

SPEECH – IoBM-ICBF

Dr. Ishrat Husain

**Mr. Bashir Jan Mohammad, Mr. Talib Kareem,
Syed Amir Ali and Ahmad Shuja , Amjad
Saqib, members of the faculty, dear
students, participants,**

First of all it is a great pleasure and honour for me to be participating in this particular Conference. I was here, I think a year ago and I always give importance to events of this nature as they create awareness about Islamic finance.

Let me also pay a tribute to the founder of this fine Institution which will be celebrating 25 years. This is because of Mr. Shahajan Karim a senior colleague of mine in the civil service that he took upon this challenge upon himself at a very difficult time. I have seen the transition from a very small institution consisting of few rooms to what it is today a whole complex. So we need to always remember

our benefactors who have actually done a great job. We seem to forget those people. Let me also respond to Mr. Bashir Jan Mohammad's remarks almost Islamic Banking. Islamic Banking introduced in 1980s during Zia-ul-Haq's regime was declared un-Islamic by the Federal Shariat Court. The court asked us i.e. the State Bank of Pakistan when I had the privilege of being the Governor to transform the entire banking system of Pakistan to Islamic banking system in just one year's time. Doing so in such a short period would have create a havoc for economic activity in this country and also disengaged Pakistan from the global economy. So we formed a commission under the Chairmanship of Mr. Imtiaz Hanafi, who was one of my predecessor consisting of scholars and practitioners. They came up with the proposal that Islamic banking should run in parallel with the conventional banking. It is left up to the customers if they want to switch from the conventional banking to the Islamic banking or they want to stay with the

conventional banking. No central bank or no government has the power to act on behalf of the people who know what is good for them. Banking customers are the ones who can make that decision. Today we have a parallel banking system in place and would continue until complete transition takes place and the entire banking system becomes Islamic. Therefore, some of the products and services which Islamic banking offer today have to be at the same level playing field as the conventional banking otherwise nobody except those who seriously believe in it will shift to Islamic banking. We carried out a survey and only a minority said that they would switch from Conventional banking to Islamic banking on the basis of faith in the new system. Because as Mr. Shuja Kidwai said we preach to be good Muslims but we do not practice what is actually preached. Hammari niyat ka fatoor hay. We talk too much about Islam but we don't practice what are really Islamic values. I now turn to the topic of today.

Why are the SMEs and microfinance Institutions not doing well? We see high non-performing loan ratio for SMEs and high lending rates for micro finance. I want to pay compliments to Dr. Amjad Saqib the founder of Akhuwat. The model which he has developed is based on trust. Not only the people borrow micro loans from the Akhuwat and return them with very miniscule default rate but they also donate to Akhuwat once their financial conditions have improved. These donations and low administrative cost have enabled Akhuwat to provide loans at rates much lower than other micro finance institutions. In fact, they recover only administrative cost and charge no interest on the loans they advance. This allows the borrowers ease in repaying the loans with enough liquidity left to expand their businesses – whether vendors hawkers, small shopkeepers or merchants. Even in Islamic banking and I agree with Amir and Shuja

that these institutions have now begun to attract people who have a lot of passion and commitment for Islamic banking. But that sense of trust has not permeated through the entire banking system. The other problem which we have is that the model they follow is a mimicry of the conventional finance which requires collateral, security, documents and audited financial statements. This exhaustive paper work satisfies the apparent need of the credit departments but they do not bother to verify if the value of collateral declared by the applicant is inflated or not, whether the stocks pledged reflect the realistic value and whether collaterals can be realized if market conditions are distressed. When I was at the State Bank we changed the prudential regulations for SMEs. We said the banks do not have to insist on collateral from small borrowers but they should instead go for program lending. You do cash flow lending and restructure the loan term sheet if the underlying assumptions change. This requires a change in the mind set, skill set and investment

in training for implementing those regulations. But the results have unfortunately, been dismal. SME lending which had reached almost 17% of total advances has slipped to 7% only. The insistence on collateral and security remains the easy way out. They do not realize that treating small loans on the same lines as large corporate loans raises transaction cost. Program lending in fact would reduce this cost. The initial investment in human resources would have large pay off subsequently. To give you an example when we removed interest rate ceiling and mandatory targets for agriculture and encouraged

competition the credit flows to that sector tripled in a few years' time. The reason was that the banks were earning returns of 500 basis points over KIBOR compared to 50 or 100 basis points on Corporate finance. Similarly, if they provide loans to SME sector which has huge untapped potential they would earn relatively higher returns compared

to the corporate sector. But old habits die hard. They would chase Mr. Bashir Jan Mohammad saying Oh we will give you 50 basis points below KIBOR because you are a good risk although the returns are not commensurate with what they would be getting if they lend to SMEs which account for 80% of business activity. Even if you do some provisioning for small loans which are going to become non performing you would still be making higher net margins. Risk reward relationship in SMEs and micro finance is quite attractive but it has not been embraced because of the risk averse and pay safe mind set of the bankers. They have to be incentivized, and trained in program lending and cash flow lending. If you have a small steel rebar making factory you prepare a proforma balance sheet on the basis of the inputs at their prevailing market prices. This would provide you the estimates of revenues, costs and profits of the factory and its repayment capacity. All the information and projections can be captured on Excel sheeting using iPad. As prices of the

scrap the main raw material go up then you make the changes in values of input costs and if need arises restructure the tenor of the loan. But if you say no, once I have given you the loan for that particular period and whatever happens in the market and the input prices go up or the output prices go down, I would still ask you to repay me on the original terms of the loan you had contracted, this approach would certainly result in a Non performing loan and you would avoid approving loans for SMEs in future. But if you have a flexibility built in through cash flow lending then the probability of the loans becoming delinquent is likely to be much smaller. I would urge Islamic banks to take this different approach in their SME financing. The whole idea is to train a few people in program lending which would replace more labour intensive appraisal for each small loan. It is natural that if you give a loan of Rs. 500 Million to Mr. Bashir Jan Mohammad, it takes a few hours or days but if you lend Rs. 500 Million to 500 SMEs on the same lines as

for corporate sector it would be cost ineffective. That is why the banks avoid entertaining requests from SMEs. But the program lending based on cash flow projections for each sub-sector would rid you of the hundreds of hours that would be spent on appraising and approving each individual loan. In the long run the bank would have a diversified portfolio with an expanded base of customers who would give you very good returns. Regrettably we have had a lot of conferences and talks but the results are very discouraging. I have gone and addressed the businessmen in Gujranwala, Sialkot, Gujrat, Multan, Peshawar and emphasized upon them the need to prepare their accounts and financial statements in a transparent manner with full disclosure as it would help you in the long run exercising much more than what you are getting at present. I told them frankly you don't have to keep two books because you are actually hurting yourself as with your own money you can go up to a certain extent but if you open up the books, prepare the balance

sheet honestly other people's money will come in and your own returns would multiply manifold by leveraging those amounts. In fact what you are getting at present is only 10% of the large potential which can be tapped by mobilizing other people's money channelled to your company. There are private equity funds looking for investment opportunities. They would not only bring in capital but also managerial know-how and turn the company around making it none efficient.

Indian businesses who have given up keeping two books have done extremely well and have become huge conglomerates. Some of them have acquired companies in the U.S, UK, Europe and Africa. Some of them have become billionaires. We have foreign companies looking for honest and clean partners for joint ventures in Pakistan provided they can provide full financial disclosure and no behind the back dealing. They cannot find enough of such companies

and have to go back abandoning their pursuits. As interest rates in the West are low, there is a lot of money chasing opportunities in emerging markets and we have not benefitted from this large pool of funds. So I have to once again emphasise. “Please do not hide your financials, pay your taxes and if you do that you would be thriving and expanding”. I am hoping that this message would be considered seriously by the children of successful business families who have returned home after getting quality education at top universities.

The next point that I wish to elucidate and which in my opinion is hindering the spread of Islamic banking is that our business practices are at complete variance with our religious precepts. Islam teaches us to be truthful, be honest, not cheat in our dealings. What we see around is that religiosity has increased in our society but so have malpractices such as food adulteration, spurious drugs,

short weights, poor quality goods compared to what was promised, reneging on contracts where things go sour, making false delivery promises, refusing to pay dues on time. How can Musharika the main pillar of Islamic banking work under such circumstances?

I now turn to the priority sectors of economy other than SMEs which have been neglected and underserved and where Islamic banks should step in. As you know the Government of Pakistan particularly the Prime Minister has given lot of personal attention and emphasis on boosting construction and low cost housing sectors. He holds meeting on this subject every week with all the relevant stakeholders and resolves the problems faced by them. Islamic Banks have a very attractive product to offer for this market i.e. diminishing Musharika, which has no parallel in the Conventional Banking. As you pay back your

instalments of rental you build up equity and the borrowed amount keeps declining. As your equity builds up your credit worthiness improves and you can access other sources of financing. This does not happen in conventional Banking. Islamic Banks are well positioned to take advantage of this superior product for promoting low cost housing. As you all know, house is not only an economic asset but has large social value. The Supreme Court has upheld the Foreclosure law allowing the banks to recover loans from defaulters without intervention of the courts. This law has been under litigation for last 17-18 years and thanks to Allah Almighty that it has now finally been endorsed by the Supreme Court. The popular excuse the banks used to put forth for not advancing housing finance was absence of the foreclosure law. This excuse is no longer valid and they have to redouble their efforts. There is a subsidy of Rs. 30 billion, which is being provided by the Government of Pakistan for Low Cost Housing. So for 10 years loan, mark-up for first five years

will be fixed at 5% and for the next five years it would be 7%. The target is Rs.300 billion of new spending on construction for low cost housing. That is a big business opportunity for the banks and allied industries. Right now Pakistan's mortgage financing is less than 1% of GDP; in Malaysia it is 1520 times, in India it is 7-8 times. So look at the scope because we have almost the same kind of per capita income as in India. The back log of housing units in Pakistan is quite large and as per capita income rises the demand for housing rises.

How can the Islamic banks outclass and overtake the conventional banks? They have to get away from the domination of MARABAHA which they have been using and for good reasons because they have to compete in the same market under the parallel system. But they have to move to MUSHARKA and they have to move to IJARA in order to support the productive Sectors of the economy. Why in my

view Islamic Banking is superior? It is based on two principles which do not exist in Conventional Banking. One is that every transaction has to be based on a real asset not a paper transaction. So what happened in 2008 in the global finance crises would not have happened if the world was actually following Islamic Banking. I assert that proposition which I have propounded at many Conferences. The second principle is we have a risk sharing arrangement with the borrower in Islamic finance not risk shifting. When a Conventional bank gives you a loan and you default for any reason whether in your control or not they seize your property. In Islamic banking both the bank and the borrower are sharing the risk. The bank would not seize the property because part of the risk it has taken itself. So the risk sharing rather than risk shifting is the element which is very very important in Islamic banking. With this kind of advantage, Islamic banking ought to have done much better. From 2001 when we introduced Islamic Banking to 2020,

they have captured only 17% of the market share. Some of the banks are doing extremely well. I mean MEEZAN the largest Islamic bank is doing well, Bank ISLAMI, ALBARKA, DUBAI ISLAMIC Bank are also making good progress. But we need more Islamic Banks and more competition as there is a lot of un fulfilled demand. In order to survey the landscape for Islamic banking I went to Quetta, Peshawar, Landi Kotal, in 2000. The businessmen there said we do not want to put our savings in the conventional banks as it is riba-based. We have lot of money lying as cash in our houses which we think is unsafe. So if you create Islamic Banking branches in our areas we will shift the money to these branches. Look at the kind of money which is still outside the banking system about 5-6 trillion rupees circulating as currency because a lot of individuals and businesses don't believe in riba-based banking. So the scope of deposit mobilization is huge but deposit returns are low in Islamic Banking why? Because they have a problem in deploying

those deposits. They carry excess liquidity that is not remunerative and puts them at disadvantage compared to those participating in interbank market. We have now introduced government of Pakistan SUKUKS which are very fine instrument for Islamic Banking to use their liquidity for risk free investment. For example, we did the SUKUK for Rs.200 billion that attracted not only the Islamic banks but high network individuals, Insurance companies, mutual funds etc. The government of Pakistan got favourable pricing 10 basis points below KIBOR. That shows that the Government and the corporate sector should issue more SUKUKS through Debt Capital market in addition to the PIBs on a regular basis. Finance Division is coming up with the calendar for SUKUK issues so that Islamic Banks are able to mobilize the deposits in full knowledge that they can be deployed remuneratively. Another area that is becoming quite popular particularly for large infrastructure projects is public-private partnership

and Islamic banks can provide long term financing for this purpose.

I want to also tell you as how this government was able to respond to this pandemic i.e Covid-19. This was unanticipated and nobody was prepared for that. The Prime Minister was very clear from the outset that we should strike a balance between shutting down economic activity by imposing a complete lock down, which will hurt the poor of this country and controlling the pandemic itself. Despite the fact that we are now facing the second wave for which we all have to be very careful, the Government of Pakistan in face of a serious financial stress and high debt to GDP ratio injected Rupees 1.2 trillion to stimulate the economy. I can say with all confidence that for the first time in the history of Pakistan we were able to provide 200 billion Rupees in cash to 16 million (96 million people) households living below the poverty line, and daily wage earning employees

who had lost their jobs, within a period of 4 months as cash emergency assistance without any questions or fingers being raised. It was a transparent process based on technology and data without any interference of any political nature. I give you the example that all of these 200 billion the share of Sindh was 31% while its population is only 23% of the country's population. As you know, Sindh was not part of the PTI Government. Punjab where the PTI Government is in power lost its share in relation to its population. At the same time the State Bank of Pakistan provided another 1.3 trillion in different forms to support the businesses so that they can continue paying the wages to their workers. Interest rate was reduced by 650 basis points which created a surplus in the hands of the businesses. Principal of loans due to banks was deferred. Loans were re-structured and ROZGAR Scheme provided concessional loans to the businesses continuing to provide the wages to their employees. So 3.3% of GDP was provided by the State Bank and almost 3.3 % by the

Government of Pakistan. Very few developing countries with this kind of fiscal difficulties and with a high debt to GDP ratio have provided 6.6% of GDP for pandemic and that is why you are now seeing the wheels of the economy turning around and the cement sale, auto sales, are on an upward path. Export orders are coming in because other countries, our competitors had lock down which disrupted the supply chain. It would have been very difficult to attract these orders if we had also opted for a complete lock down. We must realize that this debate which was very much up in the air during in the early March & April that we would have bodies on the streets if we do not completely shut down the whole country was lopsided.

Let me remind all of you that we already had a downward sloping economy after 2018 because our current account deficit was beyond control. We had to suppress demand in order to reduce that deficit. In circumstances where

external demand was also going down because of the pandemic hitting our trading partners in developed countries and they were not buying our goods and services the country would have gone into a deep economic recession. It would have been very difficult to recover with both curtailment of domestic demand and external demand contraction. That was a difficult situation in March and April and that is why we had a big dilemma and a big challenge ahead of us i.e. how to manage this particular problem where we contain the pandemic and allow minimum disruption and dislocation to economic activity. So the COVID 19 had to be managed in a situation which was economically already quite difficult. We are all very grateful to Almighty Allah that we were able to bring the new infected cases from almost the peak of six thousand to five hundred cases and the deaths were down to almost five or six till now. Recently they have gone up again.

Finally, I would like to leave a thought behind being very much passionate about education. This conference organized by IoBM should give you some food for thought. I was speaking at a webinar organized by PIDE in Islamabad and instead of only few hundred people which could be physically present in the auditorium. Several hundreds of people were listening and participating in the Webinar. I said to myself how can we bring this to our students so a Professor at Harvard can talk to our students through the Zoom and they can ask questions. It is just like you sitting together in the same room so please take advantage of this technological advance which will help you in enhancing the knowledge base of students,

In a room like this you can have a full capacity of physical attendees of not more than 250 people. But by streaming this conference proceeding you have attracted several

hundreds. I have seen people from Australia from Canada from Kenya who are participating in the conferences held in Pakistan through Zoom. You can bring in the speakers who do not want to travel long distance for just one hour or two hours' session, as the opportunity cost of their time is very high. Through this particular mechanism you can without any cost bring the best and the brightest experts in your field to enlighten and educate and particularly our young students. So may I suggest that even if the pandemic is over the educational institutions as a policy should try to tap online teaching, online courses, online conferences in order to bring in the global expertise to benefit our students. This way they can be at the same wave length as their own peers in the developed countries. So this distance between the development and developing countries will shrink if they are also exposed to the same kind of knowledge and material. I want to once again thanking IoBM and organizers for inviting me to share my thought with you.

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