving the long standing issue of liquidity management.

Similarly work is also underway for developing a Shariah compliant lender of last resort facility and standardized agreements for Islamic inter-bank market transactions. In this regard SBP also leverages its membership of various working groups/technical committees of International Islamic infrastructure institutions like IFSB, IIFM etc.

## ***10.6 Limited Outreach of Islamic Banking Institutions***

*Distribution Network:* As at end of July 2008 there were only around 330 licensed branches in the Islamic Banking sector in comparison with around 7800 branches on conventional side. The availability of financing through Islamic Banking is still very much limited. In this scenario SBP apart from considering liberal branch licensing policy is also encouraging the Islamic banking institutions to utilize alternate delivery channels for improving the accessibility of the Islamic banking services across the length and breadth of the country. These include the options of Islamic Banking Windows and Branchless Banking.

*Uncharted Sectors:* Islamic Banking due to its appeal among the masses because of its ethical and religious dimensions has a strong growth potential in fields like micro-financing, agriculture financing, infrastructure finance, Small & Medium Enterprises etc. Moreover as the demand for launching of diversified and integrated Islamic financial System in the country is on the rise there is a great potential for Islamic Banking products in these areas. Till now only one or two Islamic banking branches are engaged in Islamic Microfinance services and there is a strong need for development of

this segment. However the major issue in this regard at this point of time is awareness about Islamic microfinance. Islamic banks were till recently in developmental phase and high infrastructure cost deterred them from moving into new sectors & rural areas. However now that they have passed the break even stage they can afford to explore such avenues. In this regard SBP has already issued the Guidelines for provision of Islamic microfinance services and products by financial institutions.

*Product Development:* On the consumer banking side clean lending products like Personal Loans and Credit Cards still pose a challenge. On the Corporate side working capital loans are a test. Similarly the industry has not yet offered duly approved product under the new SBP scheme for Long Term Financing Facility (LTFF).

Lately some products in these areas have been launched by a few banks which is a good sign for development of the industry as it penetrates more sectors that are currently served only by the conventional banking sector. SBP continues to strive for charting a regulatory framework for Islamic banking that ensures adherence to Shariah principles and at the same time allows the banks to adjust their offerings in accordance with their customer needs.

### ***10.7 Awareness Creation***

Like any other “new” concept, Islamic banking and finance is also going to take some time to be fully comprehended by the people at large. Any new product when introduced in a market will go through the natural dynamics of initially being understood by a few and with the passage of time as its need and practicability is felt and appreciated by more and more people greater efforts are employed to make it recognizable for everyone. In Pakistan the failure of implementing the Islamic banking system in its true spirit in the 1980’s is another major factor that contributes to the high level of skepticism expressed by many commentators. These two factors along with many others make task of creating awareness about Islamic banking among the masses a daunting one.

To address this issue, State Bank had initially conducted a successful awareness program for providers and users of Islamic banking services.

- A series of interactive seminars were held with some of the key stakeholders including the SBP staff itself. Similarly seminars were held for prospective banks, chambers of commerce, business houses, etc.
- Lectures in various training and educational institutions have been also been made such as IBP and International Islamic University Islamabad, Bahria and Karachi University etc.
- Moreover, SBP staff participates in various talk shows and interviews on a number of TV channels. We have also tried to ensure press coverage of significant events and conferences being held in Pakistan.
- One part of our strategy has been to target decision makers i.e. the military and civil bureaucracy and have made regular presentations in the civil services academy and national defense and staff colleges.

Moreover following initiatives are also worth mentioning in this regard:

- Taking advantage of visits of dignitaries, world renowned scholars and experts in Islamic finance, special sessions have also been organized for all the stakeholders. Video conferences on various aspects of Islamic banking have been arranged in collaboration with Islamic Development Bank and other international institutions which are attended by the bankers, chartered accountants, academicians and the students of Islamic finance.
- Islamic Banking Department's page on SBP's website gives ample information about the policies, regulatory framework and other important areas.
- A quarterly Islamic Banking Bulletin providing update on local as well international developments in the field of Islamic banking and finance is being published by Islamic Banking Department.
- Seminars on Islamic Financial Accounting Standards on Murabaha and Ijarah and the Risk Management Guidelines for IBIs have been conducted which were attended by senior executives/representatives from SECP, Islamic banking industry and SBP. Professional bankers and accountants delivered lectures on the subjects from various perspectives and these events provided an excellent opportunity to the participants to discuss the practical problems faced by them in the implementation of these standards/ guidelines.

## 11. Strengthening Internal & External Linkages

### *11.1 Strengthening Links with International Islamic Infrastructure Institutions (IIIs)*

International infrastructure institutions collectively promote national development, financial stability and international financial integration, by helping to develop standards, guidelines and best practices, coordinating national policies, and organizing international financial and technical support.

In the field of Islamic finance a number of institutions have been established to act as focal points on major issues, in particular the following International Islamic Infrastructure Institutions are playing a key role:

#### **11.1.1 Islamic Financial Services Board (IFSB)**

The IFSB is an international standard-setting organization that promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles broadly defined to include banking, capital markets and insurance sectors.

Being one of its founding members SBP is playing an active role in the working of the Islamic Financial Services Board (IFSB). It is represented on Council, Technical Committee and Working Groups of IFSB. In the 9th meeting of the Council of the Islamic Financial Services Board (IFSB) held on 29th November, 2006 in Jeddah, the Council approved appointment of Dr. Shamshad Akhtar, Governor, State Bank of Pakistan as the Deputy Chairperson of the IFSB for the year 2007. Furthermore, Dr. Shamshad Akhtar is working as Chairperson of the IFSB for the year 2008.

IFSB has so far issued the following Standards as adopted by their Council:

1. Guiding Principles of Risk Management
2. Capital Adequacy Standard
3. Guiding Principles on Corporate Governance
4. Transparency and Market Discipline
5. Supervisory Review Process
6. Capital Adequacy Standard: Recognition of Ratings by External Credit Assessment Institutions for Shariah Compliant Financial Instruments

Keeping in view the local environment and in consultation with various internal and external stakeholders of Islamic banking SBP is presently working on adopting/adapting standards mentioned at serial No. 2 to 6 above whereas IFSB Standard at Sr. No.1 i.e. Guidelines on Risk Management has already been rolled out.

In order to facilitate the implementation of the Standards at its member countries, IFSB also conducts a series of workshops on “Facilitating the Implementation of IFSB Standards”. They have so far conducted, in Pakistan, the Facilitation Workshops on “Capital Adequacy Standard” and “Transparency and Market Discipline” (January/February 2008). The said workshops proved quite successful in enhancing the level of understanding on the subject and addressing the implementation issues faced by the stakeholders.

A number of individuals from Pakistan, i.e. from SBP and other institutions, have been nominated by SBP to work with IFSB in different capacities. Further, there are some SBP officers who are representing SBP in various Committees/Working Groups of IFSB. The following is the brief of this arrangement:

Member Name	Name of Working Group/Committee
Mr. Pervez Said, Director IBD	IFSB Technical Committee and Market Conduct Working Group
Mr. Kazi Abdul Muktaadir, MD- NIBAF	IFSB Task Force on Human Resource
Mr. Mahmood Shafqat, SJD-IBD	IFSB Working Group Shariah Governance
Mr. Imran Ahmad, SJD-IBD	IFSB Task Force on Compilation of Prudential Statistics

The Standards, Technical Papers and Guidelines already issued by IFSB were also represented by SBP officials who shared their intellect and experience while finalizing the documents.

Pakistan is also organizing IFSB Annual Events in Pakistan during the last quarter of 2008. This would be a weeklong event wherein international conferences, meeting of the Council of IFSB, IFSB Public Lecture, Interactive sessions and other important events would be held.

### 11.1.2 International Islamic Financial Market (IIFM)

International Islamic Financial Market (IIFM) was founded with the collective efforts of the central banks and monetary agencies of Bahrain, Brunei, Indonesia, Malaysia, Sudan and the Islamic Development Bank, as an infrastructure institution with the mandate to take part in the establishment, development, self-regulation and promotion of Islamic Capital and Money Market.

To enhance investment opportunities and strengthen linkages with the global Islamic financial market SBP has been participating in its meetings of Board of Directors, Working Groups etc. and has now been given the status of a permanent member of IIFM.

Some of the working groups of IIFM where SBP has representation include the following:

- ISDA/IIFM Islamic Derivative Master Agreement.
- Master Agreement for Islamic Treasury Murabaha Financing.
- Islamic Liquidity Management - Universal Issues.

### 11.1.3 Islamic Research and Training Institute (IRTI)

The Islamic Research and Training Institute (IRTI) was established in 1401H (1981G) to undertake research and provide training and information services in the member countries of the Islamic Development Bank and Muslim communities in non-member countries to help bring their economic, financial and banking activities into conformity with Shariah and to further economic development and cooperation amongst them.

Islamic Banking Department is working to leverage out IRTI's platform for the promotion of Islamic banking industry in Pakistan. Avenues like arranging/sponsoring International Conferences including video-conferencing etc. jointly with Islamic Development Bank/Islamic Research & Training Institute are utilized so as to contribute towards achieving the task of capacity building of the industry.

SBP and IRTI have jointly scheduled "The 3rd Third International Conference on Islamic Banking and Finance: Risk Management, Regulation and Supervision" at Pakistan during the last quarter of 2008. The conference would be held alongside IFSB Annual Events. This would attract around 120-150 prestigious participants locally and all around the globe.

Further, IBD of SBP is working on a proposal to hold international Sukuk conference with the coordination with IRTI. IBD has also planned to capitalize IRTI forum on account of capacity building at SBP level through study tours and attachment programs.

#### **11.1.4 Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)**

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is an international Islamic infrastructure organization that prepares accounting, auditing, governance, ethics and Shariah standards for Islamic financial institutions and the industry.

Apart from developing standards and encouraging their application at various jurisdictions, AAOIFI continues to organize key conferences on regulatory and Shariah issues. SBP joined AAOIFI during the last quarter of 2007. SBP is currently working on the adoption/adaptation of various AAOIFI Shariah Standards in its market and further plans to capitalize AAOIFI's platform for the promotion and strengthening of regulatory and Shariah regime of local Islamic banking industry.

#### **11.1.5 Other Initiatives**

SBP has been actively collaborating with central banks of other countries like Malaysia, Bahrain and Indonesia. In this regard MOUs have been signed with central banks of Malaysia and Bahrain for the promotion of Islamic banking, for coordination in different areas including supervision, training and sharing of technical expertise.

SBP has also supported a number of international events organized in Pakistan such as:

- November 07-08, 2006 – "Positioned for Growth" Second Pakistan Islamic Banking and Money Market Conference.
- January 24-25, 2007 - The "Islamic Financial Markets Conference & Specialized Workshops".

These conferences were attended by officials from central banks of several countries, industry experts and practitioners, corporate, investors, Shariah Scholars, financial institutions as well as academics. In these events, the need for well-developed and transparent Islamic capital and money markets was stressed.

SBP realizes the need to further improve coordination with the abovementioned and other multilateral institutions like IsDB, ADB etc and with the different Central Banks, in order to strengthen the Islamic Banking Industry in Pakistan. This would also help in attracting more Foreign

Investment in the country because active support from these institutions would play a catalytic role in the confidence building at international level.

## ***11.2 Internal Linkages***

### **11.2.1 Joint Forum of SBP and Securities & Exchange Commission of Pakistan on Islamic Financial Industry**

In recognition of the relevance of a cross sectoral approach towards the rapidly growing Islamic Financial Sector of Pakistan (IFSI), State Bank of Pakistan and Securities & Exchange Commission of Pakistan (SECP) felt the need for providing requisite emphasis to resolution of issues that entail harmonized regulatory and supervisory approach. In order to ensure adoption of a more effective mechanism for coordinating efforts on various cross-sectoral issues recently a Joint Forum comprising officials from both sides has been constituted. These efforts aim to focus on facing of common risks across sectors not only through the sharing of information, but also through the harmonization of prudential and market conduct rules and the adoption of consistent Shariah governance framework.

### **11.2.2 Coordination with ICAP, FBR, MoF etc.**

SBP has been active in interacting with such stakeholders that have key role to play in helping the industry resolve its various issues. There is a process in place that is comprehensive and provides the necessary groundwork to all the relevant government departments concerned to enable them execute their part of the change in rules.

This process consists of a forming a committee at Institute of Chartered Accountants of Pakistan (ICAP) that determines the accounting treatment of Islamic transaction modes. Based on the accounting treatment, changes needed in the tax rules at Federal Board of Revenue (FBR) to provide same effective taxation treatment to Islamic transactions as that provided to conventional transactions, are identified. These changes and the detailed rationale are then provided to all the relevant government departments. Follow up is maintained with these institutions by SBP till the rules are changed.

Similarly close coordination with Ministry of Finance (MoF) is carried out for addressing issues like liquidity management. SBP provides all the technical details and expertise required for structuring the instruments and makes necessary presentations to the ministry for sorting out the matter at an early stage.

## 12. Chronology of Policy Announcements

### **BPD Circular No. 01 dated January 1, 2003**

#### **Policies for Promotion of Islamic Banking**

In order to promote Islamic Banking in Pakistan, State Bank followed a three-pronged strategy as under:

- I) Establishment of full-fledged Islamic bank(s) in the private sector;
- II) Setting up of subsidiaries for Islamic Banking by existing commercial banks; and
- III) Allowing Stand-alone branches for Islamic banking in the existing commercial banks.

In line with Part-I of this strategy, on 1st December, 2001, State Bank of Pakistan had already issued detailed criteria for setting up of Scheduled Islamic Commercial banks based on Shariah Principles in the Private Sector in the form of a Press Release which was reproduced as Annexure-I to this circular.

As regards Part-II of this strategy, in terms of Banking Companies (Amendment) Ordinance, 2002 notified in the Gazette of Pakistan dated November 4, 2002, inter alia, a new clause (aa) was inserted in sub-section (1) of section 23 of the Banking Companies Ordinance as follows:

(aa) the carrying on of banking business strictly in conformity with the Injunctions of Islam as laid down in the Holy Quran and Sunnah”

Therefore, the scheduled commercial banks were allowed to open subsidiaries for Islamic Banking operations. Accordingly, a Detailed Criteria for setting up of Islamic Banking Subsidiaries by existing Commercial Banks was prepared which was enclosed as Annexure-II to the circular.

For Part-III of this strategy, Guidelines for opening of Stand-alone branches for Islamic banking by existing commercial banks, enlisting Eligibility Criteria, Licensing Requirements and other operational guidelines on the subject were prepared and enclosed as Annexure-III to the circular.

Those parties interested in establishing Scheduled Islamic Commercial Banks in the Private sector, Subsidiaries or Stand alone branches for Islamic banking, were advised to apply to the Director, Banking Policy Department, State Bank of Pakistan, I.I. Chundrigar Road, Karachi in line with the above-mentioned policies.

### **IBD Circular No. 2 dated April 29, 2004**

#### **Minimum Shariah Regulatory Standards**

In order to promote Islamic Banking in Pakistan it had become necessary that Guidelines issued vide BPD Circular # 1 dated 1st January, 2003 be modified and a uniform policy pertaining to minimum Shariah regulatory standards for Islamic Banks, Islamic Banking Subsidiaries and Islamic Banking Branches be issued.

The minimum Shariah regulatory standards and the “Fit and Proper Criteria” framed for selection of the Shariah Advisor, duly approved by the SBP Shariah Board, were incorporated in the Guidelines and attached as Annexures I, II, III and IV to this Circular. Banks carrying out



Islamic banking operations were asked to enforce the Fit and Proper Criteria positively by 30th June, 2004 and those who wished to start such operations as laid down in the guidelines were required to follow the instructions in both letter and spirit.

**IBD Circular Letter No. 1 dated 1st June, 2004**

**Essentials and Model Agreements for Islamic Modes of Financing**

The State Bank of Pakistan had placed on April 16, 2004 the Essentials and Model Agreements for Islamic Modes of Financing on its Website [www.sbp.org.pk/press/Essentials/Essentials-Mod-Agreement.htm](http://www.sbp.org.pk/press/Essentials/Essentials-Mod-Agreement.htm) to invite suggestions and comments from banks, Shariah scholars, chambers of commerce and industry, business community, universities and the general public.

As the Essentials and Model Agreements were to serve as the standard documents for the State Bank as also the commercial banks, they had to be finalized as soon as possible in the light of suggestions/comments received from various stakeholders. Therefore, July 31, 2004 was fixed as the cut-off date for receipt of comments to enable the State Bank to finalize relevant regulations at the earliest.

**IBD Circular No. 3 dated October 26, 2004**

**Fit And Proper Criteria For Shariah Advisors**

In order to facilitate the Islamic banking institutions, the Shariah Board of State Bank of Pakistan revised the Fit and Proper Criteria for Appointment of Shariah Advisors.

Accordingly, it was decided to replace Fit and Proper Criteria as well as Form-SAP circulated earlier, vide IBD Circular No.2 dated 29th April, 2004.

**IBD Circular Letter No. 01 /2006 dated May 05, 2006**

**Submission of Returns to IBD**

Islamic Banking Institutions were advised to submit a copy of the following returns to Islamic Banking Department as well.

Returns	Reference: BSD Circular No
Weekly Statement of Position	4 of July 16, 2005
Quarterly Report of Condition	12 of December 30, 2003
Half yearly/Quarter Ended Financial Statement	01 of January 07, 2004
Annual Accounts	01 of January 07, 2004

Timelines and all other terms and conditions for submitting these returns remained the same as per above-mentioned circulars (as amended from time to time).

**IBD Circular No. 01 dated March 5, 2007**

**Salient Features of Products and Services**

It was decided that before launching new products and services, IBIs shall submit salient features of the products as per prescribed format along with Certificate from their Shariah Advisor to the Director Islamic Banking Department, State Bank of Pakistan.

Further, all IBIs were advised to submit information about each of their existing outstanding products and services as per said format by not later than 31st March, 2007.

**IBD Circular No. 02 dated March 20, 2007**

**Fit and Proper Criteria for Shariah Advisors**

In supersession of IBD Circular No.3 dated October 26, 2004 a revised 'Fit and Proper Criteria for Shariah Advisors of Islamic Banking Institutions' and SAP-Form were introduced.

All IBIs desiring to appoint a Shariah Advisor for related evaluation and submission of information to SBP for prior clearance were advised to use the prescribed guidelines/formats.

In terms of the revised criteria, inter alia, Shariah Advisor shall not hold any executive/non-executive position in any other financial institution, except working as Shariah Advisor of Islamic mutual funds of the same IBI. In case Shariah Advisor of an IBI was already working on some executive/non-executive position in any other financial institution, except as Shariah Advisor of Islamic mutual funds of the same IBI, the position was advised to be regularized within a period of 6 months thereof by relinquishing either of the posts.

Moreover, Shariah Advisors of all IBIs have been advised to sign a declaration (on a prescribed format) before assuming office.

**IBD Circular Letter No. 02 dated May 28, 2007**

**Submission of Returns to Islamic Banking Department**

IBs & IBBs were advised to discontinue the submission of hard copy of Weekly Statement of Position to Islamic Banking Department and submit the soft copy (on enclosed format) at [ibd.reporting@sbp.org.pk](mailto:ibd.reporting@sbp.org.pk) with effect from June 02, 2006.

Further IBs/ IBBs were advised to submit a Monthly Statement of Position, on prescribed format in both soft and hard copy version.

**IBD Circular Letter No. 03 of 2007 dated July 2, 2007**

**Islamic Financial Accounting Standard-1 (IFAS-1) Murabaha**

With reference to :

- a) SRO No 865(I)/2005 dated August 24, 2005 issued by SECP on captioned subject, in terms of which Islamic Financial Institutions were required to disclose Murabaha transactions at amortized cost.
- b) BSD Circular No 4 of 2006 dated February 17, 2006, where banks were advised to prepare the Annual Audited Accounts on revised formats.

Some Islamic Banking Institutions sought guidance whether they should prepare Quarterly Report of Condition as per requirement of IFAS1-Murabaha. It was clarified that as per Accounting Polices of QRC, banks are required to follow the same polices as used in preparation of Annual Audited Accounts. Therefore Islamic Banking Institutions were advised that with effect from quarter ending on September 30, 2007, QRC would be prepared following the Islamic Financial Accounting Standard -1 "Murabaha".

**IBD Circular No. 03 of 2007 dated August 11, 2007**  
**DIRECTIVE UNDER SECTION 41 OF BCO, 1962**

It was noted that some banks were marketing their products by using the name of Islamic or Shariah compliant modes of financing without obtaining an Islamic banking license from State Bank of Pakistan. Such products often do not comply with the 'Essentials of Islamic Modes of Financing' issued by SBP notwithstanding the fact that such product offerings violate regulations and guidelines in force.

Therefore all banks not authorized by issuance of an Islamic banking license from SBP were directed under Section 41 of the Banking Companies Ordinance, 1962, not to offer products in the name of Shariah compliant products and services without first obtaining an Islamic banking license from SBP in terms of IBD Circular No. 2 of 2004 as amended from time to time.

Furthermore, any recoveries made or penalties imposed by banks from their clients in excess of originally agreed pricing under the purported Shariah compliant products, were also to be forthwith refunded to respective customers within 15 days of the circular with confirmation in writing of the same to Director, Islamic Banking Department.

**IBD Circular No. 04 of 2007 dated August 16, 2007**  
**Fit And Proper Criteria For Shariah Advisors**

For the purpose of Fit & Proper Criteria for Shariah Advisors, Takaful companies were included in the definition of financial institutions.

The period by which Shariah Advisors were required to regularize their position, was extended till June 30, 2008. Accordingly Shariah Advisors working for an IBI and holding any executive/non-executive position in any other financial institution, except as Shariah Advisor of Islamic mutual funds of the same IBI, were required to regularize the position and relinquish either of the posts by June 30, 2008.

**IBD Circular No. 05 of 2007 dated September 10, 2007**  
**Guidelines for Islamic Microfinance Business**

With the growing popularity of Islamic Banking in the country, it was deemed necessary to provide options for provision of Islamic microfinance services by microfinance and commercial banks as well as allowing full fledged Islamic microfinance banks in the country.

Accordingly, State Bank of Pakistan formulated guidelines for provision of Islamic microfinance products and services by financial institutions. These guidelines are aimed at broadening the coverage of microfinance products and services to low income segments of the society in a Shariah compliant manner. These guidelines stipulate four types of institutional arrangements for offering Islamic microfinance viz:

1. Establishing Full Fledged Islamic Microfinance Banks (IMFBs)
2. Islamic Microfinance Services by Full-fledged Islamic Banks
3. Islamic Microfinance Services by Conventional Banks
4. Islamic Microfinance Services by Conventional Microfinance Banks (MFBs)

The criterion mentioned in these guidelines is in addition to the requirements already issued by SBP under respective category of financial institutions. These regulations and guidelines, by any means, do not replace the regulations and guidelines already issued by SBP from time to time in this area.

Commercial and microfinance banks interested in building Islamic microfinance portfolio have been advised to review the different institutional/organizational arrangements and select, one or the combination of more than one mode, based on their organization structure, capacity and overall objectives.

**IBD Circular Letter No. 04 of 2007 dated October 29, 2007**

**Submission of Returns to Islamic Banking Department**

Since data of Weekly Statement of Position (WSP) was fully captured by RCOA / DAG, therefore IBs were advised to discontinue the submission of soft copy of Weekly Statement of Position by e-mail with effect from November 03, 2007. Moreover, deadline to submit the data through RCOA / DAG was advised to be two working days following respective weekend as also advised vide BSD Circular No. 4 of 2005 dated July 16, 2005. All other instructions on the subject remained unchanged.

**IBD Circular No.06 of 2007 dated November 10, 2007**

**Information about Islamic Banking Windows**

In terms of Para 10(v) of Annexure III to IBD Circular No.2 of 2004, banks having Islamic Banking Branches (IBBs) may authorize some of their branches to sell Islamic banking deposit schemes in order to efficiently utilize the existing branch network provided they comply with conditions mentioned therein.

Keeping in view the growing trend among banks to open Islamic Banking windows and to strengthen the regulatory framework and maintain information about window operations, all conventional banks having IBs were advised to submit to Islamic banking department following information before start of each Islamic banking window operations: -

- Details of products & services to be offered in IB window
- Details of systems and controls put in place in compliance with IBD Circular No. 2 of 2004.
- Commission/fee arrangement with authorized branch.
- Details about training of Human Resource in Islamic Banking.
- Contact details of Islamic Banking Window

Further, consolidated information about Islamic banking window shall be submitted to the Director Islamic Banking Department, State Bank of Pakistan along with Quarterly Report of Conditions as per the prescribed format w.e.f. quarter ending 31st December, 2007.

**IBD Circular Letter No. 05 of 2007 dated November 29, 2007**

**Declaration of Weightages & Profit Sharing Ratios**

The weightages & Profit sharing ratios are used by Banks to calculate distribution of profit as per the requirements of Shariah covering Islamic Banking. It was being observed that only few Institutions offering Islamic Banking were regularly updating weightages & Profit sharing ratios, before beginning of the period concerned, on their websites; which was not an encouraging situation. Therefore all Institutions offering Islamic Banking were advised to make sure that relevant weightages and ratios are updated regularly, before start of the period concerned, keeping in view the following minimum standards:

1. Weightages & Profit sharing ratios must be made available to all constituents before beginning of the period concerned. The weightages & Profit sharing ratios must be available on website.

2. The statement declaring weightages & Profit sharing ratios must at the minimum contain date of declaration, period for which they remain effective, all categories/pools & bank's equity share and their weightage, types, sizes, tiers of accounts and actual rates paid during the preceding period.

3. The Statement of weightages & Profit sharing ratios must be prominently displayed in all Islamic Banking Branches.

All Islamic Banking Institutions were advised to update the weightages & Profit sharing ratios on their websites within 7 days from issuance date of this Circular Letter.

#### **IBD Circular No. 01 dated January 02, 2008**

##### **Risk Management Guidelines for Islamic Banking Institutions**

The State Bank of Pakistan formulated Risk Management (RM) Guidelines for Islamic Banking Institutions (IBIs) with a view to further strengthen the regulatory framework in the area of risk management for IBIs.

These RM Guidelines are based on a 'Guiding Principles of Risk Management for Institutions offering Islamic Financial Services' issued by Islamic Financial Services Board (IFSB), which is an international-standard setting body of regulatory and supervisory agencies and the same have been tailored keeping in view the regulatory regime of State Bank of Pakistan. However, these guidelines are in addition to the various Risk Management Guidelines issued by SBP from time to time and IBIs will be required to comply with both set of guidelines.

These guidelines provide a set of principles of best practice for establishing and implementing effective risk management in IBIs. These guidelines set out fifteen principles of risk management and provide guidance for each category of risk, drawn from discussion on Islamic Financial Industry practices. Further, these set of principles are applicable to the six categories of risks viz: Credit risk, Market risk, Liquidity risk, Operational risk, Equity investment risk and Rate of return risk. For each type of risk, Risk management practices have been discussed giving examples of specific Islamic banking modes of financing and according to various roles that an Islamic Banking Institution may perform.

These guidelines further complement and enhance the current Risk Management regime of SBP by identifying and suggesting technique to manage various types of risks unique to Islamic Banking Institutions.

Most of the IBIs in Pakistan being new entrants in the market, they have been encouraged to put in place an effective risk management strategy right from the start based on the said guidelines as well as other guidelines issued by SBP. These guidelines are flexible in the sense that IBIs can adapt them in line with the size and complexity of their business.

#### **IBD Circular Letter No. 01 dated February 27, 2008**

##### **Submission of Information regarding Sukuk Issued in Pakistan**

All Islamic banking institutions (IBIs) i.e. Islamic banks and conventional banks having Islamic banking branches were advised to provide information regarding the issuance of those Sukuk where the IBI concerned is involved as an issuer or a lead arranger. The said information will be sent, as a footnote to the Quarterly Report of Condition, to Islamic banking department as per

prescribed format.

**IBD Circular No. 02 dated March 25, 2008**

**Instructions and guidelines for Shariah compliance in Islamic banking institutions**

In order to ensure effective Shariah compliance in the Islamic banking industry and maintain trust of the depositors and other stakeholders on the system, a proper Shariah compliance mechanism has been put in place by SBP.

In pursuance of its goal to further strengthen the Shariah compliance framework in the Islamic banking industry, 'Instructions and Guidelines for Shariah Compliance' were finalized in consultation with various stakeholders which were also reviewed and approved by the SBP Shariah Board. These Instructions and Guidelines for Islamic Banking Institutions (IBIs) are in addition to current Prudential Regulations, guidelines and other circulars and directives issued by different departments of SBP and have not replaced them by any means, unless specifically mentioned otherwise.

The 'Instructions for Shariah compliance in IBIs' cover various areas related to appointment, removal and working of Shariah Advisors; conflict resolution in Shariah rulings; Shariah compliant modes; use of charity fund, introduction of new products and services and schedule of service charges etc. The essentials of Islamic modes of financing, earlier issued by SBP through a press release on April 15, 2005, have now been augmented and made part of these instructions and appended as Appendix-A thereto.

Furthermore, in exercise of the powers conferred by clause (o), subsection (1) of section 7 of Banking Companies Ordinance, 1962, State Bank of Pakistan through these Instructions has specified Shariah-compliant modes of banking and finance for IBIs. Annexure-I of BCD Circular No.13 dated 20th June, 1984 stands replaced by section 'E' of these instructions insofar as it relates to IBIs.

Further, as the requirements of IBD Circular No. 1 dated March 05, 2007 have been made a part of these Instructions, therefore the said circular stands withdrawn.

The 'Guidelines for Shariah compliance in IBIs' are meant for providing guidance in areas like Shariah compliance, internal Shariah audit, investment in shares, policy for profit distribution with PLS account holders and financial reporting and general disclosure etc. Necessary flexibility has been provided in these guidelines and IBIs can set up the suggested systems and procedures keeping in view the size and scope of their operations. These guidelines have been issued on "comply or explain basis" and IBIs shall record reasons in writing for non-compliance with any of these guidelines.

## 13. List of Tables & Figures

<b>Table 8.1</b>	Shariah Compliant Modes of Banking and Finance
<b>Table 9.1</b>	Industry Progress and Market Share in Brief
<b>Table 9.2</b>	Islamic Banking (Balance Sheet) Market Share-December 2007
<b>Table 9.3</b>	Province Wise Breakup of Islamic Banking Branch Network
<b>Table 9.4</b>	City Wise Breakup of Islamic Banking Branch Network
<b>Table 9.5</b>	Bank Wise Position of Islamic Banking Branches
<b>Table 9.6</b>	Deposits and Other Accounts
<b>Table 9.7</b>	Sector Wise Break up of Financing and Share in Total
<b>Table 9.8</b>	Sources and Uses of Funds
<b>Table 9.9</b>	Capital Adequacy Ratio
<b>Table 9.10</b>	Some key Indicators
<b>Table 9.11</b>	Earning Assets as Percentage of Total Assets
<b>Table 9.12</b>	Income Statement
<b>Table 9.13</b>	Mode Wise Asset Side Offerings
<b>Table 9.14</b>	Mode Wise Liability Side Offerings
<b>Figure 9.1</b>	Year Wise Entry of Players
<b>Figure 9.2</b>	Growth in the Branch Network of Islamic Banking Industry
<b>Figure 9.3</b>	Assets
<b>Figure 9.4</b>	Bank Wise Share of Assets
<b>Figure 9.5</b>	Deposits
<b>Figure 9.6</b>	Bank Wise Share of Deposits
<b>Figure 9.7</b>	Trends of Deposit Structure & Customers Vs Financial Institutions Deposits
<b>Figure 9.8</b>	Financing
<b>Figure 9.9</b>	Bank Wise Share of Financing
<b>Figure 9.10</b>	Mode Wise Breakup of Financing Trend
<b>Figure 9.11</b>	Mode Wise Breakup of Financing - 2007
<b>Figure 9.12</b>	Investments
<b>Figure 9.13</b>	Bank Wise Share of Investments
<b>Figure 9.14</b>	Sources of Funds
<b>Figure 9.15</b>	Uses of Funds

## 14. Glossary of Islamic Finance Terms

**Gharar:** It means any element of uncertainty in any business or contract about the subject of contract or its price, or mere speculative risk. It leads to undue loss to a party and unjustified enrichment of other, which is prohibited.

**Hawalah:** Literally, it means transfer; legally, it is an agreement by which a debtor is freed from a debt by another becoming responsible for it, or the transfer of a claim of a debt by shifting the responsibility from one person to another – contract of assignment of debt. It also refers to the document by which the transfer takes place.

**Hibah:** Hibah means Gift.

**Ijarah:** Letting on lease; Sale of a definite usufruct of any asset in exchange of definite reward. It refers to a contract of land leased at a fixed rent payable in cash and also to a mode of financing adopted by Islamic banks. It is an arrangement under which the Islamic banks lease equipments, buildings or other facilities to a client, against an agreed rental.

**Ijarah-wal-Iqtina':** A mode of financing adopted by Islamic banks. It is a contract under which the Islamic bank finances equipment, building or other facilities for the client against an agreed rental together with a unilateral undertaking by the bank or the client that at the end of the lease period, the ownership in the asset would be transferred to the lessee. The undertaking or the promise does not become an integral part of the lease contract to make it conditional. The rental as well as the purchase price are fixed in such a manner that the bank gets back its principal sum along with some profit, which is usually determined in advance.

**'Inah (A kind of Bai):** Double sale by which the borrower and the lender sell and then resell an object between them, once for cash and once for a higher price on credit.

**Istisna'a:** It is a contractual agreement for manufacturing goods and commodities, allowing cash payment in advance and future delivery or a future payment and future delivery. Istisna'a can be used for providing the facility of financing the manufacture or construction of houses, plants, projects, and building of bridges, roads and highways.

**Maisir:** An ancient Arabian game of chance played with arrows without heads and feathering, for stakes of slaughtered and quartered camels. It came to be identified with all types of hazard and gambling.

**Mudarabah:** A form of partnership where one party provides the funds while the other provides expertise and management. The former is called Rabul Maal and the latter is referred to as the Mudarib. Any profits accrued are shared between the two parties on a pre-agreed basis, while loss is borne by the provider of the capital.

**Murabaha:** Literally it means a sale on mutually agreed profit. Technically, it is a contract of sale in which the seller declares his cost and profit. This has been adopted by Islamic banks as a mode of financing. As a financing technique, it involves a request by the client to the bank to purchase a certain item for him. The bank does that for a definite profit over the cost which is settled in advance.



**Musawamah:** Musawamah is a general kind of sale in which price of the commodity to be traded is bargained between seller and the purchaser without any reference to the price paid or cost incurred by the former.

**Musharakah:** Musharakah means a relationship established under a contract by the mutual consent of the parties for sharing of profits and losses in the joint business. It is an agreement under which the Islamic bank provides funds which are mixed with the funds of the business enterprise and others. All providers of capital are entitled to participate in management, but not necessarily required to do so. The profit is distributed among the partners in pre-agreed ratios, while the loss is borne by each partner strictly in proportion to respective capital contributions.

**Qard:** Legally Al-Qard means lending of a fungible object, such as money, by someone to another person, on condition that the borrower is responsible to return the same object at any specified time. Loaning in Islam is a voluntary and gratuitous act and cannot carry any return over the loan given. The repayment of loan is obligatory. The Holy Prophet (PBUH) is reported to have said “.....Every loan must be paid.....”. But if a debtor is in difficulty, the creditor is expected to extend time or even to voluntarily remit the whole or a part of the principal.

**Qimar:** Qimar means gambling. Technically, it is an arrangement in which possession of a property is contingent upon the happening of an uncertain event. By implication it applies to a situation in which there is a loss for one party and a gain for the other without specifying which party will lose and which will gain.

**Riba:** An excess or increase. Technically, it means an increase over principal in a loan transaction or in exchange for a commodity accrued to the owner (lender) without giving an equivalent counter-value or recompense (‘iwad) in return to the other party; every increase which is without an ‘iwad or equal counter-value.

**Riba Al-Fadl:** Riba Al-Fadl (excess) is the quality premium in exchange of low quality with better quality goods e.g. dates for dates, wheat for wheat, etc. – an excess in the exchange of Ribawi goods within a single genus. The Concept of Riba Al-Fadl refers to sale transactions while Riba Al-Nasiah refers to loan transactions.

**Riba Al-Nasiah:** Riba Al-Nasiah or riba of delay is due to exchange not being immediate with or without excess on one of the counter values. It is an increment on principal of a loan or debt payable. It refers to the practice of lending money for any length of time on the understanding that the borrower would return to the lender at the end of the period the amount originally lent together with an increase on it, in consideration of the lender having granted him time to pay. Interest, in all modern banking transactions, falls under purview of Riba Al-Nasiah. As money in present banking system is exchanged for money with excess and delay, it falls, under the definition of riba. A general accord reached among scholars about its prohibition.

**Al- Rahn:** Pledge, Collateral; legally, Rahn means to pledge or lodge a real or corporeal property of material value, in accordance with the law, as security, for a debt or pecuniary obligation so as to make it possible for the creditor to recover the debt or some portion of the goods or property.

**Shariah:** The term Shariah refers to divine guidance as given by the Holy Qur’an and the Sunnah of the Prophet Muhammad (PBUH) and embodies all aspects of the Islamic faith, including beliefs and practice.

**Shirkah:** A contract between two or more persons who launch a business or financial enterprise to make profits. In the conventional books of Fiqh, the partnership business has been discussed under the option of Shirkah that, broadly, may include both Musharakah and Mudarabah.

**Sunnah:** Custom, habit or way of life. Technically, it refers to the utterances of the Prophet Muhammad (PBUH) other than the Holy Quran known as Hadith, or his personal acts, or sayings of others, tacitly approved by the Prophet (PBUH).

**Salam:** Salam means a contract in which advance payment is made for goods to be delivered later on. The seller undertakes to supply some specific goods to the buyer at a future date in exchange of an advance price fully paid at the time of contract. According to normal rules of the Shariah, no sale can be effected unless the goods are in existence at the time of the bargain, but Salam sale forms an exception given by the Holy Prophet (SAW) himself to the general rule provided the goods are defined and the date of delivery is fixed. It is necessary that the quality of the commodity intended to be purchased is fully specified leaving no ambiguity leading to dispute. The objects of this sale are goods and cannot be gold, silver or currencies because these are regarded as monetary values exchange of which is covered under rules of Bai al Sarf. Barring this, Salam covers almost everything which is capable of being definitely described as to quantity, quality and workmanship.

**Sukuk:** Plural of 'Sakk', which refers to a financial paper showing entitlement of the holder to the amount of money shown on it. The English word "cheque" has been derived from it. Technically, Sukuk are financial instruments entitling their holders to some financial claims.

**Takaful:** An equivalent to the contemporary insurance contract whereby a group of persons agree to share a certain risk (for example, damage by fire) by collecting a specified sum from each. In case of loss to any one of the group, the loss is met from the collected funds.

**Tabarru':** Any benefit that is given by a person to other without getting anything in exchange is called Tabarru'. Gracious repayment of debt, absolutely at lender's own discretion and without any prior condition or inducement for reward, is also covered under Tabarru'. Repaying a loan in excess of principal and without a pre-condition is commendable and compatible with the Sunnah of the Holy Prophet (peace be upon him). But, it is matter of individual discretion and cannot be adopted as a system because this would mean that loan would necessarily yield a profit. If such reward takes the form of a system, it would be considered Riba.

**Wakalah:** A contract of agency.

## ***ANNEXURE-A: Brief Background of the Full Fledged Islamic Banks***

### **1. Meezan Bank**

In 2002 the first Islamic banking license was issued to Meezan Bank by the State Bank of Pakistan. Societe Generale', a French commercial bank, operations in Pakistan was acquired by Meezan Bank and concurrently Al Meezan Investment Bank converted itself into a full fledged Islamic commercial bank. The new bank was renamed Meezan Bank Limited. Notable shareholders of the bank include Pak Kuwait Investment Company, Shamil Bank of Bahrain, Noor Financial Investment Company and Islamic Development Bank. In 2005 Meezan Bank launched the Meezan Islamic Institution Deposit Account (MIIDA), a unique product tailored exclusively for Islamic Financial Institutions (IFIs). The facility was the first of its kind in Pakistan, whereby Islamic Banks (including dedicated, as well as conventional banks' Islamic branches) got the opportunity to manage excess liquidity by maintaining a checking account with Meezan Bank specifically designed for this purpose.

### **2. AlBaraka Islamic Bank B.S.C. (E.C.)**

AlBaraka Islamic Bank Pakistan (AIB) has been operating in the country through branches of AlBaraka Islamic Bank, Bahrain since 1991. AlBaraka Islamic Bank operates under the auspices of the Bahrain-based AlBaraka Banking Group (ABG), which is a leading contributor of Islamic banking, investment and treasury services. The bank is second oldest Islamic bank in Pakistan after it was awarded an Islamic banking license under the current licensing regime issued for Islamic banking institutions.

### **3. BankIslami Pakistan Limited**

BankIslami started its commercial operations in April, 2006. The founding shareholders of BankIslami are Randeree family of the DCD Group, UK, Dubai Bank, U.A.E and Jahangir Siddiqui and Company Limited, Pakistan. Approximately 30% of the bank's branch network is in rural areas. In 11 Cities, BankIslami is the first Islamic Bank to starts operations. The Bank is said to have the distinction of being the 1st Bank in Pakistan and 2nd worldwide to have used 'Biometric' technology in ATMs.

### **4. Dubai Islamic Bank Pakistan Limited (DIB)**

Dubai Islamic Bank Pakistan Limited started its operations in the year 2006. DIB is a wholly owned subsidiary of the Dubai Islamic Group headquartered in UAE. The Group has maintained its status quo as the undisputed market leader in Islamic financing since its inception in 1975. Dubai Islamic Bank also has the honorable distinction of being the first Islamic bank in the world.

The Bank has launched Pakistan's first Islamic Visa Debit Card. Besides regular banking services, the Bank aims at bringing foreign investment to the country. DIB's corporate wing has actively pursued foreign investors and convinced world renowned giants from the GCC to be part of Pakistan's economy.

### **5. Dawood Islamic Bank Limited**

Dawood Islamic Bank Limited is the result of an initiative of the First Dawood Group who teamed up with Islamic Corporation for the Development of the Private Sector (ICD) Jeddah, Unicorn Investment Bank - Bahrain, Al Safat Investment Company - Kuwait, Gargash Enterprises (LLC) - Dubai, Mr. Azam Essof Kolia - a Singapore based entrepreneur and Shaikh Abdullah Mohammad Al-

Romaizan, an entrepreneur from the Kingdom of Saudi Arabia. The bank started its operations in the year 2007.

In addition to the standard and innovative products in retail and corporate banks, the bank is said to be focused on the growing segment of importers and exporters that are reluctant of utilizing bank financing with the fear of breaching Islamic laws as defined in the Holy Qur'an and Sunnah. This segment is still substantially untapped, even by existing Islamic Financial Institutions hence it is said to be the core focus of the Bank's marketing strategy.

#### **6. Emirates Global Islamic Bank Limited**

Emirates Global Islamic Bank Limited which started operations in the year 2007 is backed by leading investors from United Arab Emirates and Saudi Arabia. The sponsoring shareholder of the bank, Emirates Investments Group (EIG) LLC is an investment company in the United Arab Emirates. Sheikh Tariq Bin Faisal Al Qassimi, a member of the ruling family of Sharjah, is the Chairman and co-founder of Emirates Investments Group.

EIG has setup ENSHAANLC, a high quality property development company which is a joint venture with National Logistics Cell (NLC) for development of the Karachi Financial Towers, a state of the art commercial complex on I. I. Chundrigar Road, Karachi. Other major investments of the group in Pakistan include Trust Securities and Brokerage Limited (TSBL), which is a brokerage firm based in Lahore. The other major shareholder of Emirates Global Islamic Bank Limited is Al Rajhi family of Saudi Arabia. This group is also a major shareholder in the Al Rajhi Bank of Saudi Arabia which is the largest Islamic bank in the world with assets over SAR 100 Billion.

## ***ANNEXURE-B: Fifteen Principles of Best Practice for Establishing and Implementing Effective Risk Management in IBIs***

### **1. General Requirement:**

Principle 1.0: IBIs shall have in place a comprehensive risk management and reporting process, including appropriate board and senior management oversight, to identify, measure, monitor, report and control relevant categories of risks. The process shall take into account appropriate steps to comply with Shariah rules and principles and to ensure the adequacy of relevant risk reporting to the supervisory authority.

### **2. Credit Risk:**

Principle 2.1: IBIs shall have in place a strategy for financing, using various instruments in compliance with Shariah, whereby they recognize the potential credit exposures that may arise at different stages of the various financing agreements.

Principle 2.2: IBIs shall carry out a due diligence review in respect of counterparties prior to deciding on the choice of an appropriate Islamic financing instrument.

Principle 2.3: IBIs shall have in place appropriate methodologies for measuring and reporting the credit risk exposures arising under each Islamic financing instrument.

Principle 2.4: IBIs shall have in place Shariah-compliant credit risk mitigating techniques appropriate for each Islamic financing instrument.

### **3. Equity Investment Risk:**

Principle 3.1: IBIs shall have in place appropriate strategies, risk management and reporting processes in respect of the risk characteristics of equity investments, including Mudarabah and Musharakah investments.

Principle 3.2: IBIs shall ensure that their valuation methodologies are appropriate and consistent, and shall assess the potential impacts of their methods on profit calculations and allocations. The methods shall be mutually agreed between the IBIs and the Mudarib and/or Musharakah partners.

Principle 3.3: IBIs shall define and establish the exit strategies in respect of their equity investment activities, including extension and redemption conditions for Mudarabah and Musharakah investments, subject to the approval of the institution's Shariah Advisor.

### **4. Market Risk**

Principle 4.1: IBIs shall have in place an appropriate framework for market risk management (including reporting) in respect of all assets held, including those that do not have a ready market and/or are exposed to high price volatility.

## **5. Liquidity Risk:**

Principle 5.1: IBIs shall have in place a liquidity management framework (including reporting) taking into account separately and on an overall basis their liquidity exposures in respect of each category of current accounts and PLS deposits.

Principle 5.2: IBIs shall assume liquidity risk commensurate with their ability to have sufficient recourse to Shariah-compliant funds to mitigate such risk.

## **6 Rate of Return Risk:**

Principle 6.1: IBIs shall establish a comprehensive risk management and reporting process to assess the potential impacts of market factors affecting rates of return on assets in comparison with the expected rates of return for PLS deposit holders.

Principle 6.2: IBIs shall have in place an appropriate framework for managing displaced commercial risk, where applicable.

## **7. Operational Risk:**

Principle 7.1: IBIs shall have in place adequate systems and controls, including Shariah Advisor, to ensure compliance with Shariah rules and principles.

Principle 7.2: IBIs shall have in place appropriate mechanisms to safeguard the interests of all fund providers. Where PLS deposit holders' funds are commingled with the IBIs' own funds, the IBIs shall ensure that the bases for asset, revenue, expense and profit allocations are established, applied and reported in a manner consistent with the IBIs' fiduciary responsibilities.

## ***ANNEXURE-C: Salient Features of the Islamic Export Refinance Scheme***<sup>22</sup>

1. The facility is allowed only against transactions, designed on the basis of Islamic Modes of financing approved by the Shariah Advisor of the concerned bank.
2. Each Islamic bank is under obligation to create a Musharakah pool (having a minimum of 10 companies - to be achieved in first year of operations) consisting of financing to blue chip companies on Islamic modes. The blue chip companies shall mean such companies involved in the export business or other business or both, or a manufacturing concern marketing their products in Pakistan or abroad, who have:
  - i) good track record on the stock exchange or
  - ii) have a rating of minimum B + or equivalent by the rating agencies approved by the State Bank for rating banks in Pakistan, such rating should be acceptable to the bank as per its own lending policies, for advancing loans, or
  - iii) companies having Return on Equity (ROE) during last three years which should be at least higher than the rates of finance prescribed by the State Bank during those years on its conventional EFS. In case of a company which is in operation for less than three years, the ROE of the available number of years shall be considered. The Islamic Bank shall ensure that companies selected for Musharakah Pool under the above criteria does not have adverse Credit Information Bureau report as also export overdues of more than one year.
3. The State Bank will share in the overall profit (gross income less any provision created under Prudential Regulations during the period plus amount recovered against prior periods' losses and reversal of provision) earned by the Islamic bank on the Musharaka pool under the provisions of the IERS calculated on daily product basis.
4. If, on the basis of the annual audited accounts of the Islamic Bank, the profit accruing to the SBP is more than the profit paid to the SBP on quarterly basis as per un-audited accounts of earnings of the pool, the difference shall be deposited by the Islamic bank, within 7 days of its determination, in a special non remunerative reserve fund viz. "Takaful Fund" to be maintained at the office of the SBP BSC (Bank), where the head office/country office of the concerned bank is situated. This arrangement shall remain effective for all intents and purposes for the duration of the agreement.
5. If, on the basis of the annual audited accounts of the pool, the share of the State Bank in the profit works out to be less than the amount, which has already been paid to the State Bank on provisional basis, the State Bank will refund the excess amount involved out of balance held in the Takaful Fund, if any.
6. In the event of loss suffered on the Musharakah pool on the basis of annual audited accounts, the Islamic bank and the State Bank shall share the loss in the proportion of their share of investment in the Musharakah Pool expressed on daily product basis. The share of loss to State Bank will first be met out of credit balance in the Takaful Fund, if any. The loss not met from the Takaful Fund shall be borne by the State Bank.
7. In case of loss, the Islamic bank shall be entitled to claim refund on account of share of profit paid by it to SBP on provisional basis, alongwith SBP's share in the loss of principal amount extended to the Musharakah pool.

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<sup>22</sup> For detailed version of the Scheme please visit <http://www.sbp.org.pk/incentives/iers.htm>

**ANNEXURE-D: Tentative *Roll out Plan of IFSB Standards/Guidelines***

<b>S. No.</b>	<b>Name of the Working Group</b>	<b>Status</b>	<b>Roll out Date</b>
1.	Risk Management	Standard Issued	September 2007
2.	Capital Adequacy	Standard Issued	December 2008
3.	Corporate Governance	Standard Issued	June 2009
4.	Transparency and Market Discipline	Standard Issued	June 2009
5.	Supervisory Review Process	Standard Issued	June 2009
6.	Special Issues in Capital Adequacy	Under Process	Within Two years of issuance of final standard
7.	Market Conduct	Under Process	Within One year of issuance of final standard
8.	Shariah Governance	Under Process	Within One year of issuance of final standard
9.	Governance of Islamic Investment Funds	Under Process	To be implemented by SECP
10.	Corporate Governance of Takaful Operations	Under Process	To be implemented by SECP