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New Deposits; New Returns

The Islamic Finance Industry has emerged as one of the most dynamic industries in the world today. With over 300 Islamic Financial Institutions managing assets in excess of USD 300 billion, this industry is positioned to expand even more rapidly in the foreseeable future. In Pakistan too Islamic Finance Industry has illustrated substantial growth in past three years despite the country's late arrival into the arena compared to few other Muslim nations.

This report will begin by examining the robust development of Islamic Finance in recent years across the globe and the challenges and debates that continue to grip the industry. The report will then analyze the presence of Islamic Finance in Pakistan, highlighting the progress made by Islamic banks and non-bank institutions while offering recommendations to enhance the penetration of the industry further.

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A New World Order


In the past decade Islamic Finance (IF) has assumed growing significance in the global financial markets, emerging as one of the most dynamic industries. Currently there are over 300 Islamic Financial Institutions (IFIs) worldwide managing assets in excess of USD 300 billion. This industry is likely to expand more rapidly in the foreseeable future in the wake of rising oil prices which have resulted in high levels of liquidity in the Gulf and other oil producing nations. These developments have fuelled additional demand for Islamic finance and it is no surprise to witness emergence of IFIs which are much bigger in size than those established five years earlier. Furthermore the already existing IFIs are increasingly moving towards growing their equity to compete with the new generation of IFIs.

Rooted in the framework of Islamic Shariah, known as *Fiqh-al- Mualmat* (Islamic rules and principles on transactions), the IF system aims to promote economic maximization and social welfare opportunities. Among these rules are the prohibition of the paying and charging of interest (*riba*) and proscription of speculation (*gharar*). Precisely any financial remuneration earned or paid by the bank must result from the risk of investing in real economic activity and not what is considered by Islamic scholars as *passive speculation*. For this reason all Islamic financing transactions need to be backed by assets.

Since IFIs comply with the rules of Shariah they offer a distinct appeal to Muslims. However interest in this discipline has recently been extending beyond Islamic countries to non-Islamic financial institutions as well.

The level of development and interest in this industry varies across the globe with the growth in Middle East being exceptional. Bahrain has emerged as the main centre adopting and implementing Islamic banking regulation with Central Bank of Bahrain being the first to issue Sukuk and establishing centre for IF education. Iran and Sudan declared 100% conversion to Islamic banking a few years earlier. Within South East Asia, Malaysia stands out with USD 31 billion Islamic banking assets and USD 1.7 billion parked in *Takaful* industry. The country has the largest Islamic private debt market which constitutes 45.5% of its total debt market. Other countries in South East Asia have smaller Islamic financial markets with Singapore positioned to offer strong wealth management potential. While growth in Islamic finance has long been apparent in these Middle Eastern and South East Asian regions, the industry has witnessed increasing interest from South Asia, Europe, North America and the Far East.

Within South Asia, Pakistan has made its mark with its proactive and systematic stance to develop IF Industry. There are also a few non Islamic countries whose financial centers have shown increased interest in this industry. For example England now provides policy and tax incentives to promote IF industry to attract funds from high net worth clients.



Same motivation seems to have driven global banks such as HSBC, Standard Chartered, Deutsche Bank and Citibank to set up special hubs to structure and explore a wider range of Islamic financial products and services.

While the current growth in industry is at least partially driven by surge in capital from oil rich economies, Islamic banking is also rising as an alternate financing option that coexists with the conventional financial industry. Besides traditional Islamic financial products, the industry offers consumer financing for residential purposes and an Islamic credit card based on *Tawarruq* has been introduced which offers all features of a credit card, easy purchases and repayments through a series of commodity transactions. Special Purpose Vehicles have been established supporting infrastructure and housing finance projects. Product innovation is also apparent in the several different types of hybrid *Sukuks* offered and other combination of structures which involve different forms of *Musharaka* with other products. Nevertheless equity based credit products, such as *Murabaha* and *Ijara*, remain the dominant form of Islamic financing across the IFIs.

These trends are expected to persist and the industry is positioned to grow. Standard & Poor Services Rating Agency estimates that industry has a potential to grow to USD 4 trillion over the medium term.

(Appendix on pg 9 tersely defines terms common to IF literature)


Islamic Finance – Deeply Embedded in Debates and Challenges

Despite depicting strong growth across the globe the IF industry continues to face debates and challenges which are characteristic of almost all IFIs.

What is True Islamic Finance?

Since the very beginning this industry has been gripped in a continual debate on what is true Islamic finance. Several questions have been raised in this regards; How to structure better Shariah based products? Is there a real difference between Islamic and conventional products? Others observe that IF Industry exhibits greater dependence and reliance on *Murabaha* in Islamic markets which though easy to comprehend and has manageable risk is similar to non-participatory mode of financing and offers profit margins known to both client and bank. Some argue that magnitude of profit is just one aspect of Islamic banking while the Shariah compliant transaction has to fulfill other requirements as well like the existence of underlying real assets, no room for speculation, no misuse of funds for unethical or unproductive purposes.

Such debates emanate from the fact that there are number of faiths and disciplines across Muslim jurisdictions (for example Syria and Pakistan predominantly follow the *Hanafi* School, Bahrain, Dubai and Abu Dhabi follow *Maliki* School while Saudi Arabia and



Qatar draws principles from *Hanbali* school). Even within a single country there may exist followers of different schools and hence similar debates. Subsequently each faith is developing its own applications rather than pursuing harmonized views. These differences along with different interpretations of Shariah Scholars create doubts on viability of IF, confusing the general masses. They further limit the extent of product innovation and carry the risk of Shariah arbitrage which creates more complications.

It has to be recognized that IF is still in its evolutionary stage and its sustainability in the future depends critically on its ability to provide consumers with flexible and shared, if not unified, understandings on principle elements at international level, despite differences in faiths and disciplines. Hence in order to enhance public acceptability and thereby allow the industry to grow and compete on level playing field, it is important that scholars of diverse views reach a consensus and develop a more unified institutional mechanism for adoption of common Shariah standards, ensuring proper enforcement through effective internal controls for their compliance.

Liquidity – A key weakness

Liquidity has always been the most critical issue for Islamic banks. First of all, only a small secondary market exists for IFIs to manage their liquidity. Islamic banks' assets are generally not saleable in any secondary market. In addition, the interbank market is very thin for Islamic banks, which either deal with one another or develop relationships with non-Islamic financial institutions, although the latter option is limited. Indeed, Sharia prohibits entities from entering into economic transactions with others involved in *impure* businesses, including those profiting from *riba*. Finally, IFIs can neither invest in fixed income instruments for managing treasury nor rely on lenders of last resort in times of stress, as they usually rely on interest-based instruments to manage liquidity in the banking system.

In addition to the liquidity disadvantage, IFIs are facing risks of maturity mismatches. Although Islamic banks have been keen to develop longer term financing transactions (for large projects, for example), their funding profiles have remained mainly short term, as they rely on customer deposits that can be withdrawn at any time. To address this constraint, lengthening the maturity of liabilities would be a major step forward.

Conventional Banking – Always a Challenge

Islamic banks, entering the financial industry just recently, face an aggressive competition from the conventional banks given their long standing presence and market share and their predominant role as a price setter for deposits as well as advances. In an attempt to compete effectively these banks tend to align their products and pricing with the returns offered by conventional banks. Additionally full-fledged Islamic banks as per their licensing requirements have to confine themselves to Islamic businesses and products, while conventional banks with Islamic windows have inherent advantage as they can compete more aggressively offering both conventional and Islamic businesses.



Islamic Finance Industry in Pakistan – Policies and Developments

The IF Industry in Pakistan has illustrated substantial growth in recent years despite the country's late arrival into the arena compared to few other Muslim nations. Nevertheless the industry faces similar debates and challenges outlined earlier.

Thus far the regulation of IFIs is bifurcated such that Islamic banks are regulated by State Bank of Pakistan (SBP) while the non-bank IFIs, namely *Modarabas*, Islamic mutual funds and *Takaful* companies operate under the regulatory oversight of Securities and Exchange Commission of Pakistan (SECP).

Being a high priority area for the SBP, Islamic Banking has expanded considerably in Pakistan in the past three years. The SBP has been committed towards developing the Islamic banking industry to levels where it offers a viable alternative to conventional banking. In the process it has established a comprehensive regulatory framework in line with best international practices, providing innovative Shariah compliant products and services so as to achieve equitable economic growth.

As a first step for the promotion of Islamic Banking in Pakistan, the SBP has laid out the following three-pronged strategy:

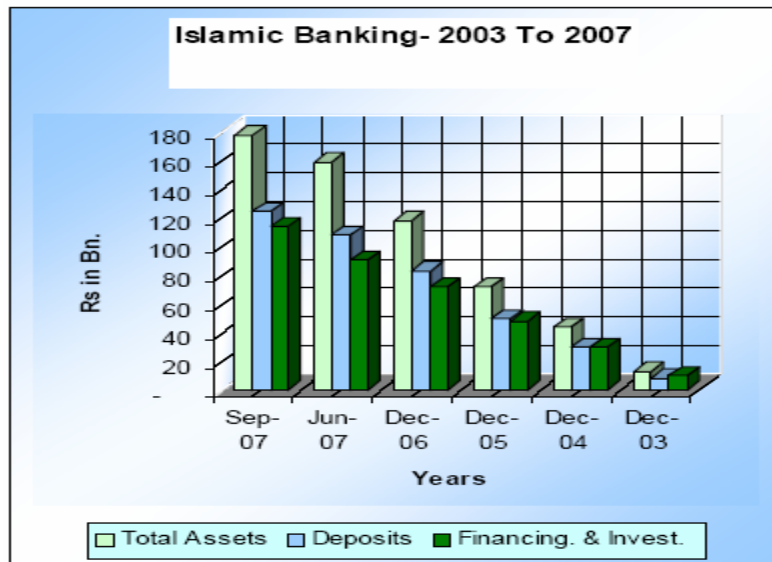
1. Establishment of full-fledged Islamic bank(s) in the private sector
2. Setting up of subsidiaries for Islamic Banking by existing commercial banks; and
3. Allowing stand-alone branches for Islamic banking in the existing commercial banks

Furthermore in view of the equity based nature of Islamic banking and lack of Shariah compliant financial instruments, SBP has allowed Islamic banks a relatively higher exposure (35% in spot market and 10% in futures market) in capital markets compared to conventional banks (20% in spot market and 10% in futures market). In addition, the SBP has relaxed statutory reserve requirement (SLR) for Islamic banks at 8% versus industry norm of 18%.

Today Islamic banks in the country account for 3.8% of the local banking industry in terms of assets compared to a share of 0.5% in Dec-2003. Excluding Meezan Bank, most of these Islamic banks have only been licensed in 2006. As of 31st Dec-2007 there are six full fledged licensed Islamic banks with 185 branches. In addition, 12 commercial banks are offering Islamic banking services through 103 branches.

Besides offering trade loans like *Murabaha* the Islamic banks in Pakistan offer equity and quasi equity products, such as *Musharaka* and diminishing *Musharaka*, and investment banking activities such as loan syndication. Furthermore Islamic banks are allowed to nurture parent-subsiary/affiliate model whereby they are by and large setting up asset management companies, brokerage firms and recently *Takaful* businesses. This non banking segment of IF Industry has also performed strongly in tandem with the banking sector.

Figure 1: Islamic Banking in Pakistan



Source: SBP

Islamic Funds


Since 2003 six Islamic funds have been launched in Pakistan; two of which were launched last year only:

1. Meezan Islamic Fund
2. Meezan Islamic Income Fund
3. Atlas Islamic Fund
4. UTP Islamic Fund
5. United Composite Islamic Fund and
6. Pakistan International Element Islamic Fund

The investments of any Islamic fund are screened for Shariah Compliance based on the criteria approved by the Shariah Advisory Council. Though the returns offered by Islamic mutual funds are low compared to returns on Karachi Stock Exchange, these funds have witnessed increased interest from investors. Today the total assets of Islamic mutual funds stand at over PKR 7 billion.

Islamic Index

Additionally the Dow Jones-JS Pakistan Islamic Index was launched in Aug-2006 to facilitate investment in Shariah compliant stocks. Jointly marketed by Dow Jones Indexes and JS and Co Limited, the index measures the stock performance of companies traded in Pakistan that pass screens for compliance with Islamic principles. The components of the index are weighted by free-float market capitalization, subject to a 10% cap on the



weights of any individual security. Moreover the index is reviewed quarterly in March, June, September and December. Initially 30 companies, capturing 56% of the KSE market capitalization were represented in the index. However the prerequisite for any company to be listed is that of Shariah compliance.


Takaful – A New face for Insurance

Following the global trend, the IF Industry in Pakistan is also increasingly moving towards establishing *Takaful* industry – the Islamic alternative to insurance. Takaful companies present themselves as offering Muslims an acceptable solution to risk management and prevention. These institutions offer protection to contributors, or policyholders, by accumulating contributions (equivalent to premiums) to a fund for the mutual benefit of the contributors. This fund is the resource out of which payments may be made to contributors in the event of their suffering a claimable loss. From the Takaful perspective, the key requirements of the business model are to adhere to Islamic principles of avoiding uncertainty (*gharar*), gambling (*maisir*), and interest (*riba*). Globally the *Takaful* industry has assumed considerable prominence; it has been growing at the rate of 10-20% per annum compared to the global average growth of insurance industry of 5% per annum. There are over 60 companies offering Takaful services in 23 countries around the world spanning from Middle East, Far East, Iran, Turkey, and Sudan to some non Islamic countries. The real tangible benefits to policyholders compared with mainstream insurance solutions appear slight, however, if the religious connotations are discounted. Nevertheless, the Islamic solution offers strong potential for business development.

Currently there are two licensed Takaful companies in Pakistan. The first Takaful was set up through international collaboration between leading financial institutions from Pakistan, Kuwait, Malaysia, Saudi Arabia and Sri Lanka. However this segment of IF industry is still in its infancy in the country and would require concerted efforts from the Government as well as the private sector to establish firmly.

Sukuks – Leading the developments

As the IF industry flourishes, Sukuks have acquired growing significance relative to traditional debt market instruments. Globally the Sukuk market is estimated to be at USD 18 billion. These are securities that comply with *Shariah* and its investment principles. Sukuks are generally issued by institutionally sponsored Special Purpose Vehicles. The issuance of Sukuk requires an exchange of a Shariah compliant underlying asset for a financial consideration through application of various Islamic commercial contracts such as the *Modarabas*, *Musharaka*, *Ijarah* and *Murabaha*. The *Modarabas* and the *Musharaka Sukuk* are equity based securities which expose investors to the risks associated with the performance of the project for which financing is raised. The *Ijarah* and *Murabaha Sukuk* on the other hand yield deterministic receivables and hence result in predictable and somewhat fixed returns.



In Pakistan the first Islamic *Sukuk* was issued in 2002 by Sitara Chemicals industries. However market for these securities flourished mainly after 2005 when large corporations and conglomerates like WAPDA, Engro Chemicals, PEL, Eden Developers and Maple Leaf Cement issued Sukuks to fund their infrastructure and other requirements. So far in Pakistan, Sukuk bonds worth at least PKR 30 billion have either been issued or are in the pipeline.

Promising Prospects

The IF Industry is still in its evolutionary phase given its current size and structure in the world. Strong demand for Islamic financial products and services from a large segment of about 1.4 billion Muslim populations and growing interest of non Islamic financial markets in this avenue indicate the tremendous growth potential that exists within this industry.

The IF industry in Pakistan is relatively new, compared to other Islamic economies. Nonetheless the growth recorded, particularly in the past three years, has been impressive on the back of government and central bank's support. The SBP has continually been in the process of developing initiatives to further align the industry's administrative structure and prudential regulation and supervisory framework to Shariah principles. However lack of public awareness/understanding of Islamic financial products and services, incongruent Shariah interpretations, lack of liquidity management instruments, taxation issues and dearth of trained Islamic bankers and financial analysts, continue to create hindrances in growth of IF industry.

Hence in order to increase the penetration of this industry and exploit the existing potential it is important to address these challenges. Firstly what is needed is harmonization of Shariah interpretations and promotion of homogeneous Islamic financial products and services. Though the economy has adopted few interim arrangements for liquidity management, more Shariah compliant securities will have to be issued to ensure more effective liquidity management. Furthermore, being a latecomer, Pakistan must develop stronger alliance with the international and regional Islamic banks to benefit from emerging financial innovation and practices. It is also about time to develop educational institutes which will offer edification in Islamic banking and finance. Existing universities must also be encouraged to offer courses in this genre. SBP has already started a certificate course in IF through its subsidiary National Institute of Banking and Finance (NIBAF). The central bank is also in process of establishing institutes to allow research in various areas of Islamic Banking and Finance and offer higher level certification programs. Similarly, efforts are underway to collaborate with International Centre of Education in Islamic Finance (INCEIF), Malaysia for furthering the education in IF in both the countries. Nonetheless strong growth and industry presence will inevitably create incentives for individuals to acquire formal training for Islamic Finance and Banking.



Appendix

Ijarah

Ijarah means lease, rent or wage. Generally, Ijarah concept means selling benefit or use or service for a fixed price or wage. Under this concept, the Bank makes available to the customer the use of service of assets / equipments such as plant, office automation, motor vehicle for a fixed period and price.

Mudarabah (Profit Sharing)

Mudarabah is an arrangement or agreement between the bank, or a capital provider, and an entrepreneur, whereby the entrepreneur can mobilize the funds of the former for its business activity. The entrepreneur provides expertise, labor and management. Profits made are shared between the bank and the entrepreneur according to predetermined ratio. In case of loss, the bank loses the capital, while the entrepreneur loses his provision of labor. It is this financial risk, according to the Shariah, that justifies the bank's claim to part of the profit. The profit-sharing continues until the loan is repaid. The bank is compensated for the time value of its money in the form of a floating interest rate that is pegged to the debtor's profits.

Murabaha (Cost Plus)

This concept refers to the sale of goods at a price, which includes a profit margin agreed to by both parties. The purchase and selling price, other costs, and the profit margin must be clearly stated at the time of the sale agreement. The bank is compensated for the time value of its money in the form of the profit margin. This is a fixed-income loan for the purchase of a real asset (such as real estate or a vehicle), with a fixed rate of interest determined by the profit margin. The bank is not compensated for the time value of money outside of the contracted term (i.e., the bank cannot charge additional interest on late payments); however, the asset remains in the ownership of the bank until the loan is paid in full.

Sukuk (Islamic Bonds)

Sukuk is the Arabic name for a financial certificate but can be seen as an Islamic equivalent of bond. However, fixed-income, interest-bearing bonds are not permissible in Islam. Hence, Sukuk are securities that comply with the Islamic law and its investment principles, which prohibit the charging or paying of interest. Financial assets that comply with the Islamic law can be classified in accordance with their tradability and non-tradability in the secondary markets.

Takaful (Islamic Insurance)

Takaful is an alternative form of cover that a Muslim can avail himself against the risk of loss due to misfortunes. Takaful is based on the idea that what is uncertain with respect to an individual may cease to be uncertain with respect to a very large number of similar individuals.



Economic Snapshot

Fiscal year 07-08														
	Units	Feb	March	April	May	June	July	Aug	Sep	Oct	Nov	Dec	Jan	Feb
<u>Inflation</u>														
Headline Inflation	%	7.39	7.67	6.9	7.4	7.0	6.4	6.5	8.4	9.3	8.7	8.8	11.9	11.3
Core inflation	%	5.72	5.42	5.2	4.7	5.1	6.0	6.0	6.1	6.5	6.9	7.2	7.8	8.1
Food inflation	%	9.99	10.74	9.4	11.3	9.7	8.5	8.6	13	14.7	12.5	12.2	18.2	16
Non-food inflation	%	5.59	5.54	5.2	4.7	5.1	4.9	4.9	5	5.4	5.9	6.3	7.3	7.8
<u>T-bill (Wgt Avg)</u>														
3 month	%	8.64	8.65	8.69	8.69	8.69	8.69	9.05	9.05	9.05	9.05	9.09	9.09	9.38
6 month	%	8.81	8.82	8.9	8.9	8.9	8.9	9.12	9.12	9.12	9.21	9.29	9.29	9.61
12 month	%	9.01	9.01	9.08	9.10	9.16	9.16	9.39	9.39	9.39	9.4	9.49	9.44	9.87
<u>External Sector</u>														
Export	Mln US\$	1,421	1,536	1,446	1,540	1,583	1,434	1,475	1,463	1,593	1,524	1,500	1,634	n.a
Import	Mln US\$	2,103	2,070	2,159	2,190	2,373	2,423	2,206	2,150	2,555	2,864	2,910	3,271	n.a
Trade balance	Mln US\$	(682)	(534)	(713)	(650)	(790)	(989)	(731)	(687)	(962)	(1340)	(1410)	(1637)	n.a
<u>Remittances</u>	Mln US\$	457	520	513	537	505	495	489	516	580	505	479	557	n.a
<u>Forex Reserves</u>	Mln US\$	13,378	13,624	13,661	13,778	15,182	15,723	16,106	16,145	16,354	15,807	15,604	15,074	n.a



Research Desk

Treasury and Investment Banking Group

MCB BANK LIMITED

20th Floor

MCB Tower

LI Chundrigar Road

Karachi

Contact

Sana Qureshi

Research Analyst

Telephone: 92-111-000-111 Ext. 4420

0333-3800744

Email: sanaqureshi@mcb.com.pk

Usman Siddique, CFA

Head of Research and Structured Products

Telephone: 92-21-2270024

0333-2153438

Email: usman.siddique@mcb.com.pk

Fax: 92-21-2270094

92-21-2270109

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