PAKISTAN ISLAMIC
FINANCE REPORT 2016

INNOVATION AT ASIA'S CROSSROADS

A JOINT INITIATIVE BY

المعهد الإسلامي للبحوث والتدريب
ISLAMIC RESEARCH AND TRAINING INSTITUTE
A MEMBER OF THE ISLAMIC DEVELOPMENT BANK GROUP

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The Centre for Excellence in Islamic Finance (CEIF) was established in October 2015 at IBA with the objective of providing a platform for discovery, enhancement and dissemination of knowledge in the field of Islamic Finance. It aims to be a world class Centre through education and research, carrying on the IBA's legacy of thought leadership in the Islamic Finance industry.

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vision

To Excel as a knowledge Centre of first choice, providing thought leadership to the domestic and global Islamic Finance industry.

mission

To be recognized as a reputable, research driven institution with strong industry linkages offering innovative world class education, training and research programs in Islamic finance to a wide range of audience and be a catalyst for change.

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Member of the Islamic Development Bank Group

The Islamic Research and Training Institute (IRTI) is a Member of the Islamic Development Bank (IDB) Group responsible for enabling the development and sustenance of a dynamic and comprehensive Islamic financial services industry, which supports socio-economic development in Member Countries and Muslim Communities worldwide. Established in 1401H (1981), IRTI serves as the IDB Group's primary organizational unit for the delivery of Islamic finance research, training, information, advisory, technical assistance, and Islamic financial products development services. IRTI is also responsible for basic and applied research in Islamic finance with the mission to facilitate its practical application in Member Countries and Muslim Communities in non-Member Countries.

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IRTI conducts research on how the principles and best practices of Islamic economics and finance can be harnessed for the socio-economic development of Member Countries and Muslim Communities globally. IRTI research seeks to enable the development of a dynamic, innovative and sustainable Islamic financial services industry, including assisting countries to create and foster an enabling environment for Islamic finance sector development.

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IRTI provides training and other capacity development services in Islamic economics and finance in order to build the necessary human capital that can serve as the catalyst for the development of Islamic financial services in Member Countries as well as globally.

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IRTI provides advisory services to governments, public and private sector institutions on the practical application of Islamic economics, banking and finance principles to promote socio-economic development. Through technical assistance, IRTI also undertakes activities to develop the Islamic financial services industry.

INFORMATION SYSTEMS

IRTI collects, systematizes and disseminates data and knowledge in Islamic economics, banking and finance for the benefit of all industry stakeholders.

PRODUCT DEVELOPMENT

IRTI assesses the existing Islamic finance products and instruments and identifies areas of further improvement, develops innovative Islamic finance products and instruments, and promotes their use by the IDB Group and Member Countries.

PUBLICATIONS

IRTI produces a wide range of publications in the field of Islamic economics and finance, including textbooks, journals, edited books, and lecture papers. To date, IRTI has released hundreds of publications in Arabic, English, French, Turkish, Russian, Portuguese and Bahasa Indonesia languages.

COLLABORATIONS

IRTI is the IDBG's focal point for collaboration and coordination with Islamic infrastructure institutions, multilateral bodies and other organizations to promote Islamic economics, banking and finance. IRTI engages in collaborations to hold policy dialogues and to collect, synthesize and disseminate the results of Islamic economics and finance research conducted by external entities.

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Content

EXCLUSIVE INTERVIEWS

LEADERSHIP ARTICLES

Policymakers and Industry Executives United to Expand Islamic Finance in Pakistan

Commitment at the highest level of the government, development of an enabling regulatory environment, building Shariah- compliant innovative products, enhancing public awareness, and developing professionals are the key drivers in the growth of Islamic finance in Pakistan

SENATOR MOHAMMAD ISHAQ DAR
Minister of Finance, Pakistan

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- Islamic finance tends to draw a closer focus on social ethics and fair financial practices.
- Islamic finance has the potential to contribute significantly towards financial inclusion by extending the outreach of the financial system to the many people who don't use conventional banks because of their religious beliefs.
- The Steering Committee for the Promotion of Islamic Banking has worked aggressively towards fostering the growth of Islamic finance.
- The SBP has established the Centres of Excellence for professional training, the launch of the All Islamic Share Index and the creation of a policy framework for establishment of Islamic banking subsidiaries.
- Pakistan presently has a pool of leading practitioners and Shariah scholars who can work with expatriate Islamic finance professionals and contribute towards the development and promotion of Islamic finance both at local and international levels.
- Pakistan has already provided technical support to SAARC countries, including Bangladesh and Afghanistan. Going forward we are more than willing to help other countries in the region to develop and promote their Islamic finance industries.

ASHRAF MAHMOOD

Governor, State Bank of Pakistan

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- The Central Bank and other stakeholders including Ministry of Finance, Federal Board of Revenue and Securities and Exchange Commission are working towards a more amenable taxation environment for the Islamic banking industry.
- The Knowledge Attitude and Practices survey indicates a strong demand for Islamic banking services prevailing in the country in both the retail (95%) and corporate sectors (73%)
- The risk and reward sharing nature of Islamic finance contracts not only has the potential of increasing efficiency in the allocation of resources to the real sectors of the economy, but it can also be an effective tool for wealth redistribution.
- Recent regulatory measures for the Islamic banking industry include the issuance of a new Shariah Governance Framework.
- The government has made a downward revision of the initial paid-up capital requirement for the establishment of Islamic banking subsidiaries.
- Proposals for short-term Government of Pakistan (GOP) Sukuk and Islamic discount window facilities are also being reviewed at SBP.

MUHAMMAD TAQI USMANI

Justice (Retd.), Shariat Appellate Bench, Supreme Court of Pakistan

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- A parallel system of conventional banking is the biggest challenge to Islamic banks, putting them at a disadvantage when competing with larger rivals.
- The undocumented economy allows business organizations to hide their income, evade liabilities and misrepresent their business affairs, hindering equity-based investments at Islamic banks.
- Different Islamic juridical opinions are natural, but institutions such as AAOIFI can help spread standardization in best practices.
- The current judicial system prevents Islamic financiers from undertaking projects that have social benefits but financial risks.

ZAFAR HIJAZI

Chairman, Securities and Exchange Commission, Pakistan

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- The SECP has adopted investor education as a key strategy to enhance investor protection… and fosters investor engagement in financial planning and decision-making.
- Mutual funds are an ideal investment product for increasing financial inclusion.
- Funds offer low-income and less-informed investors with professional management, diversification and safe custody of assets.
- Mutual funds play an important role in the economic development of our country by pooling funds and making them available through the capital market.
- The SECP spearheaded the establishment of capital market business hubs in Pakistan by targeting cities that have small industries and residents receiving foreign remittances from relatives working abroad, such as Mirpur, Abbottabad, Sialkot and Dhadial.

Executive Survey of Pakistan Islamic Finance Experts revealed the following growth strategies

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INNOVATION IN ISLAMIC FINANCE STRUCTURES AND PRODUCTS

"Respondents emphasized the need for development of Islamic liquidity management products (46%) and further highlighted the need for Islamic agricultural financing (43%). The executives also showed preferences for musharakah (35%) and SME financing (32%)."

DEVELOPING PROFESSIONAL TALENT

"Respondents considered the most important skills in an [Islamic finance employee] candidate to be awareness of basic product concepts (74%), Shariah knowledge (58%), and understanding of Islamic financial transactions (58%)."

REACHING OUT TO NEW CUSTOMERS

"Each bank is playing an independent role in the promotion of Islamic banking practices and concepts to increase awareness... Advertisements through various channels are the most common method..." Islamic banks are increasingly looking to open rural branches and collaborate with unbanked social groups.

Foreword

Since its independence in 1947, Pakistan is striving to develop an economic system based on Islamic principles. In the past 15 years, Pakistan has shifted to a dual Islamic/conventional financial system, which facilitates business with the global economy while making progress towards a fully Islamic financial system by building market demand for it. Policymakers and regulators in Pakistan have made positive strides to reform the legal and regulatory framework in the past decade.

With the second largest Muslim population in the world after Indonesia, Pakistan has resilient agricultural production, strong potential for hydropower generation, oil production, natural gas reserves, and large gold and copper ore deposits. These resources should be fully utilised to help accelerate the growth and development of the country, and the Islamic finance industry is a potential partner for structuring and financing such industrial projects.

The share of Islamic financial market is rising since the adoption of a dual financial system policy in early 2000s. Currently, Islamic banking in Pakistan holds a 11.9% market share of the overall banking system by assets — as of March 2016 — and it is expected to reach 15% by the end of 2018. Islamic capital market sector registered a remarkable growth at a double-digit rate in the past decade, recorded mostly by Islamic mutual funds. Takaful and Modaraba companies are catching up, despite the relatively small size of these industries. In all Islamic finance industry segments, finance professionals and investors maintain a positive economic outlook, and Islamic finance institutions have built strong fundamentals.

It gives us great pleasure to present the Pakistan Islamic Finance Country Report a joint effort of the Islamic Research and Training Institute (A member of Islamic Development Bank Group), Thomson Reuters and Centre for Excellence in Islamic Finance (CEIF) - Institute of Business Administration (IBA) Pakistan. We hope this report will provide an insights and analysis required to better understand and capture the opportunities that Pakistan presents in Islamic finance.

The report highlights some key trends in the future growth of Islamic finance in Pakistan. These include the rise of branchless Islamic banking via mobile services, the fast growth of the KME Meezan Index (KMI-30) and Islamic All Shares stock Indices, open market operations on government Sukuk to maintain the liquidity of the Islamic banking system, the rapid expansion of Islamic microfinance, and more. To maintain this pace of growth, we recommend that policymakers and professionals continue their reform of regulations and integration with global Shariah and governance standards, the expansion and deepening of an Islamic finance education curriculum, and their marketing effort towards rural areas, to spread awareness and financial inclusion.

We have no doubt that in the coming decade, we will see Pakistan as key international player for the growth of the global Islamic finance industry.

Mustafa Adil
Head of Islamic Finance
Thomson Reuters

Dr. Mohammed Azmi Omar
Director General
IRTI

Dr. Ishrat Husain Chairman
Chairman
Centre for Excellence in Islamic Finance (CEIF) — Institute of Business Administration (IBA)

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Executive summary

Since its independence, Pakistan has striven to develop an economic system based on Islamic values. The government made a series of unsuccessful policy changes during the 1980s seeking to completely eliminate the use of interest from the financial system. Since the early 2000s, its strategy has shifted instead to gradually increasing the penetration of Islamic finance with a dual financial system, and Pakistan has remained at the global forefront of Islamic finance since that time. There are several legal and regulatory changes in the pipeline that have the potential to reform the entire financial sector, moving it closer to Shariah compliance.

With Pakistan's large Muslim population, second in the world only to Indonesia, Islamic banking and financial services have the potential for strong growth in the coming years. The State Bank of Pakistan (SBP) and Securities and Exchange Commission of Pakistan (SECP) have made strides in the past decade to promote Islamic finance in the country. The SBP has issued regulations in the past decade establishing a new Shariah compliance and governance framework, pool management for Islamic banks, Islamic banking window operations, and the adoption of AAOIFI standards. The SECP has similarly established a dedicated Islamic Finance department, which will help establish the legal infrastructure to support the elimination of interest from the corporate sector in Pakistan. There has been great progress on the legal and regulatory framework over the past decade. However, Islamic finance experts are calling for a further reassessment of the tax code and regulations regarding the industry that would clearly distinguish it from conventional financial services and products.

A low supply of qualified Islamic banking professionals is slowing Pakistan's transition toward an interest-free financial sector. The stakeholders have made a strong start with three new Centres of Excellence in Islamic Finance at educational institutions, but a standard curriculum combining finance and Islamic law should be used throughout the higher educational system.

Presently, Islamic banking in Pakistan holds about 11.9% market share of the overall banking system by assets, and experts anticipate that this share will reach 15% by the end of 2018. However, the Islamic banking sector faces several challenges, including the unfair competition of conventional banks because of the particular requirements of Islamic finance, the lack of Shariah-compliant liquidity management products, the tax inefficiency of Shariah-compliant products compared to the debt products of conventional banks, and the lack of human capital trained in both Shariah and finance. Besides addressing these legal and regulatory challenges, Islamic banking needs to build a positive public image and to increase financial inclusion by serving unbanked Pakistanis from all segments of the population. The SBP should provide incentives for Islamic banks to offer micro-saving and microfinance products. Furthermore, the Islamic banking industry would benefit from more transparency in the application of Shariah in their products, ideally through stronger disclosure requirements.

Islamic capital markets provide investment opportunities to investors through Shariah-compliant equities, mutual funds and Sukuk. The Islamic mutual fund industry has grown at a double-digit rate in the past decade, and it now handles about quarter of all assets under management in the Pakistan mutual fund industry. While Sukuk issuance has seen some oscillation over the past five years, it has provided crucial capital funding for large-scale public and private projects. Among other major non-bank players offering finance and investment services are takaful operators, Modaraba companies and leasing companies, which are catching up to banks despite the relatively small size of these industries.

Takaful, Shariah-compliant insurance, is the newest segment of Islamic finance in Pakistan, and it is already making strides. Five full-fledged takaful companies founded roughly ten years ago have been joined by seven takaful windows at conventional insurers since new regulations permitting this practice were passed in 2014. This industry is seeking to expand further by pushing for regulations allowing bancatakaful, including microtakaful through microfinance companies, and for a local takaful reinsurance (retakaful) company.

Islamic social finance is another sector that will be instrumental not only in reducing poverty in Pakistan, but also in reducing income inequality and increasing financial inclusion. Several government programmes provide direct income distribution, such as the Benazir Income Support Programme and Pakistan Bait-Ul-Mal. However, there is a need for better safety net provisions, such as micro-insurance for small farmers and entrepreneurs. Zakat and waqf are two important Islamic institutions that can support the lowest income earners. There is a need for innovation especially in the utilization of waqf funds.

Key insights

IMPROVEMENTS IN REGULATION AND THE PROFESSION SINCE 2012

- In 2012, the regulator allowed the operation of takaful windows
- A new Shariah governance framework was issued in 2014
- Sukuk rules were issued in 2012 and amended in 2015
- Three Centres of Excellence in Islamic Banking for higher education were established in 2015

BANKING

- 35 banks operate in Pakistan, of which 6 are Islamic and 17 conventional banks with Islamic branches
- Total banking loans: Rs 44 trillion in June 2015 64% was private sector lending and 25% government and public sector lending
- Total Islamic banking assets: Rs 1.625 trillion as of March 2016
- Between 2010 and 2015 the Islamic banking industry has witnessed a compound annual growth rate of more than 30% both in terms of assets and deposits
- The Islamic banking branch network reached 2,082 branches as of March 2016

CAPITAL MARKET

Equities

- The Securities and Exchange Commission of Pakistan (SECP) was established by the SECP Act in 1997
- The Islamic Finance Department (IFD) was introduced in February 2015 by the SECP
- Pakistan Stock Exchange (PSX) was launched early 2016, merging the Lahore, Karachi and Islamabad stock exchanges
- KMI-30 is one of the two Shariah-compliant indices, launched in 2008

Funds

- Islamic asset management first appeared in 2003
- Total mutual fund assets: Rs 443 billion in 2015
- Shariah-compliant fund assets: Rs 129.82 billion in December 2015
- Al Meezan holds a market share of 57% in Islamic asset management

Sukuk

- The net value of Sukuk issued in 2011 was US$ 1.9 billion
- In 2015, new Sukuk issues by value declined to US$216 million
- To provide liquidity to Islamic banks, the SBP began Shariah-compliant open market operations using ijarah Sukuk in 2014
- In 2014, the government made a sovereign Sukuk issue of US$1 billion with a five-year tenor and 6.75% profit

Non-Banking Financial Institutions

- The NBFI and Modaraba Association was formed in 2010
- There were 22 Modaraba companies, 10 leasing companies, and 3 investment banks operating at the end of 2014
- NBFIs lending: Rs 418 billion
- Sector net profit CAGR between 2010 and 2014: 146%

INSURANCE

- Total insurance gross written premiums: Rs 184 billion (2014)
- There are five takaful operators; two family insurers and three general
- Total takaful assets: Rs 12 billion (2014)
- Total takaful gross written contributions: Rs 8 billion (2014)
- There is only one local reinsurance company; still no retakaful company

ROLE OF ISLAMIC FINANCE IN SOCIAL DEVELOPMENT

- Pakistan's strategy for poverty alleviation is based on four pillars: 1) accelerated and broad-based economic growth while maintaining macroeconomic stability; 2) improved governance and consolidated devolution; 3) investment in human capital; 4) and targeted programmes with emphasis on social inclusion
- The Government of Pakistan provides food subsidies, social security, the peoples' work programme and the natural calamities and disaster management programme
- Deserving people are provided assistance directly through the Local Zakat Committees or indirectly through state and private institutions
- Awqaf (Waqfs) in Pakistan in their current form have limited potential as instruments of social finance or as a tool of social protection or economic and social transformation, until and unless the sector undergoes a major reform
- The microfinance industry is flourishing, although it hardly covered 10% of the potential microfinance demand in 2013

EXECUTIVES' SURVEY

A majority of Pakistani business executives agreed:

- Islamic liquidity management products, Islamic agricultural financing and musharakah financing are the most needed products
- A shortage of finance professionals trained in Islamic law is the most significant barrier to the development of new financial products
- Low public awareness of Islamic finance is due insufficient PR campaigns by Islamic finance institutions
- Islamic microfinance and agricultural financing present potential areas of growth for Islamic financial institutions
- New financial products should be marketed to the rural poor

ABOUT
THOMSON REUTERS Islamic Finance

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Global Growth Solutions	Thomson Reuters consulting professionals include renowned experts with subject-matter know-how and extensive experience in all major areas of the Islamic financial services industry, including deep understanding of Shariah law.
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ISLAMIC FINANCE GATEWAY

1 Pakistan at a glance

View of Faisal Mosque in Islamabad at night. Mr. High Sky / Shutterstock.com

INSIDE THIS CHAPTER

PAKISTAN ECONOMIC SNAPSHOT

The Islamic Republic of **PAKISTAN**

FULL NAME

H.E. Mamnoon Hussain

PRESIDENT

Official Language
English

National Language
Urdu

Religion
Islam

Monetary Unit
Pakistani Rupee (Rs Or PKR)

EXCHANGE RATE (August 2016)
1 Pakistani Rupee = 0.0096 US Dollar

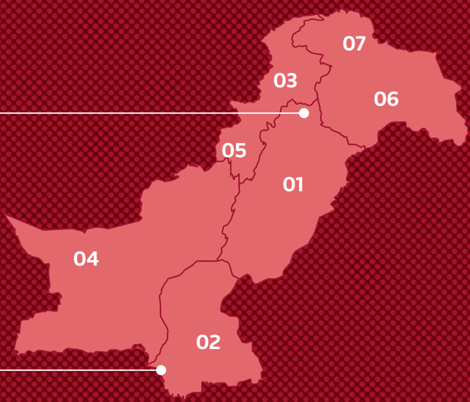
International Dialing Code
+92

Internet Domain
.pk

Life Expectancy (2015 Estimate)
Male: 65.47 Years / **Female:** 69.4 Years

Capital

Islamabad **(08)**



Largest City

Karachi

Area (2016)
796,095 Km^2

01.
Punjab
Districts: 36
Population (2012):
91,379,615

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02.
Sindh
Districts: 29
Population (2012):
55,245,497

03.
Khyber Pakhtunkhwa
Districts: 26
Population (2012):
26,896,829

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04.
Balochistan
Districts: 6 frontier regions
Population (2012):
13,162,222

05.
Federally Administered Tribal Areas
Districts: 7 tribal agencies
Population (2012):
3,930,419

—

06.
Azad Jammu and Kashmir
Districts: 32
Population (2012):
2,972,501

07.
Gilgit-Baltistan
Districts: 10
Population (2012):
1,441,523

—

08.
Islamabad Capital Territory
Districts: 1
Population (2012):
1,151,868

Total Population (July 2015 estimates) : 199 Million

US$ 289 Bn

GDP (2015)
Source: Pakistan Economic Survey, 2014-15.

US$ 1,512

GDP PER CAPITA (2015)
Source: Pakistan Economic Survey, 2014-15.

0.4%

FOREIGN DIRECT INVESTMENT, NET INFLOWS (% OF GDP) 2015
Source: World Bank.[1]

Agriculture 25.5%
Industry 19%
Services 55.5%

MAJOR EXPORTS
Cotton &Textiles Manufacturing (55.4%)
Food (19.4%)

MAJOR IMPORTS
Petroleum (26.09%)
Machinery/telecommunications (15.37%)

147th

(Out Of 188 Countries — 2015)
HUMAN DEVELOPMENT INDEX RANKING
Source: UNDP Human Development Index.[2]

138th

(Out Of 189 Countries — 2013)
EASE OF DOING BUSINESS IN PAKISTAN
Source: World Bank.[3]

4.2%

ECONOMIC GROWTH RATE (2015 ESTIMATE)

4.5%

INFLATION RATE (2015 ESTIMATE)

1.46%

POPULATION GROWTH RATE (2015 ESTIMATE)

6.5%

UNEMPLOYMENT RATE (2015 ESTIMATE)

Note: Most of the economic data are sourced from the WORLD FACTBOOK — CIA. The data was last updated on August 1st, 2016.[4]

1 World Bank data
2 http://hdr.undp.org/en/composite/HDI
3 http://www.doingbusiness.org/rankings
4 https://www.cia.gov/library/publications/the-world-factbook/geos/pk.html

PAKISTAN'S ISLAMIC FINANCE GLOBAL POSITION: SNAPSHOT

Overall Ranking 5th

Based on ICD - Thomson Reuters Islamic Finance Development Indicator 2014 - 2015

Quantitative Development (6th) Total Islamic Finance Assets: PKR 2,189 billion	**Banking**	• Total Islamic Banking Assets: PKR 1,611 billion • Number of Islamic Banks: 6 • Number of Islamic Banking Windows: 17	6th
	Takaful	• Takaful Operators' Assets: PKR 12 billion • Number of Operators: 11	17th
	Other Islamic Finance Institutions	• Total Assets: PKR 34 billion • Number of Modarabas: 25	5th
	Sukuk	• Sukuk Value Outstanding: PKR 392 billion • Number of Sukuk Outstanding: 41	13th
	Islamic Funds	• Funds AuM Outstanding: PKR 140 billion	6th
Knowledge (6th)	**Research**	• Nº of published Research Papers on IF related • topics between 2012 and 2014: 107	4th
	Education	• Nº of IF Degree Providers: 11 • Nº of IF Courses Providers: 21	6th
Governance (4th)	**Regulation**	Exists for: • Islamic banking & Takaful • Accounting for Islamic Finance Institutions • Sukuk & Funds • Shariah Governance	1st
	Shariah Governance	• Centralized Shariah Board Exists for State Bank of Pakistan (SBP) and the Securities and Exchange commission of Pakistan (SECP)	8th
	Corporate Governance	• Average Financial Reporting Disclosure Index Score 43.76 out of 70 items that need to be reported	11th
CSR (18th)	**CSR Funds**	• CSR Funds distributed of USD 2.81 Million	13th
	CSR Activities	• Average CSR Disclosure Index for annual reports 4 out of 11 items that need to be reported	16th
Awareness (5th)	**News (During 2014)**	• Islamic Finance Related Regional & Exclusive News: 2,447	4th
	Conferences	• Number of conferences held: 3	19th
	Seminars	• Number of seminars held: 45	1st

*Data obtained for Islamic banking, Takaful, Sukuk and Funds represent the latest data reported by State Bank of Pakistan (SBP) and the Securities and Exchange Commission of Pakistan (SECP), while other Islamic Financial Institutions assets were obtained purely from Securities Exchange Commission of Pakistan (SECP).

The economic environment

The Islamic Republic of Pakistan is located in South Asia, on the Arabian Sea. It shares borders with India to the east, China to north, Afghanistan to the west and Iran to the southwest. The total area of the country is 796,095 square kilometers[1], and it has a total population of 191.7 million (in 2015). It has the second largest Muslim population after Indonesia and the sixth largest population in the world. Pakistan is gifted with the fertile Indus river valley, suitable for productive year-round agriculture, and it is bounded by the Himalayan Mountains, including the second highest peak in the world, K2. It thus has strong potential for hydropower generation that has not yet been utilized. Oil production met only 22% of domestic consumption in 2014. The country's natural gas reserves are depleting, although it has abundant shale gas reserves of 105 trillion cubic feet.[2] The country has large coal reserves, equivalent to 618 billion barrels of oil, which would satisfy domestic demand for 200 years at current consumption levels. The country has large gold and copper ore deposits, with other mineral resources such as iron ore, gypsum, limestone, chromite, rock salt, silver, precious stones, gems, marbles, tiles, sulfur, fire clay, and silica sand.[3] These resources are yet to be fully exploited, and they could help accelerate the growth and development of the country.

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A man hangs decorations on a pole next to a banner showing Pakistan's President Mamnoon Hussain (L), China's President Xi Jinping (C) and Pakistan's Prime Minister Nawaz Sharif, ahead of Xi's visit to Islamabad. REUTERS/Faisal Mahmood

SENATOR MOHAMMAD ISHAQ DAR

Finance Minister, Pakistan

SENATOR MOHAMMAD ISHAQ DAR has been Minister for Finance, Revenue, Economic Affairs, Statistics and Privatization in Pakistan since June 2013. He held first public office in 1992 and 1993 as Minister of State and Chief Executive of the Pakistan Investment Board (PIB). He served as Federal Minister for Commerce and Investment (1997–1999). He was twice Federal Minister for Finance, Economic Affairs, Revenue and Statistics (1998-99 and 2008). He was Leader of the Opposition in the Senate of Pakistan in 2012-13, before assuming the office of Finance Minister for a third time in June 2013. He is currently serving his fifth term in the Parliament.

Senator Dar's professional acumen and remarkable understanding of complex financial, economic, social, trade, investment and industrial issues have earned him wide acknowledgment as a thorough professional. He has 42 years of professional experience in auditing, financial advisory, management consultancy, business, commerce and industry, both in the private and public sectors, in Pakistan and abroad.

1. It is said that Pakistan has strong potential for Islamic finance because of its large Muslim population, but the penetration of Islamic finance remains low. Islamic banks hold about 11.9% of overall banking sector assets. What do you see as the main factors contributing to the slow penetration of Islamic Finance in Pakistan?

Pakistan is one of the active and effective players in the global Islamic finance industry, and it has remained at forefront in developing and promoting Islamic finance. During the 1980s, various amendments were made in the legal and regulatory framework to transform the entire banking sector into a Shariah-compliant system. However, these efforts did not achieve the desired results, mainly because of the absence of supporting infrastructure and the unavailability of adequate human resources.

Learning from past experience, we adopted an evolutionary approach for establishing Islamic banking in the country in 2001, whereby both conventional and Islamic banks were allowed to operate in parallel. This approach has worked well since then. The industry has started from scratch in 2001, acquiring more than an 11% share of assets and a 13% share of deposits in the overall banking industry. Over the last ten years from 2006 to 2015, the Islamic banking industry has witnessed a compound annual growth rate of more than 30% both in terms of assets and deposits.

Given its strong fundamentals and increasing public acceptability as a more sustainable form of finance, the further growth prospects of Islamic finance in Pakistan are very bright. So far, the Islamic finance industry has not penetrated deep enough to serve the financial needs of small and medium enterprises

(SMEs), agriculture, microfinance and low-cost housing. These sectors are largely untapped in most countries with Islamic finance institutions, including Pakistan. We believe that the banking sector in Pakistan has potential for growth through diversification into these underserved areas and segments.

The Islamic banking industry in Pakistan, as elsewhere, faces some key challenges. Among these challenges, the limited availability of trained employees and the public's lack of understanding the Islamic banking paradigm are the major impediments in the further growth of the industry. The present government has shown a strong commitment and inclination towards the promotion of Islamic finance. It formed a high-level Steering Committee for the Promotion of Islamic Banking in 2013. During the last two years, the committee has worked aggressively towards fostering the growth of Islamic finance in the country, and some of its key recommendations like establishment of the Centres of Excellence for professional training, the launch of the All Islamic Share Index and the creation of a policy framework for establishment of Islamic banking subsidiaries have already been implemented. The central bank has also been playing an active role in the development of the Islamic banking industry in the country by developing an enabling policy and regulatory environment.

2. How would you describe the role of Islamic finance in shaping the economic development of Pakistan? What role do you believe the Islamic banking and financial markets can play in achieving the medium to long-term economic goals of the government?

Islamic finance tends to draw a closer focus on social ethics and fair financial practices, which consequently affect the socioeconomic order of the economy. Islamic finance has the potential to contribute significantly towards financial inclusion by extending the outreach of the financial system to the many people who don't use conventional banks because of their religious beliefs. Moreover, we believe that Islamic financing to infrastructure-related projects and other areas like SMEs, agriculture, microfinance, low-cost housing sectors will not only be beneficial for the sustainable growth of the Islamic industry itself, but it will also ensure the economic development of the country.

3. Pakistan is planning large-scale infrastructure developments to meet the growing demand for energy, roads and public transportation. Looking at the historical experience of Pakistan issuing sovereign Sukuk, how do you view the Islamic capital markets for infrastructure development in Pakistan?

The emergence of Sukuk has been a significant development in Islamic capital markets because of its ability to raise funds under Shariah-permissible modes, while maintaining a link between the real economy and the financial sector. In the case of Pakistan, the Sukuk market has witnessed growth over the years with both sovereign and corporate entities issuing Sukuk. The present government is focused on promoting Islamic finance in the country. Islamic capital markets form an integral part of the Islamic financial system, and we are therefore working towards providing a conducive environment for the growth of Shariah-compliant capital markets. Our government has taken major steps to promote the Islamic capital markets by re-entering the global Sukuk markets after nine years and launching the All Share Islamic Index at the Pakistan Stock Exchange. Taking the lead from the government's initiatives, corporate entities have also started tapping the domestic Sukuk market and have received an overwhelming response from investors. The power sector's K-Electric Sukuk, the largest corporate Sukuk issue in the country, worth Rs 22 billion, was oversubscribed on the day of subscription, reflecting the huge potential of this fundraising tool.

Going forward, the increased demand for long-term Islamic funds for infrastructure projects will be met through the Islamic capital market. Global experience has shown that Sukuk issues have been successful in raising proceeds for this purpose. The government of Pakistan is keen to utilize Sukuk for meeting various developmental and infrastructure needs of the country. In collaboration with the State Bank of Pakistan (SBP), the Securities and Exchange Commission of Pakistan (SECP) and other stakeholders, the government is working to develop appropriate Sukuk structures with a particular focus on infrastructure and developmental projects.

4. Social finance (for SMEs and microfinance) has been a hallmark success in Pakistan. How can this be further expanded and brought within the ambit of Islamic finance?

The eradication of poverty, the promotion of socioeconomic justice, and the more equitable distribution of income are among the primary

> THE ISLAMIC FINANCE INDUSTRY IN PAKISTAN AND INDEED THE WORLD HAS NOT DONE ENOUGH TO SERVE THE FINANCIAL NEEDS OF SMES, POOR HOUSEHOLDS, AGRICULTURE AND LOW-COST HOUSING. ISLAMIC BANKING INSTITUTIONS NEED TO REACH OUT TO THESE IMPORTANT SECTORS FOR FINANCING.

goals of Islam, and they should be features of an Islamic economic system. It is imperative for Islamic financial institutions to include social dimensions in their operations and to work for the fulfilment of the needs of all social groups in Pakistan.

The Islamic finance industry in Pakistan and indeed the world has not done enough to serve the financial needs of SMEs, poor households, agriculture and low-cost housing. Islamic banking institutions need to reach out to these important sectors for financing. In particular, SMEs remain crucial for achieving the growth of our economy. Both developing and underdeveloped countries support SMEs as major contributors towards their growth.

Because of its inherent strengths, the Islamic banking system has the potential to simultaneously achieve the objectives of economic development and socioeconomic justice. Given its risk-sharing model, these investment areas overlooked by conventional financial institutions offer a good opportunity for Islamic banks to finance projects that are technically viable. Islamic banks have a business model that enables them to cater to such clients, although further sophistication is required in their product range to capitalize on this opportunity.

To encourage the outreach of Islamic banking institutions to these priority sectors, the SBP has assigned indicative targets to banks for SME and agricultural financing. Similarly to encourage Islamic microfinance, SBP has introduced a comprehensive framework that permits the establishment of full-fledged Islamic microfinance banks, Islamic microfinance services by full-fledged Islamic banks, Islamic microfinance services by conventional microfinance banks (MFBs), and Islamic microfinance divisions in conventional microfinance banks to offer Shariah-compliant microfinance services. Subsequently, NRSP Microfinance Bank, Ltd. has started offering the first Islamic microfinance banking services through a dedicated division.

5. Another major challenge for Islamic finance is developing qualified employees and managers that can operate at a national and global scale. How does the government plan to tackle this challenge? There is also a large pool of Pakistani professionals serving the Islamic finance industry overseas. Are there opportunities to attract them to return and support the Islamic financial services industry in Pakistan?

It is true that the development and sustainability of Islamic banking and finance requires the development of adequate human resources. The government is fully aware of the need for qualified human resources in the field of Islamic banking and finance. It is for this reason that three Centres of Excellence in Islamic Finance have been established at renowned institutions, including Institute of Business Administration (IBA) in Karachi, Lahore University of Management Sciences (LUMS), and Institute of Management Sciences (IMSciences) in Peshawar. We are hopeful that these centres will not only help educate great Islamic finance professionals to satisfy the growing needs of the industry, but also that they will create an environment that promotes innovation. Moreover, these centres will act as a platform for the industry and key stakeholders to discuss and resolve the various issues they face.

Pakistani professionals serving the global Islamic finance industry are assets for the country, and their efforts for the promotion of Islamic finance are acknowledged globally. In particular, the pioneering work they did on the legal, regulatory and supervisory fronts during the 1980s was hailed at the international level as a number of countries leveraged this work to establish their own Islamic finance industries. Pakistan presently has a pool of leading practitioners and Shariah scholars who can work with expatriate Islamic finance professionals and contribute towards the development and promotion of Islamic finance both at the local and international levels.

6. IRTI and IDB are supporting various initiatives for the development of Islamic finance in Pakistan including the recently established Centres for Excellence in Islamic Finance. What else can IRTI and IDB do for the promotion and development of Islamic finance in Pakistan?

The government appreciates the support provided by IRTI and IDB for the recently-established Centres for Excellence in Islamic Finance. However, the long-term nature of these initiatives warrants continued efforts on the part of stakeholders for their realization. We look forward to an increase in the frequency of such joint programmes in future as well. Similarly, IRTI and IDB can also extend their support to the Islamic financial sector through various technical assistance and public awareness campaigns. Moreover, the rich experience of Pakistan's Islamic finance professionals can be used by IRTI and IDB to develop Islamic finance in other member countries of the Islamic Development Bank Group.

7. You are seen as a proponent of intra-SAARC (South Asian Association for Regional Cooperation) trade. However, there remain significant challenges regarding harmonization, stability and governance. What do you see as a realistic way forward, and what implications do you see for the banking sector in general and Islamic finance in specific?

The global Islamic finance industry has witnessed substantial growth in the last four decades. However, the penetration of Islamic finance in the SAARC region is still very limited. Given high levels of financial exclusion and a significant Muslim population in this region, Islamic finance has great potential in the SAARC countries. Pakistan, as one of the most important members of the global Islamic finance community, has extensive expertise to help other countries in the region develop their Islamic finance sector. Pakistan has already provided technical support to SAARC countries, including Bangladesh and Afghanistan. Going forward we are more than willing to help other countries in the region develop and promote their Islamic finance industries.

8. China has ambitious plans for the revival of the Silk Road through collaboration with Muslim-majority Central Asian states. Pakistan, with its existing Islamic finance infrastructure could provide an advisory role to the Asian Infrastructure Investment Bank (AIIB) and the Government of China to structure these deals using Islamic modes of financing. Is there an opportunity for Pakistan to promote Islamic finance as viable alternative to conventional finance in China in this process?

The China-Pakistan Economic Corridor (CPEC) is a milestone initiative that is going to speed up economic cooperation and connectivity between Pakistan and China. The Islamic banking industry, as an integral part of our financial system, has the opportunity to finance infrastructure projects contributing towards real economic growth and expanding China's business.

Pakistan is an active member of International standard setting agencies like Islamic Financial Services Board (IFSB), the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the International Islamic Financial Market (IIFM). They all are playing key roles in developing the Islamic finance industry around the world. Over the years, we have developed expertise in Islamic banking, and we have a pool of experienced practitioners and renowned Shariah scholars who can provide advisory services to countries and financial institutions that are interested in developing their legal and regulatory framework and Shariah-compliant products.

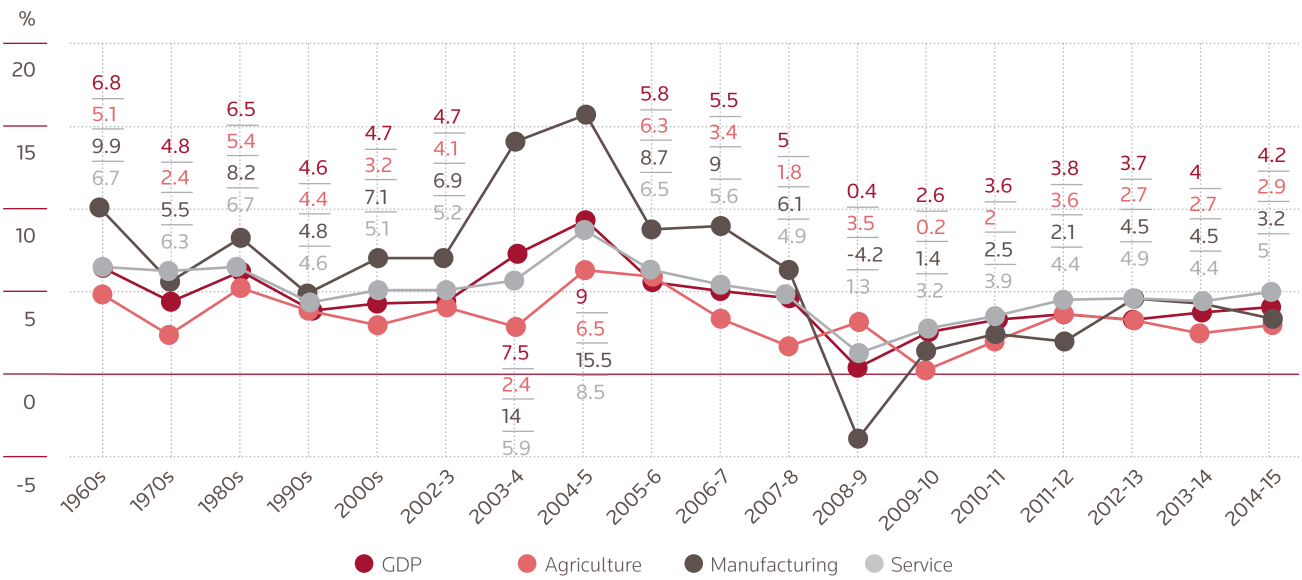
All major multilateral agencies, such as the World Bank, IMF, Asian Development Bank (ADB) and other related agencies such as IFC are very keen to use Islamic modes of financing. AIIB is at a very early stage of operationalization. Once it has started its full-scale operations, I think, it will also be interested in including Shariah-compliant products among the services it is going to offer.

MACROECONOMIC FUNDAMENTALS

Pakistan is a lower-middle-income country with a nominal GDP of US$289 billion and GDP per capita of US$1,512 (2015),[4] which is below average in South Asia (US$2,909, 2015). The economy grew in the range of 4.6% to 6.8% on average per annum during recent decades. GDP growth picked up to 7.5% in 2003-04 and remained 6.56% on average per annum during 2003-04 and 2007-08. Economic growth dropped to 0.4% as a result of the global financial crisis during 2008 and 2009. The manufacturing sector experienced real contraction while the growth of agriculture and services slowed. After the crisis, the economy resumed growth, climbing to 4.2% in 2015. It is expected that GDP will grow in the range of 4.5% to 5.2% in the coming period, 2016 to 2020.[5]

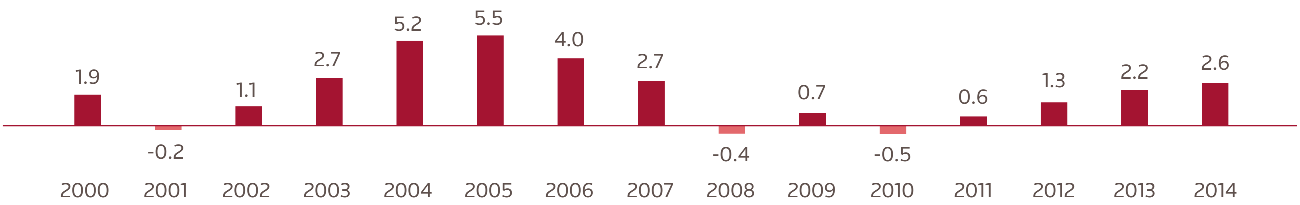
Per capita GDP has been growing at average rate of 2% per annum during the last 15 years. The rate has fluctuated, registering negative growth in the years 2001, 2008 and 2010, but recovering in recent years, reaching 2.6% in 2014. The decreasing rate of population growth and the expected increase in GDP growth may lift GDP per capita growth in the coming years.

GDP GROWTH BY SECTOR (%)



Source: Pakistan Economic Survey (2014-15)

GROWTH TREND IN GDP PER CAPITA (%)



Source: World Bank, World Development Indicators (2015)

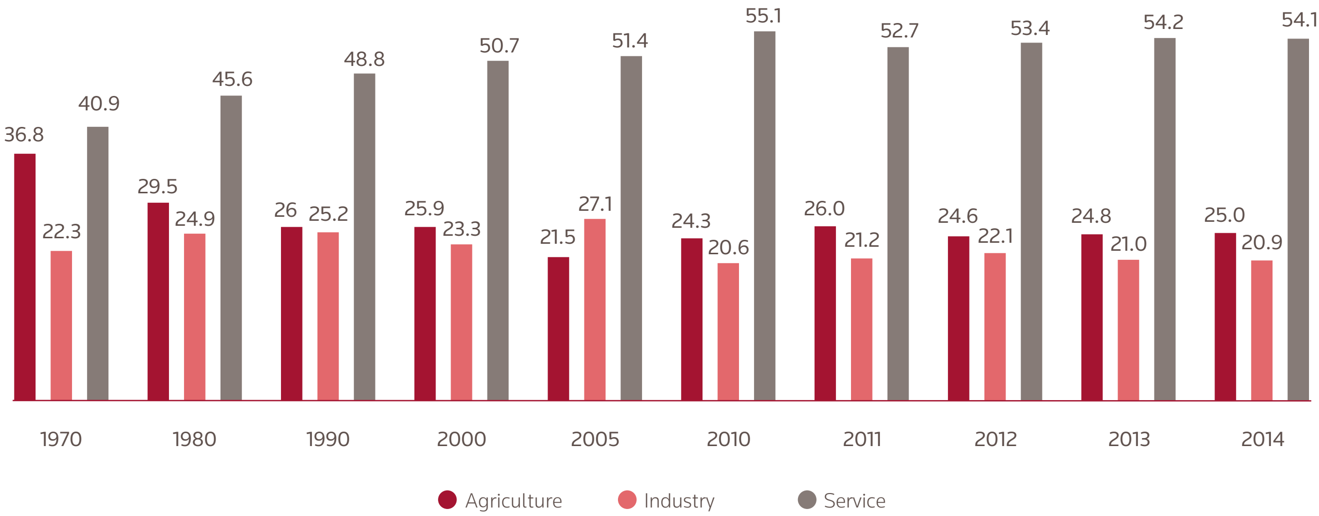
Moderate Structural Shift in GDP

Pakistan has experienced a moderate structural shift in its economy from agriculture towards the services sector.[6] The relative share of the services sector was 41% of the GDP in 1970, while the agriculture and industrial sectors contributed 36.8% and 22.3% respectively during the same period. The contribution of the services sector has increased slowly to 54% of GDP by 2014. The share of the industrial sector to GDP did not change over the same period, which indicates stagnation in industry. The slow growth of industry sector largely attributes to large scale nationalisation of industries in the early 1970s and inconsistent industrial development policies, and unfavourable regional situation due to the war in Afghanistan.

Improving the Fiscal Balance

Pakistan is facing a persistent fiscal deficit over the years. From 2001 to 2015, annual state revenues averaged 14.4% of GDP, while average expenditures were 19.2% of GDP. The largest recent single-year fiscal deficit was 8.6% of GDP in the fiscal year of 2012. Subsequently, the budget deficit has declined substantially. According to IMF estimates, the fiscal deficit will decline further to 3.1% of GDP on average during 2016 to 2020, and it is expected to reach 2.4% of GDP by 2020.

SECTOR SHARES OF GDP (%)



Source: World Bank, World Development Indicators (2015)

GOVERNMENT NET LENDING AND BORROWING (% OF GDP)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
General government revenue	14.36	14.38	14.23	14.3	12.6	13.03	13.46	15.30	14.6	15.4	16.3	16.7	17.44	17.69
General government net lending/borrowing	5.12	7.06	5.05	6.0	6.7	8.63	8.37	4.88	5.2	4.2	3.3	2.93	2.66	2.41
General government total expenditure	19.48	21.44	19.28	20.3	19.3	21.66	21.83	20.18	19.8	19.6	19.6	19.63	20.1	20.1

Source: IMF, World Economic Outlook (2015)

Declining Inflation

The growth in consumer prices was limited between 2000 and 2003. After 2003, inflation increased towards 7% to 9% between 2004 and 2007, with a spike to 20.3% in 2008 reflecting high global commodity prices. Inflation remained in the double digits between 2008 and 2011. However, it has shown a declining trend since 2012, and it has been in the single digits, closer to 7% per annum. It dropped further to 4.8% in 2015.[7] Declining global oil and commodity prices have largely contributed to the fall in consumer prices.

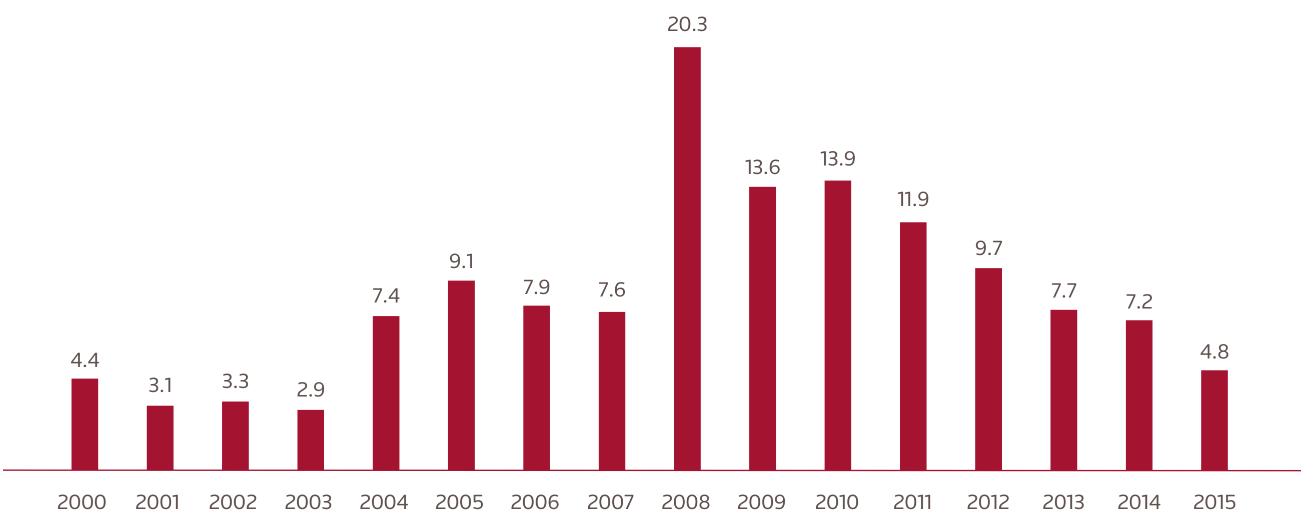
Widening Savings and Investment Gap

Savings and investment are important pre-condition for economic growth. Domestic savings are the most important component of investment. For high, sustained growth in contemporary economies, at least 25% of GDP must be invested.[8] Compared to this, the gap between savings and investment has been widening in Pakistan, a bad sign for the potential growth of the economy. Gross investment on average was 16.9% of GDP between 2000 and 2014, ranging from 15% in 2014 to 19% in 2005. On the other hand, domestic savings is experiencing a declining trend since its peak of about 17% of GDP between 2003 and 2004. The gap between gross domestic capital formation and gross domestic savings has been widening over the subsequent years. Low savings has been a major constraint on investment in the country. The impact of lower saving rates can be seen in gross fixed capital formation, which averaged at 15.3% of the GDP between 2000 and 2014 with an average 11.1% share in the private sector during the same period.

Low Domestic Credit to the Private Sector

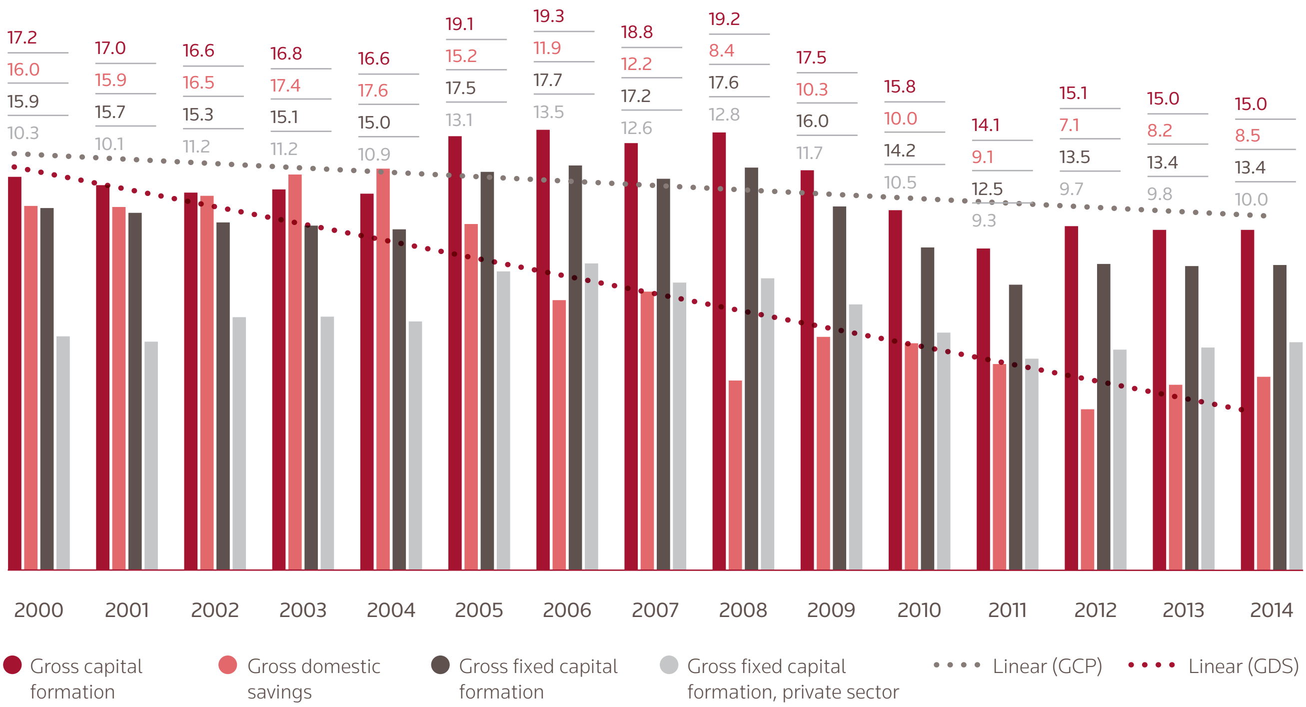
Increasing domestic credit to the private sector is one of the indicators of a prosperous economy. More credit in the private sector leads to a greater contribution of the private sector to GDP growth. In economies that have developed these avenues, the share of domestic credit exceeds 100% of GDP. Domestic credit to the private sector in Pakistan, by contrast, has remained around 23% of the GDP in the years 2001 to 2014. Domestic credit showed a positive trend from 2001 through 2008, but it has been on a declining trend since 2008, reaching 15.6% in 2014. Domestic credit to the private sector in Pakistan is lower than in neighbours such as Nepal and Bangladesh. In Pakistan, domestic credit was overwhelmingly directed towards the industrial sector (63.2%), as compared to services (16.9%) and agriculture (8.9%) in 2014-2015. Consumer financing was 11% of total commercial bank financing in the same period.[9]

INFLATION (CPI, % PER ANNUM)



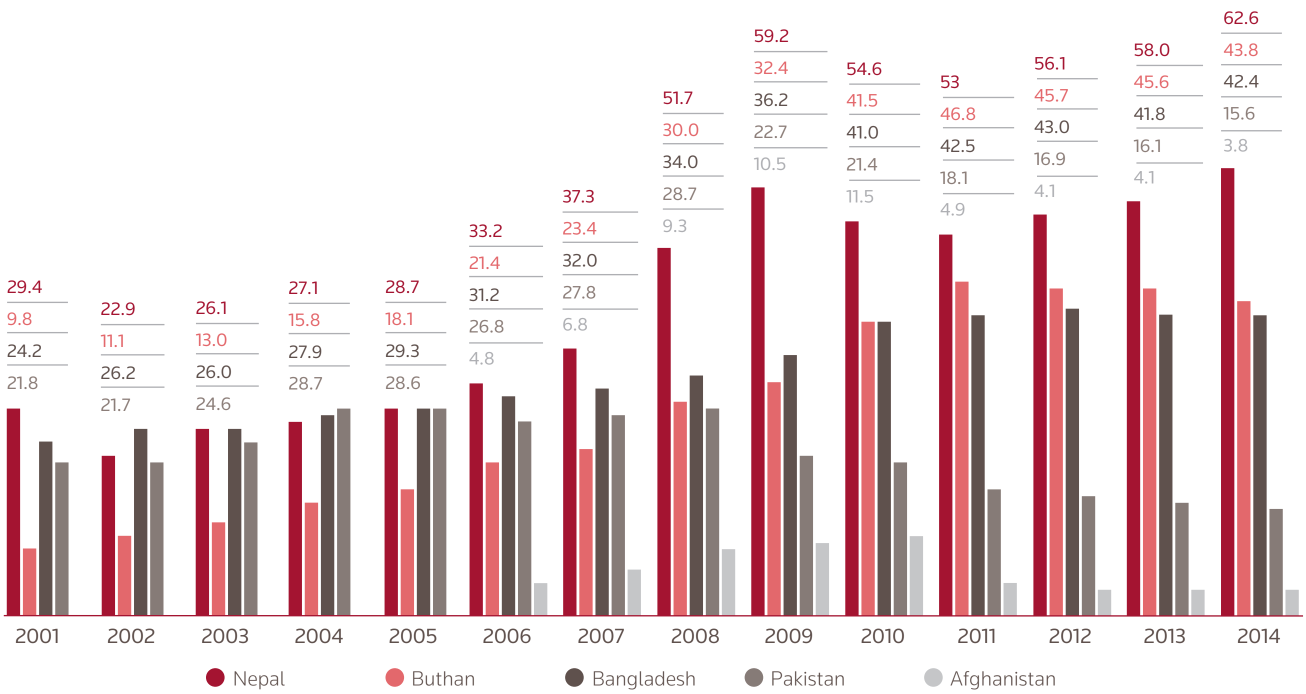
Source: World Bank, World Development Indicators (2015)

GROSS SAVINGS VS CAPITAL FORMATION (% OF GDP)



Source: World Bank, World Development Indicators (2015)

DOMESTIC CREDIT TO PRIVATE SECTOR (% OF GDP)



Source: World Bank, World Development Indicators (2015)

Current Account

The current account balance of Pakistan was positive between 2001 and 2004. However, it returned to deficits from 2005 through 2015, with the exception of 2011. Pakistan's trade deficit is the major component of its current account deficit. It is expected that the current account deficit will remain less than 1% of GDP (in the range of 0.5 to 0.9%) in the coming period from 2016 through 2020.

Increasing External Debt

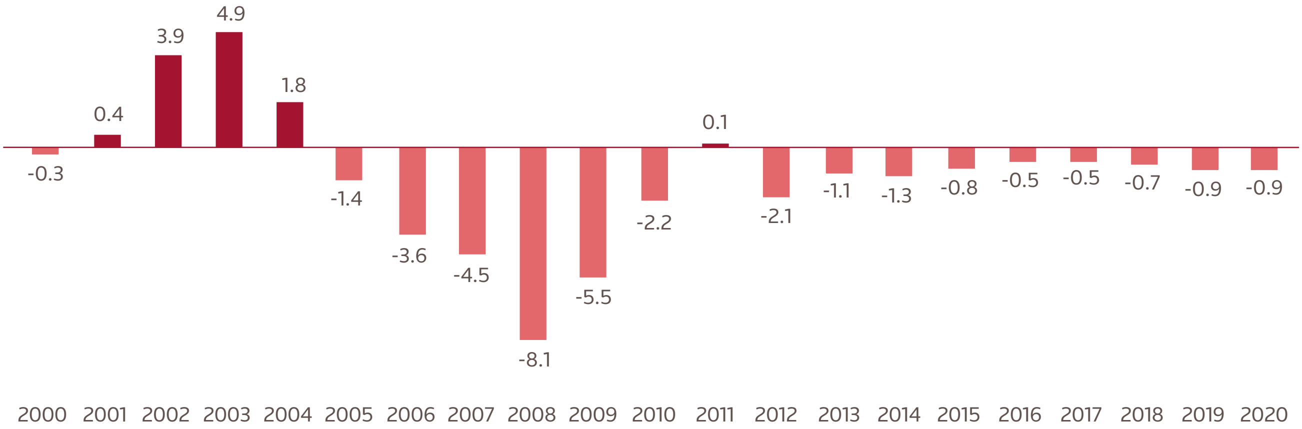
The external debt has increased considerably over the last decade. Pakistan's external debt almost doubled from US$32 billion in 2001 to US$62 billion in 2014. The country is paying on average one-fifth of its export earnings as debt service, which is a big drain on the earnings of the country.

Improving Foreign Exchange Reserves

Pakistan held low foreign exchange reserves between 2005 and 2014, when they were worth an average value of 3.6 months of retained imports. The year 2013 registered the lowest value, 1.7 months of imports (US$7.65 billion), which has since improved and reached 3.1 months of imports (US$14.3 billion) in 2014. However, in the last year, this value further improved to 5 months of retained imports (about US$18 billion). The increased flow of foreign remittances and the reduction of the imports bill of 6.7% in 2014-15 contributed to the improvement in foreign reserves.

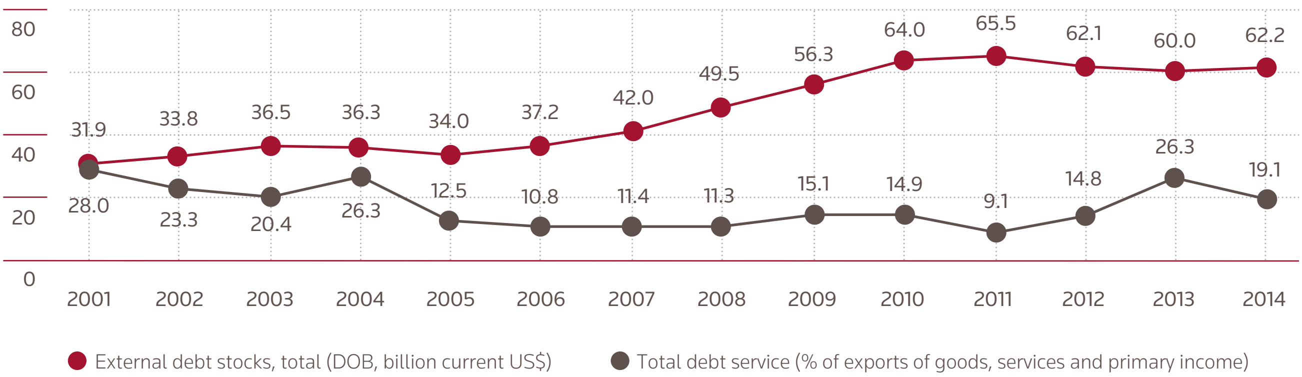
> A man stands near an electronic board displaying stock prices during a trading session at Karachi Stock Exchange. REUTERS/ Akhtar Soomro

CURRENT ACCOUNT BALANCE (% OF GDP)



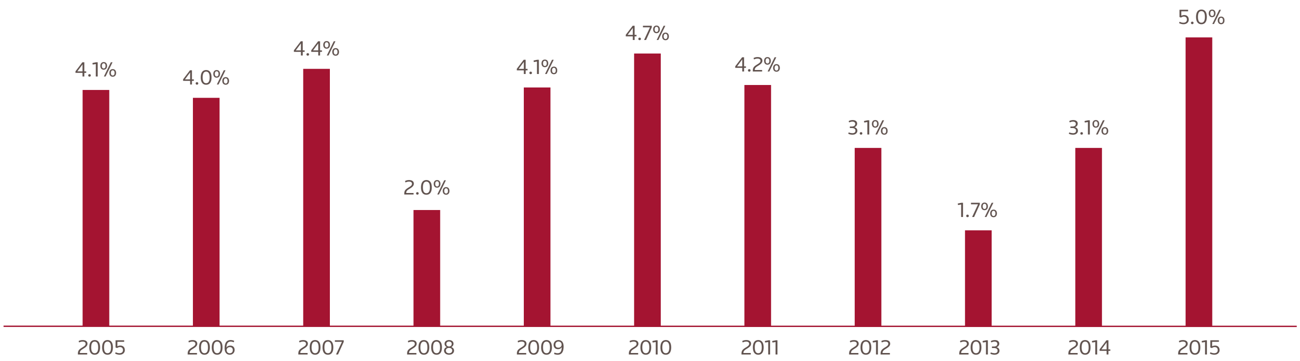
Source: IMF, World Economic Outlook (2015)

EXTERNAL DEBT AND DEBT SERVICE



Source: World Bank, World Development Indicators (2015)

TOTAL RESERVES IN MONTHS OF IMPORTS



Source: World Bank, World Development Indicators (2015), data for 2015 SBP Annual Report

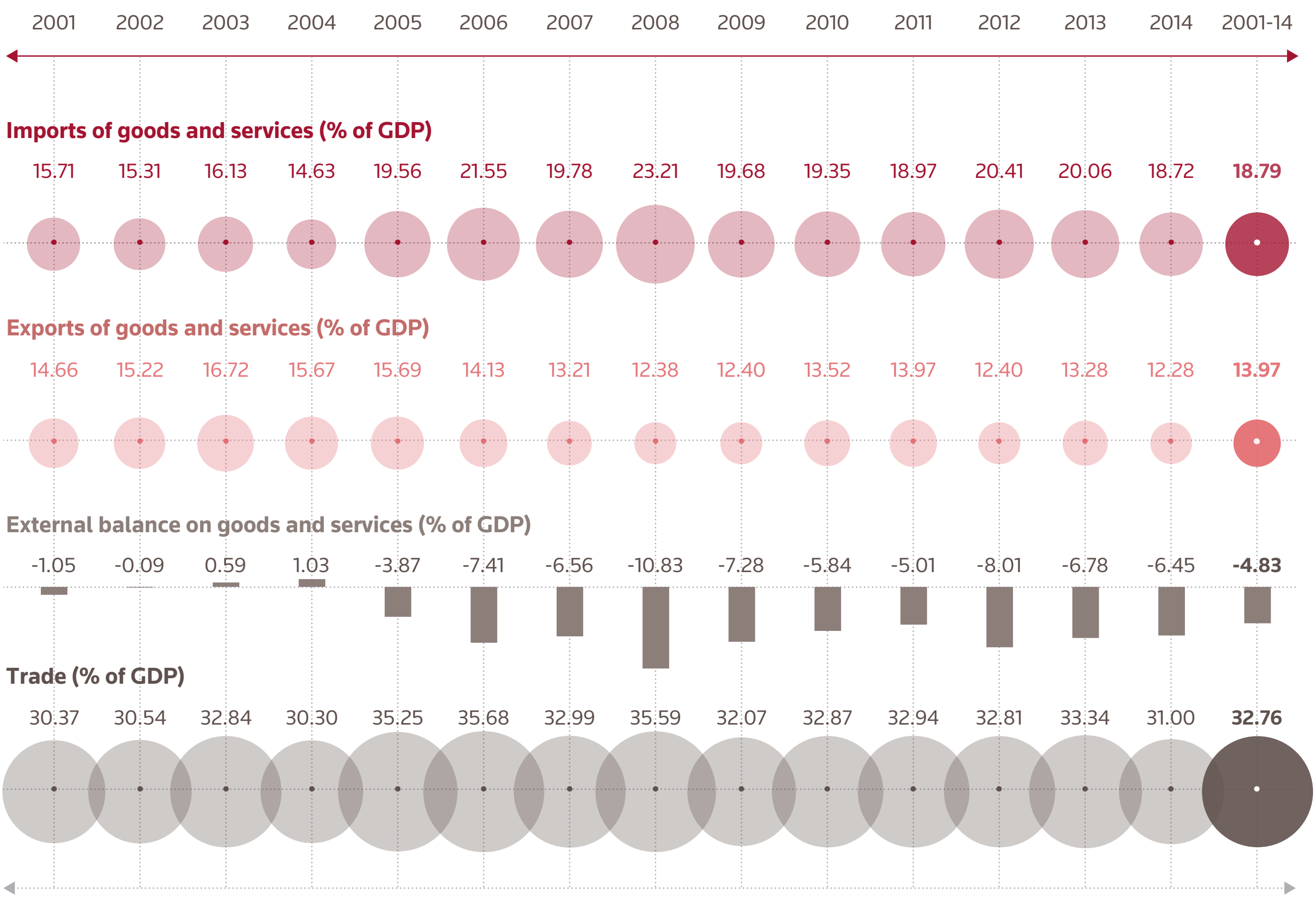
FDI FLOWS AND THE HIGH TRADE DEFICIT

Pakistan is facing a consistent balance of trade deficit because of its narrow base of exports, mostly raw commodities, and its increasing imports. The trade volume fluctuated between 30 to 35% of GDP during the period 2001-2014. Pakistan has been struggling to increase its exports, which remained between 12% and 16% of GDP during 2001-2014. Meanwhile, imports ranged between 15% to 23% of GDP. The average annual trade deficit consequently was 5% of GDP per annum during this period, reaching highs of 10.8% in 2008 and 8% in 2012.

The export base of Pakistan is very narrow. The major exports of the country in the past year were cotton and textiles (55.4% share), food (principally rice, 19.4%), other manufactures, including carpets, sports, surgical goods and leather (16.1%) and petroleum (2.7%). These product groups add little value to their feedstock, and they are subject to international price fluctuations, which affects consistent export earnings. Pakistan requires the diversification of its exports to improve its trade balance, and it should try to develop high-tech manufacturing to address this problem.

Pakistan's trade centres on a few major export partners, such as the United States (15%), European Union (20%), China (9%), UAE (4%), and Afghanistan (8%). It could improve its trade balance by expanding exports to African, South American, ASEAN and Central Asian countries.[10]

IMPORTS, EXPORTS AND TRADE DEFICIT (% OF GDP)



Source: World Bank, World Development Indicators (2015)

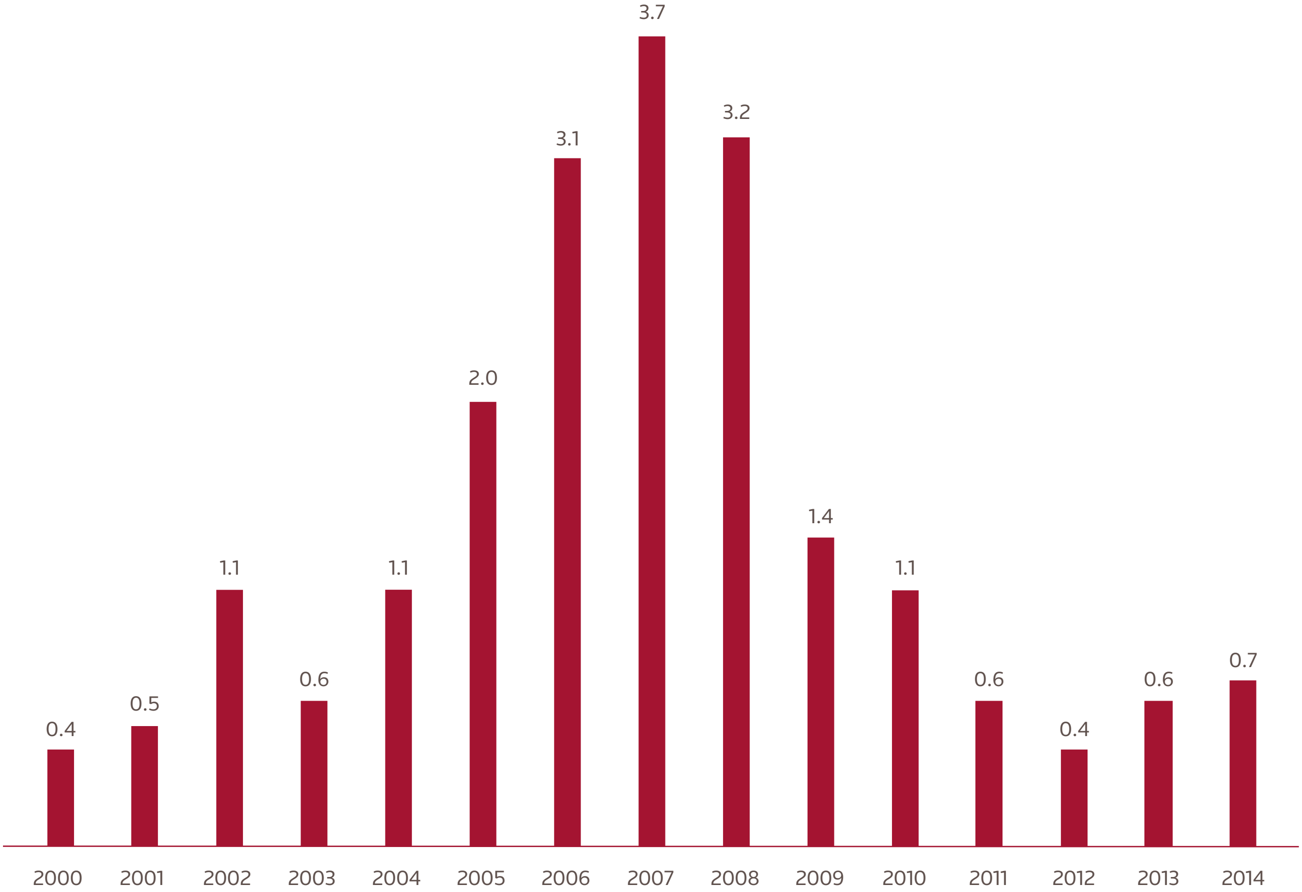
Pakistan's major import partners are also concentrated, including countries of the Middle East, China, India, Indonesia, Malaysia, Japan, Germany and the United States. In 2013-2014, its major imports consisted of petroleum (26.1 %), machinery, including telecommunications (15.4%), food (11.1%), consumer durables (5.9%) and raw materials (15.7%).

Foreign Direct Investment

Foreign direct investment (FDI) plays a pivotal role in the growth and development of emerging economies. Pakistan has been receiving a small net inflow, an average of 1.4% of GDP per annum, of FDI between 2000 and 2014. FDI net inflow increased from 1.1% of GDP in 2004 to 3.7% in 2007. It subsequently declined during the financial crisis to 0.4% of the GDP by 2012. During this period, the country faced repeated challenges in maintaining law and order because of the war on terrorism and domestic political disruptions. In the present political regime, the business environment is improving and terrorist attacks have been reduced. With the stabilization of the domestic situation, economists and businesspeople anticipate the inflow of FDI will soon improve.

Investors have targeted most FDI at oil and gas exploration, telecommunications, finance, construction and real estate. In 2013-14, about 30% of total FDI went to oil and gas, followed by the telecommunication sector (25.3%) and the financial sector (11.4%). The chemical and power sectors received 4.6% and 4.2%, respectively.

FOREIGN DIRECT INVESTMENT, NET INFLOWS (% OF GDP)



Source: World Bank, World Development Indicators (2015)

DEMOGRAPHIC OVERVIEW

Unemployment

The agriculture sector remains the most significant employer in Pakistan, contributing 43.5% of total employment in 2014. Services employ 34% of workers, while the industrial sector provides 22.5% of the remaining jobs. During the 1980s and 1990s, the economy was performing well and the unemployment rate was low. According to the Pakistan Economic Survey (2014-15), the unemployment rate has declined from 6.24% in 2012-13 to 6.0% in 2013-14. However, youth unemployment (of the total labour force aged 15-24) increased from 8.4% in 2010 to 10.4% in 2014, according to an estimate by the World Bank. Female youth unemployment is more severe than male youth unemployment, at 12,9% and 9.4% respectively. The International Labour Organization projects that total unemployment will decline to 4.9% in 2020.

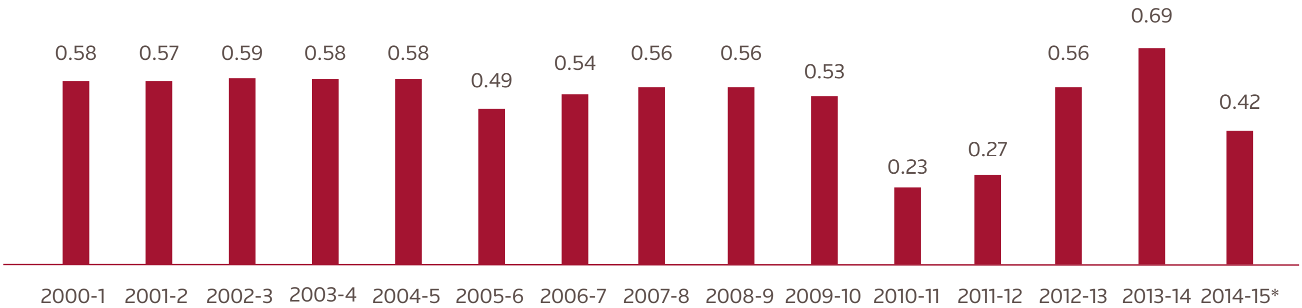
The government of Pakistan has been making efforts to reduce youth unemployment through training and entrepreneurship programmes. Prime Minister Nawaz Sharif launched the Youth Development Programme in September 2013 with the objective of providing various opportunities for young people. The programme aims to provide individuals from 16 to 45 years of age new opportunities for education, scholarship, training and employment. The programme funds and organizes six different schemes, including Micro Interest-Free Loans, Small Business Loans, Youth Training, Youth Skill Development, Educational Fee Reimbursement and the Youth Laptop Programme. The government has provided 15,487 loans totalling Rs. 4.4 billion (US$41.9 million) under the Small Business Loan scheme and 35,545 loans totalling Rs 729 million (US$6.94 million) under the Interest-Free Loan scheme in 2014-15. In addition, degree holders from recognized institutions are provided internship opportunities in the private and public sector offices. The programme utilizes existing vocational and technical training institutions to grant young people training and skill development.

Human Development

Pakistan's progress in improving education has been steady but slow. In the 2000s, the national literacy rate was 52.6%. It increased to 58% by 2014, including 70% male and 47% female. Pakistan had traditionally allocated only 1.4% to 1.7% of GDP to education from the 1960s to the 2000s. In 2014, government expenditures on education reached 2.1% of GDP, but this still remains low even by the standard of many lower-middle-income economies.

In 2015, average life expectancy was 65.2 years for men and 67.3 years for women. As with education, the government has allocated insufficient resources to the health sector. Public expenditures for health remained in the range of 0.23% to 0.69% of GDP from 2010-11 to 2013-14. The low commitment of resources for education and health has had a negative impact on Pakistan's UNDP Human Development Index (HDI) rank.

GOVERNMENT HEALTH EXPENDITURES (% OF GDP)



Source: Pakistan Economic Survey (2014-15)

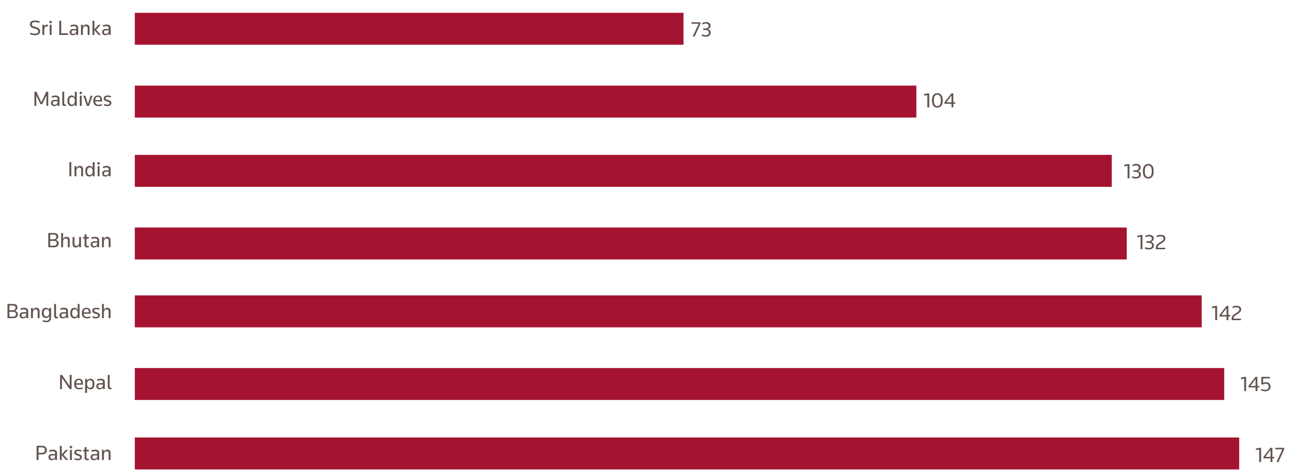
Human Development Index

Human development index (HDI) is a broader measure of development than GDP per capita. HDI takes health, education and income inequality indices into account.

The United Nations ranks Pakistan 147 of 188 countries in 2015, which is poor compared to its neighbours in South Asia. Pakistan experienced an increase in HDI from 0.337 in 1980 to 0.538 in 2014. This represents marginal improvement over 34 years, and it has slowed particularly over the period 2005 to 2014. Due to its slow progress in health, education and nutrition, Pakistan has been trying their best to achieve Millennium Development Goals targets set by the United Nations.

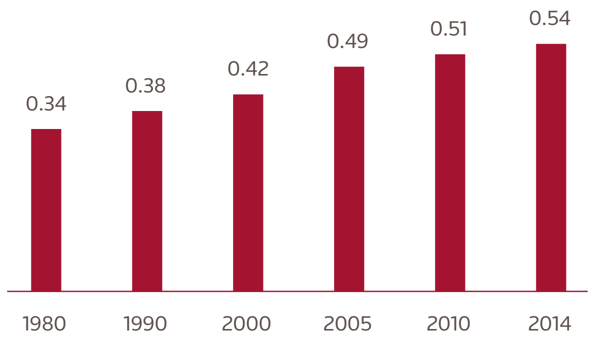
Foreign remittances are a major component of the current account balance of Pakistan. These remittances have therefore played a crucial role in the development of the economy. Overseas workers' remittances increased from 5.2% of GDP (US$11.2 billion) in 2011 to 6.8% of GDP (US$18.5 billion) in 2015. Regarding regional inflow of remittances, 30% originates from Saudi Arabia, followed by the United States and United Kingdom (26%) and the UAE (22.8%). Other GCC countries and EU countries contribute 11.7% and 2% respectively.[11]

HDI RANKING (OUT OF 188 COUNTRIES), 2015



Source: Human Development Report (2015)

PAKISTAN'S HUMAN DEVELOPMENT INDEX VALUE (1980 - 2014)



Source: Human Development Report (2015)

FOREIGN WORKERS' REMITTANCES (MILLION US$)

Year	2011	2012	2013	2014	2015
Total	11,200.97	13,186.62	13,921.66	15,837.71	18,454.04
% of GDP	5.24	5.88	6.02	6.51	6.84

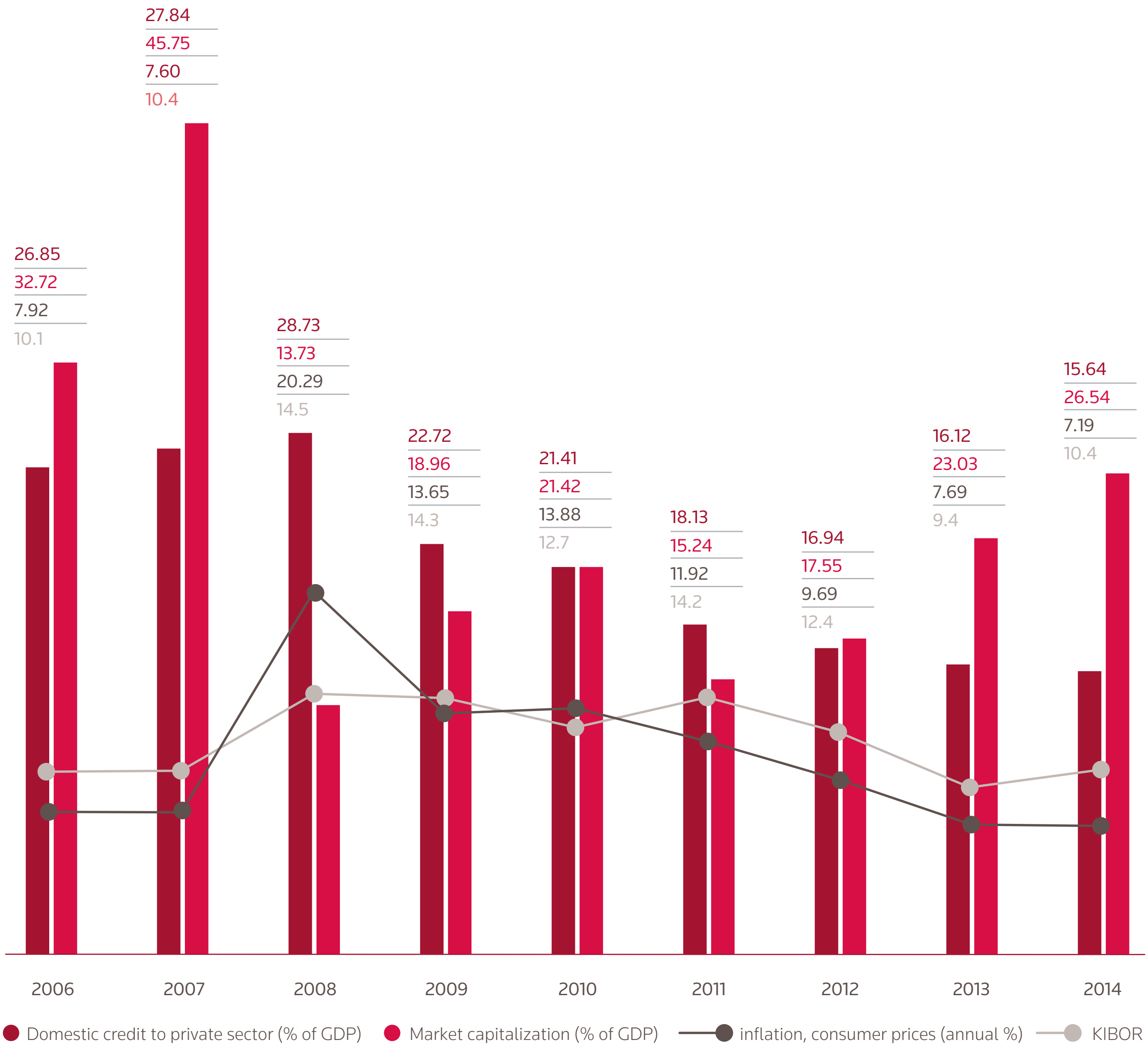
Source: State Bank of Pakistan (SBP) annual report 2015

Cost of Funding

The government of Pakistan has adopted an expansionary monetary policy recently to stimulate private investment. Currently, KIBOR[12] stands at 6% per annum.

The prevailing trends in KIBOR, inflation, domestic credit, and market capitalization clearly indicate that credit to the private sector is insensitive to KIBOR. Furthermore, the relationship between KIBOR and market capitalization is not evident either. This indicates that cheap money is not the key factor for private investment. Rather, other factors such as the business environment, corruption, domestic security, property protection, policy consistency and political credibility may play the major role. In the absence of growth in credit to the private sector, increased borrowing from the banks by the government may rather lead to the crowding out of domestic borrowers.

COST OF FUNDING VERSUS DOMESTIC CREDIT AND MARKET CAPITALIZATION



Source: World Bank, World Development Indicators (2015) and SBP, annual report (2015)

A farmer checks his wheat crop on the outskirts of Lahore. REUTERS/ Mohsin Raza

SERIOUS EFFORTS NEEDED TO IMPROVE GENERAL BUSINESS ENVIRONMENT

Both improved domestic security and consistent government economic policies are important to attracting both foreign and domestic investment. Although Pakistan has is endowed with rich natural resources and an abundance of labour, because of significant political and economic instability, Pakistan has not been an attractive market for investment.

The World Bank *Doing Business* Report for 2015 ranks Pakistan 138 of 189 countries, which reflects these difficulties in conducting business. Pakistan ranks below the regional average in the categories "starting a business," "getting electricity," "registering property," "getting credit," "paying taxes" and "enforcing contracts," while it ranks 24 worldwide in "protecting minority investors" and 63 in "dealing with construction permits." Nevertheless, these figures demonstrate Pakistan needs to make a strong effort to improve many aspects of its business environment. Potential investors consider corruption, high taxes, inflation, poor access to finance, and inefficient government bureaucracy as the most problematic factors for doing business in Pakistan. In recent years, the present government has taken steps to curb extremism and terrorism. It has been successful to a certain extent in achieving its goals of enforcing law and order and creating a business-friendly environment.

RANKING OF DOING BUSINESS 2015 (189 COUNTRIES TOTAL)

Country	Ease of Doing Business Rank	Starting a Business	Dealing with Construction Permits	Getting Electricity	Registering Property	Getting Credit	Protecting Minority Investors	Paying Taxes	Enforcing Contracts	Resolving Insolvency
Afghanistan	175	23	186	155	183	90	189	83	172	159
Bangladesh	172	111	118	189	184	128	87	85	188	155
Bhutan	70	85	74	52	56	71	114	26	50	189
India	134	164	184	99	138	36	8	156	178	136
Nepal	94	104	85	128	73	128	54	124	152	78
Pakistan	136	114	63	157	137	128	24	171	151	92
Sri Lanka	113	104	106	101	151	90	46	157	161	84
Regional average	127	100	116	126	132	96	74	114	150	127

Source: World Bank, Doing Business Report (2015)

The World Bank Country Policy and Institutional Assessment (CPIA) rates economies against 16 different categories that are grouped into four clusters. It rates each category from 1 (lowest) to 6 (highest). The economic management cluster includes macroeconomic management, fiscal policy, and debt policy. Pakistan's rating was fair (4) in the beginning of early 2000s, but its rating has been declining in subsequent years and declined to 2.8 in 2013, while it increased to 3.2 in the year 2014. Despite the efforts of the present regime, it will take time to redress these problems and move the economy more consistently towards growth. Macroeconomic management, which is a component of the cluster, showed a similar downward trend, although it rebounded in the year 2014.

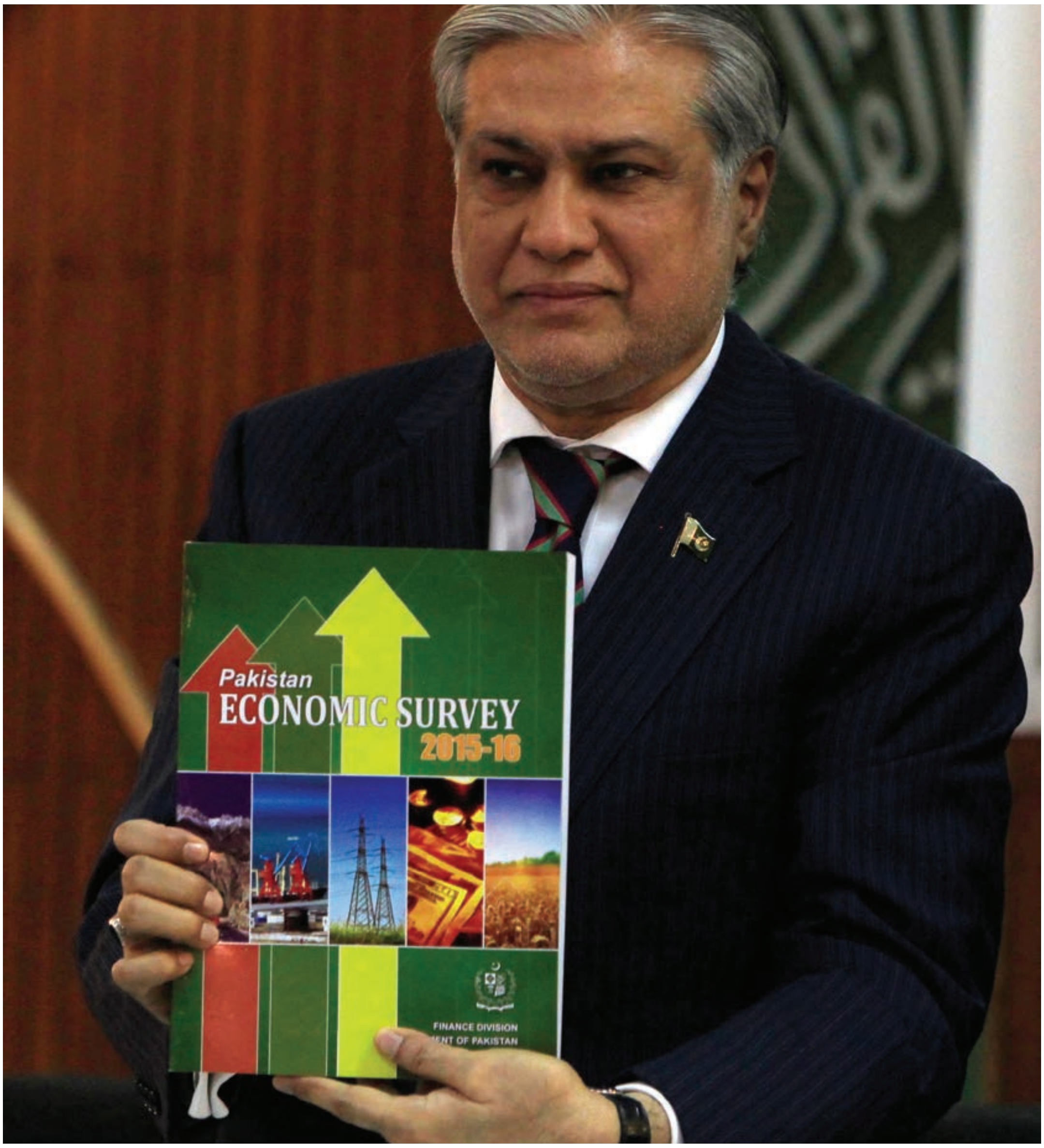
CPIA RATINGS

Source: World Bank, World Development Indicators (2015)

Pakistan's economic outlook in 2016

Pakistan has been facing serious security challenges for more than a decade. Particularly, it has been fighting against domestic terrorism. The War in Afghanistan has had a huge impact on the bordering Federally Administered Tribal Areas, and Pakistan has had to pay a huge price to combat the insurgency in these areas.

The Pakistan Economic Survey estimates the state has spent US$107 billion on the war against terrorism in the past 14 years. This has not only put an unprecedented financial burden on the economy, but it has also disrupted and damaged its various sectors. The survey estimates total losses to different sectors of the economy at US$6.6 billion and US$4.5 billion in the fiscal years 2013-14 and 2014-15.



Pakistan's Finance Minister Ishaq Dar shows a copy of Economic Survey to media during a news conference in Islamabad, Pakistan. REUTERS/ Faisal Mahmood

The National Action Plan was launched in 2015 to curb terrorism. The security situation has improved considerably since then. Current macroeconomics indicators reflect the improving security situation.

Pakistan's GDP growth is improving across all sectors and GDP per capita is also growing. Savings and investment are expected to increase, which will give a boost to growth. The state fiscal deficit is declining and the current account balance is improving. Unemployment is decreasing, and it is expected to fall to 4% by 2020. Absolute poverty is declining and it has reached 8.3% of the population, as per World Bank estimates. The inflation rate has decreased significantly. The central bank has accordingly reduced the policy rate, which will encourage private investment in the economy. Foreign remittances have shown significant growth in the recent years and the country's foreign reserves have increased to the value of five months' imports. The government has put a strong emphasis on infrastructure development. The China-Pakistan corridor[13] will make a significant contribution in employment opportunities and boosting the economy. All these economic indicators are positive, which represent the foundation for a promising economic outlook.

However, the country is facing a number of challenges. Overcoming these challenges will put the economy on a path towards sustainable growth. The World Bank's *Doing Business* indicators reveal that various factors of Pakistan's business environment lag behind its neighbours. Most importantly, businesspeople feel corruption, tax rates, access to finance, bureaucracy, and policy instability are the major competitive barriers for doing business in Pakistan. The improvement of these factors will not only attract foreign investment, but it will encourage domestic investors as well.

Pakistan's exports are mainly commodity based, and the export market is limited. There is a need to diversify exports and to manufacture higher value-added and technology oriented exports. Pakistan's export market should be expanded to Africa and South America.

The present power shortage[14] has affected industrial production. This is a serious challenge, and the present government has promised to overcome this shortage by 2018.

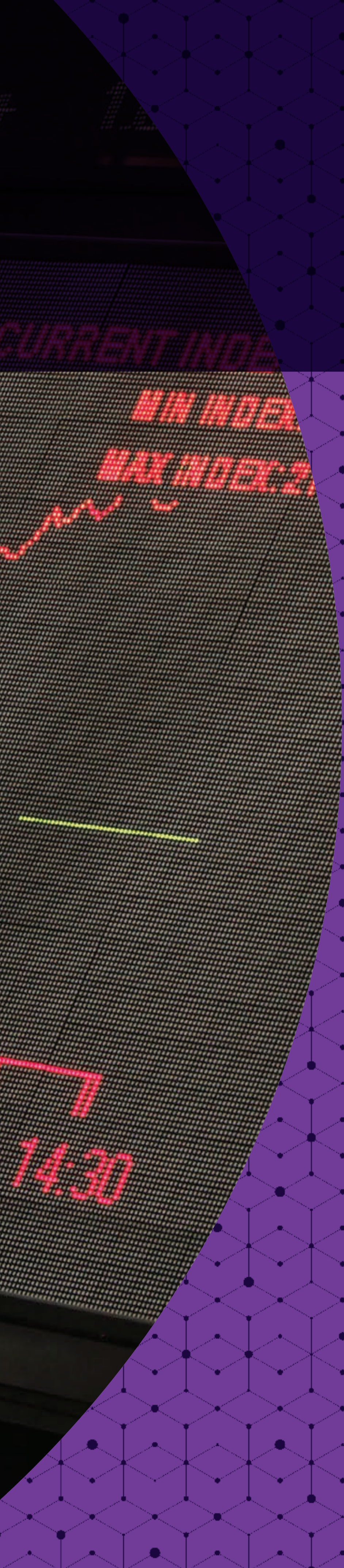
Domestic private credit provision is currently very low. Government borrowing from the banking system has perhaps crowded out the credit market for the private sector, which has resulted in low private investment. Low levels of private investment may also occur because of the ongoing state of insecurity, inconsistent government policies and power shortages.

The external debt is increasing very quickly. Pakistan is paying more than 20% of the value of its exports and primary income earnings servicing its debt. Foreign borrowing has arrived at a level troubling to economists. At current rates, Pakistan will not be able to reduce its debt and will be forced to make difficult fiscal compromises. The Pakistan government will require extensive efforts to raise domestic revenue for development projects like building infrastructure, energy projects and other mineral exploration.

Human development is another challenge for Pakistan. The overall literacy rate is low, and Pakistan's HDI is poor compared to other South Asian countries. The government should increase its allocation for education and health sectors and make policies to encourage private investment in these areas.

2 Financial market landscape and trends

An electronic board displaying stock prices and index graph is seen during a trading session at the Karachi Stock Exchange.
REUTERS/Akhtar Soomro



INSIDE THIS CHAPTER

PAKISTAN'S FINANCIAL INDUSTRY STRUCTURE

BANKING *

Islamic (RS billion)		Conventional (RS billion)
1,611	Assets	14,143
645	Loans / Financing	4,816
1,375	Deposits	6,881
Islamic Banks: 6 Conventional Banks with Islamic Branches: 17	No. of Institutions	Commercial Banks: 31 All Banks: 35

INSURANCE **

Full Family	Full General	Family Windows	General Windows		Non-Life	Life	Reinsurance
10	2	-	-	Assets (Rs Billion)	138	138	-
6	2	-	-	Gross Premiums /Contributions (Rs Billion)	62	62	9
2	3	3	4	No. of Operators	38	7	1

NON-BANK FINANCIAL INSTITUTIONS (NBFIs) *

Islamic		Conventional
Modaraba Companies: 34	Assets (Rs Billion)	Development Financial Institutions: 190 Leasing Companies: 42 Asset Management Companies: 31 Investment Banks: 10
Modaraba Companies: 25	No. of Institutions	Development Financial Institutions: 8 Leasing Companies: 9 Asset Management Companies: 25 Investment Banks: 7

DEBT SECURITIES ***

Islamic		Conventional
Privately Placed Sukuk: 37 Listed Sukuk: 4	Number Outstanding	Participation Term Certificates (PTCs): 1 Commercial Papers (CPs): 1 Privately Placed Term Finance Certificates (TFCs): 33 Listed TFCs: 20
Privately Placed Sukuk: 383 Listed Sukuk: 9	Value Outstanding (Rs Billion)	Participation Term Certificates (PTCs): 0.9 Commercial Papers (CPs): 0.5 Privately Placed TFCs: 69 Listed TFCs: 30

FUNDS *

Islamic		Conventional
Islamic Mutual Funds: 139 Islamic Pension Funds: 0.9	AuM Outstanding (Rs Billion)	Mutual Funds: 495 Pension Funds: 16

Islamic		Conventional
Rs 2,189 bn	**Total Finance Assets**	**Rs 15,303 bn**

* Latest data: Q4 2015 ** Latest Data: Q4 2014 *** Latest Data: June 4, 2015 for sukuk and February 28, 2015
Source: State Bank of Pakistan (SBP) and the Securities and Exchange Commission of Pakistan (SECP)

Islamic banking is the biggest contributor to the Islamic finance industry in Pakistan. By comparison to conventional debt instruments, Sukuk plays a bigger role in Islamic finance:

Islamic banking
74% of total Islamic finance assets

Rs 1.6 tn (US$15.2 bn)

Sukuk
18% of total Islamic finance assets

Rs 392 bn (US$3.73 bn)

Conventional Banking
92% of conventional industry assets

Rs 14.1 tn (US$134 bn)

Conventional Bonds
1% of conventional industry assets

Rs 100.4 bn (US$ 0.86 bn)

ASHRAF MAHMOOD

Governor, State Bank of Pakistan

MR. ASHRAF MAHMOOD WATHRA is serving a three-year term as Governor of the State Bank of Pakistan that started April 29, 2014. Mr. Wathra was appointed Acting Governor, SBP on January 31, 2014. Mr. Wathra brings 35 years of commercial and investment banking experience to his new assignment. Prior to joining the SBP, he had been Senior Executive Vice President and Group Chief, Credit Management Group, at the National Bank of Pakistan (NBP) since 2012. Before joining NBP, Mr. Wathra worked at Habib Bank Limited from 1999 to 2012 as Regional General Manager (Bangladesh), Executive Vice President and Regional General Manager (Singapore), Executive Vice President, Group Executive and Risk Manager, and Senior Credit Officer, Asset Remedial Management Group. Mr. Wathra holds a Master's in Business Administration, and has attended a number of seminars, conferences and courses at home and abroad including the Wharton/SMU General Management Programme, Operational Risk Management and the Asian Bonds Summit.

1. The Islamic banking industry in Pakistan has undergone tremendous growth since its re-emergence. What role did the State Bank of Pakistan play in the growth of Islamic banking and finance in the country?

Since the re-launch of Islamic banking in 2002, the State Bank of Pakistan (SBP) has taken on the dual responsibility of regulator and facilitator of the Islamic banking industry, and it has played a key role in its development and promotion. As a regulator, we have introduced a comprehensive legal, regulatory, and Shariah-compliance framework for the Islamic banking industry. Recent regulatory measures for the Islamic banking industry include the issuance of the Shariah Governance Framework, the downward revision of the initial paid-up capital requirement for the establishment of Islamic banking subsidiaries, instructions for profit and loss distribution and pool management for Islamic banking institutions, and an effort to provide liquidity management solutions for the industry. Apart from providing a roadmap for the industry through our five-year strategic plan, SBP is actively engaged in building the capacity of the industry through various promotion and training programmes. For this purpose, the SBP recently helped launch the three new Centres of Excellence for Islamic Banking and Finance Education.

2. The role of the central bank is considered pivotal for the promotion of Islamic finance. What are the key steps that the State Bank of Pakistan intends to take specifically for the promotion of Islamic banking in the country? Where do you see the Islamic finance industry in the next five years?

The State Bank of Pakistan has remained at the forefront of all major initiatives for the development and promotion of the Islamic banking industry. The findings of our recent survey-based study "Knowledge, Attitude and Practices (KAP) of Islamic Banking in Pakistan" indicate a strong demand for Islamic banking services prevailing in the country in both the retail (95%) and corporate sectors (73%). Going forward, the SBP remains committed to strengthening the foundations of Islamic banking in the country, and it will keep providing support for developing and nurturing a sound and stable Islamic financial system. We will continue to work with the industry and other stakeholders to ensure further strengthening of the macro-scale prudential framework. Encouragingly, the present government is also committed towards promoting Islamic banking and finance in the country. We believe that concerted efforts from all stakeholders will lead to consistent growth and will significantly increase the footprint of Islamic finance in Pakistan.

3. Islamic banks in Pakistan often complain about the lack of supporting infrastructure such as a shortage of Sukuk, and the absence of a discount window and concessional financing facilities like long-term financing facilities (LTFF) for Islamic banks. What is your view on this and how do you plan to overcome these challenges?

The limited availability of Sukuk and the absence of a discount window are some of the challenges Islamic banking industry faces in Pakistan. However, the SBP is aware of these challenges and we are working towards finding appropriate solutions for them. In this regard, work on Shariah-compliant LTFF for Islamic banks is at an advanced stage of implementation. Moreover, proposals for short-term Government of Pakistan (GOP) Sukuk and Islamic discount window facilities are also being reviewed at SBP.

4. Limited liquidity management instruments can be considered one of the key issues faced by Islamic Banks in Pakistan. What remedial actions or intervention has the State Bank of Pakistan taken so far? What is it planning to do in this regard?

Considering liquidity management a major challenge for the Islamic banking industry, SBP is working to provide multiple liquidity management solutions to the industry. In this regard, a significant milestone was achieved in recent past with the launch of Shariah-compliant open market operations on the basis of credit sale (bai muajjal) of GOP ijarah Sukuk. Subsequently, the government has also purchased ijarah Sukuk from Islamic banking industry on deferred payment basis for one year. These transactions have extended support to the industry by providing it a new investment avenue. Further, Shariah-compliant financial instruments of various types and tenors are being reviewed at the SBP, which will further facilitate efficient liquidity management.

5. Presently, the Islamic banking sector holds close to 12% of total banking assets, and it is expected that it will surpass the 15% level within the next two years. This growth trend enhances the systemic importance of Islamic banks. How do you see the contribution of Islamic banking and finance for the stability of the financial sector in Pakistan?

> "APART FROM PROVIDING A ROADMAP FOR THE INDUSTRY THROUGH OUR FIVE-YEAR STRATEGIC PLAN, SBP IS ACTIVELY ENGAGED IN BUILDING THE CAPACITY OF THE INDUSTRY THROUGH VARIOUS PROMOTION AND TRAINING PROGRAMMES.

The Islamic banking industry in Pakistan has shown significant growth since its re-launch in 2002. Islamic banking and finance has great potential for providing stability in the financial sector by contributing to economic growth and financial inclusion. In its true spirit, Islamic finance focuses on real economic activities based on equity and justice. Its distinctive asset-backed character provides stability to the financial system by creating linkages between financial sector growth and overall economic development. The risk and reward-sharing nature of Islamic finance contracts not only has the potential of increasing efficiency in the allocation of resources to the real sectors of the economy, but it is also an effective tool for wealth redistribution. If applied in its true essence, Islamic finance has the capacity to provide sustainable and broad-based economic growth.

6. In 2013, Government of Pakistan formed the Steering Committee for the Promotion of Islamic Banking in Pakistan. How successful has the committee been in achieving harmony among the stakeholders of Islamic finance industry in Pakistan?

The government of Pakistan formed a high level Steering Committee for the Promotion of Islamic Banking in Pakistan in December 2013, chaired by Mr. Saeed Ahmad, Deputy Governor, State Bank of Pakistan (SBP). The main objective of the committee was to carry out an objective review of the current policy paradigm of Islamic banking and formulate a comprehensive policy framework for an Islamic financial system in the country. The committee recently completed its tenure of two years, and during this time, it provided an effective platform for collaboration between the various stakeholders of the industry. To this end, various sub-committees with representation from Shariah scholars, the Securities and Exchange Commission of Pakistan (SECP), the SBP, the Ministry of Finance, industry experts and business leaders were formed that worked on different initiatives. The major achievements of this platform include the start of Shariah-compliant open market operations, the establishment of the Centres of Excellence in Islamic Finance Education and the launch of the All Share Islamic Index of Pakistan. The committee has compiled a comprehensive set of recommendations and we believe that their implementation can help in addressing challenges faced by the industry.

7. The recent KAP study by the State Bank of Pakistan highlighted a shortage of qualified professionals working in the Islamic finance. How is SBP addressing this issue?

Enhancing the capacity building of stakeholders of the Islamic banking industry has been one of the strategic objectives of the State Bank of Pakistan. To achieve this objective, the SBP has planned and conducted various promotion and training programmes. The SBP is offering dedicated Islamic banking certificate courses at the National Institute of Banking and Finance (NIBAF), the training arm of SBP. We are also mobilizing the support of reputed international organizations such as Islamic Research and Training Institute (IRTI), a member of Islamic Development Bank (IDB) Group, International Islamic Financial Market (IIFM), and IFC (International Finance Corporation), World Bank Group. Moreover, we are organizing targeted seminars and conferences for the business community, academics, bankers and policymakers throughout the country.

SBP has also helped in establishing the Centres of Excellence in Islamic Finance at three renowned institutions: Institute of Business Administration (IBA), Karachi; Lahore University of Management Sciences (LUMS); and Institute of Management Sciences (IMSciences), Peshawar. Going forward, we believe that these centres will not only serve as a focal point for leading efforts and initiatives to bridge the huge capacity gap faced by the Islamic banking industry, but they will also serve as research incubators.

8. As the State Bank of Pakistan, what are the benefits and drawbacks of the existing legal framework that governs Islamic banks and banking activities?

The State Bank of Pakistan has introduced a comprehensive legal, regulatory, and Shariah compliance framework for Islamic banking, and it has issued dedicated policies for laying sound foundations for the Islamic banking industry. These new policies include licensing requirements, guidelines on Shariah compliance, and other operational matters at Islamic banks. Considering the dynamic nature of Islamic banking products, the changing global financial landscape and changes in the regulatory environment, we are continuously refining and improving the legal and regulatory framework. Recent measures taken by the Central Bank to achieve this include:

i. The downward revision of initial paid up capital requirement for Islamic banking subsidiaries from Rs 10 billion to Rs 6 billion;

ii. The issuance of the Shariah Governance Framework for strengthening of Shariah compliance at Islamic banking institutions; and

iii. Instructions for Profit and Loss Distribution and Pool Management of Islamic Banking Institutions to increase transparency.

9. Double taxation is often cited as a major hindrance to the growth of the Islamic finance industry. What initiatives have been taken to amend the taxation system of Pakistan to improve this environment?

It is vital that both Islamic banking institutions and their customers are treated fairly in terms of taxation and that they are not at a disadvantage in comparison to conventional banks and their customers. There are challenges in the current taxation regime for Islamic banks. The Central Bank and other stakeholders including Ministry of Finance, Federal Board of Revenue and Securities and Exchange Commission are working towards a more amenable taxation environment for the Islamic banking industry.

10. AAOIFI and IFSB have developed prudential standards and guidelines for the global Islamic finance industry. What has the State Bank done for the implementation of these standards?

Pakistan is a key member of global Islamic finance standard-setting institutions like the Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). In order to increase standardization and to elevate the local industry to international standards, the SBP has adopted various standards issued by these agencies after customizing them in accordance with the local market. To date, the SBP has adopted six AAOIFI Shariah standards, including "Default in Payment by a Debtor," "Murabahah to the Purchase Orderer," "Ijarah and Ijarah Muntahia Bittamleek," "Mudarabah," "Investment Sukuk," and "Sharika (Musharakah) and Modern Corporation." Further, three prudential standards issued by IFSB under the headings "Risk Management," "Corporate Governance," and "Shariah Governance" have been updated, while a revised Standard on "Capital Adequacy" is in the process of adaption.

"IT IS VITAL THAT BOTH ISLAMIC BANKING INSTITUTIONS AND THEIR CUSTOMERS ARE TREATED FAIRLY IN TERMS OF TAXATION AND THAT THEY ARE NOT AT A DISADVANTAGE IN COMPARISON TO CONVENTIONAL BANKS AND THEIR CUSTOMERS.

THE EVOLUTION OF THE ISLAMIC FINANCIAL SYSTEM IN PAKISTAN

1948

Inaugural speech at the inauguration of the SBP by Quaid-e-Azam Muhammad Ali Jinnah regarding Islamic banking

1962

Establishment of the Council of Islamic Ideology (CII) under the 1962 Constitution to eliminate interest from Pakistan's economy

1979-1980

Elimination of interest from two government-owned mutual funds and the state-run House Building Finance Corporation (HBFC)

1980

A fifteen-member committee of the Council of Islamic Ideology prepared a report on the elimination of riba and outlined the Islamic modes of financing

Allowance of Participation Term Certificate (PTC), an interest-free instrument of corporate financing

Modaraba Companies and Modaraba Ordinance introduced the mudarabah concept in Pakistan

Introduction of the Zakat system

1981

Introduction of Modaraba Companies and Modaraba Rules

Nationalized commercial banks allowed to mobilize profit- and loss-sharing deposits through separate counters

1983

Introduction of the Ushr system

1984

Regulation of non-interest modes of financing by amending seven laws by the Banking and Financial Services (Amendment of Laws) Ordinance 1984

1985

All financing to Federal and Provincial Governments, public or private join stock companies and public sector corporations are interest free

All commercial banking in Pak Rupees were made interest free, but foreign currency deposits and loans remained as before

1991

The Federal Shariat Council (FSC) declared the procedure adopted by the banks in 1985 as un-Islamic and some banks and DFIs made appeals to the Supreme Court of Pakistan's Shariat Appellate Bench (SAB)

1995

Al Meezan Investment Bank was established

1999

The Shariat Appellate Bench (SAB) of the Supreme Court upheld the decision by Shariat Court

A high level commission was set up by the government to promote Islamic banking on a parallel basis with conventional banking system

2001

Introduction of the Islamic Banking Policy

2002

Al Meezan Investment Bank received a license to operate as Pakistan's first fully Islamic bank by State Bank of Pakistan, renaming it to Meezan Bank

First Islamic Term Finance Certificate (TFC) based on musharakah was issued

The Securities and Exchange Commission of Pakistan allowed Modarabas to float musharakah-based TFCs

The country's first open-ended Islamic mutual fund was established (UTP – Islamic Fund now JSIL Islamic Fund)

2003

Regulation of Islamic subsidiaries and stand-alone banking branches of existing commercial banks

Establishment of the Islamic Banking Department (IBD) the Shariah Board at the State Bank of Pakistan

2005

The regulatory framework for Takaful, Takaful Rules 2005

Start of operation for Pakistan's first takaful operator, Pak-Kuwait Takaful Company, Ltd.

2007

Issuance of draft guidelines on Islamic microfinance

2008

Issuance of ijarah-based Sukuk by the Government of Pakistan

2010

Islamic banking captured 6.7% market share in the overall banking industry

2012

Issuance of Sukuk guidelines and Takaful rules which allowed takaful windows

2013

Karachi Stock Exchange (KSE) along with Al Meezan Investment Management launched first Shariah compliant index

2014

Establishment of takaful windows

Issuance of Shariah governance framework

2015

SECP issued Islamic Finance Department and Shariah board

Issuance of Sukuk rules

Establishment of three Centres of Excellence in Islamic banking

Islamic banking has acquired an 11.2% market share in assets and a 13.1% market share in deposits in September 2015

1950s and 1960s: Strong Roots since Pakistan's Independence

The state of Pakistan was established as the world's first republic founded upon Islamic principles in August 1947. The Constituent Assembly passed the Objectives Resolution two years later, which stated that the constitution of the republic would be bound to follow Islamic Law in accordance with the Holy Quran and the Sunnah. According to Pakistan's founding father, Quaid-e-Azam Muhammad Ali Jinnah, at the founding of the State Bank of Pakistan in 1948:

> "I shall watch with keenness the work of your research organization in evolving banking practices compatible with Islamic ideas of social and economic life... We must work our destiny in our own way and present to the world an economic system based on true Islamic concepts and equality of manhood and social justice" [15]

To pursue this goal, Pakistan has taken a variety of steps starting early in its history towards developing an Islamic finance industry.

The Pakistani government first attempted to eliminate interest from its economy through the Council of Islamic Ideology (CII) created in Pakistan's first constitution promulgated in 1956. This council, officially established in 1962, sought to develop an inclusive framework for applying the Islamic economic doctrines to Pakistan's economy. As a result, Pakistan began preparing state support for Islamic finance even earlier than the introduction of the world's first interest-free banking in Egypt by Mit Ghamr Savings Bank and the establishment of Malaysia's Tabung Haji, the national Hajj Savings institution in 1963. In 1969, the council advised the government to pass a resolution stating that interest-based lending is considered riba, which is prohibited in all its forms in Islam. As a result, the government started dedicating efforts towards establishing an interest-free financial system.

1970s and 1980s: Accelerated Conversion

Towards the end of the 1970s, the government made clear attempts to integrate non-interest-based transactions into its financial system, such as the elimination of investment in interest-bearing securities from two government owned mutual funds in 1979, National Investment Trust Limited (NIT) and Investment Corporation of Pakistan (ICP).

The following year, the government introduced several sweeping initiatives towards Islamizing the financial system in Pakistan. These included the removal of interest by the state-owned House Building Finance Corporation (HBFC) and the introduction of interest-free instruments for corporate financing, Participation Term Certificates (PTC).

In the same year, the government created a landmark regulatory framework for Modaraba investment funds through the Modaraba Companies and Modaraba Ordinance 1980, followed by the passage of the Modaraba Companies and Modaraba Rules in 1981. The Ordinance and Rules provide matters related to management, floatation and regulation of modarabas, as well as the registration of modaraba companies. Modarabas are two-tier fund structures that invest in Shariah-compliant businesses. Modarabas in Pakistan continue to operate as a legal corporate entity that are allowed to undertake different types of Islamic financing activities such as ijarah, murabahah, salam, istisnaa and musharakah along with other activities such as trading of commodities, investing in stock market and project financing. While Islamic banks provide traditional forms of intermediation between depositors and borrowers, in Modaraba companies, investors supply capital directly to company entrepreneurs. In 2016, there are 25 Modaraba companies currently in operation.

In the early 1980s, nationalized commercial banks and one foreign bank (Bank of Oman) were permitted to operate separate interest-free counters in order to mobilize deposits based on profit and loss sharing. In order to accommodate this, Islamic modes of financing were allowed by the amending seven laws by the Banking and Financial Services (Amendment of Laws) Ordinance 1984 to allow the prohibition of interest-based transactions. Twelve modes of interest-free financing were defined by SBP which were classified into three categories: the choice of the mode of financing was left to the bank and its client.[16]

Finally, the State Bank of Pakistan (SBP) issued BCD Circular No. 13 in 1984 asking for the prohibition of riba in Pakistan's banking system. In 1985, the government implemented interest-free banking in two phases. Starting in April 1, 1985, all financing to federal and provincial governments, public- or private-sector joint stock corporations and public sector corporations became interest free. In late 1985, all commercial banking that conducted business in Pakistan Rupees was made interest free. As a result, profit and loss sharing deposits grew to 62% of total deposits in 1985 from 9.2% only in 1981.[17] However, foreign currency deposits and loans continued in conventional interest-bearing instruments.

1990s: Constructive Revision

The measures introduced in the 1980s resulted in the compulsory Islamisation of banking across Pakistan. However, there were difficulties in carrying out the accelerated conversion of the financial system to Islamic banking because of the public's lack of understanding and the preparedness and regulation of financial institutions. The Federal Shariat Court (FSC) declared banking procedures and products adopted in this period to be un-Islamic, as some of them did not completely adhere to Shariah law. Instead, many banks employed a mark-up lending technique which was sometimes followed by a buy-back arrangement in a dual contract.

Consequently, by the 1990s, several banks coordinated with the government of then-Prime Minister Nawaz Sharif to press for the repeal of laws banning interest. The Shariat Appellate Bench (SAB) of the Supreme Court eventually upheld an original verdict delivered by the Shariah Court in 1999, directing the government to create a new plan for the Islamisation of the financial system by June 2001.

The bench worked towards setting up new guidelines for the financial system through the Commission for Transformation of the Financial System (CTFS), which included economists, Shariah scholars, chartered accountants and bankers to promote a dual or parallel banking system with conventional and Islamic institutions operating side-by-side. Additionally, it established two task forces, one set up by the Ministry of Finance to suggest ways to eliminate interest from government transactions and another by Ministry of Law to help in amending the legal framework to implement the judgement. The commission also created a Committee for the Development of Financial Instruments and Standardised Documents in the SBP to prepare new model agreements and financial instruments to establish a ground for the introduction of the new financial system distinguishing Islamic financial products from conventional products.

2000s: Re-emergence and Gradual Growth

In an inter-ministerial meeting held in September 2001 supervised by President Pervez Musharraf, it was decided that the movement towards an interest-free economy should occur in a gradual fashion to prevent the economic dislocation characteristic of the period with the compulsory ban on interest. It was also decided that the SBP would allow three types of Shariah banking (full-fledged Islamic banks, Islamic subsidiaries and Islamic branches for commercial banks).

Eventually, Islamic Banking Policy 2001 was introduced as a result of these negotiations, and the republic's first full-fledged Islamic bank, Meezan Bank, received a licence to operate in January 2002. Islamic subsidiaries and Islamic branches were allowed starting in 2003. Currently, there are six full-fledged Islamic banks and 17 Islamic branches operating in Pakistan with assets totalling Rs 1.6 trllion across 2,082 branches and sub branches in eight districts in the country. Pakistan's Islamic banking sector is overseen by the SBP's *Centralised Shariah Board*, which was set up in 2003 along with the SBP's Islamic Banking Department (IBD). The SBP has also produced the Shariah Governance Framework for Islamic Banking Institutions (IBIs), mandating that Islamic banks should have Shariah advisors and internal Shariah auditors, and that these banks are subject to Shariah inspections by the SBP.

Regulations for other Islamic finance concepts such as takaful were introduced later, with the issuance of a regulatory framework, Takaful Rules 2005, followed by the operation of Pakistan's first takaful company, Pak-Kuwait Takaful Company Ltd. In 2014, takaful windows at conventional insurers were regulated, and EFU General Takaful opened Pakistan's first takaful window. Currently, it is competing with five other takaful windows and five full-fledged takaful companies in Pakistan.

Pakistan has expanded more recently into regulating Islamic capital market instruments. The country's first Islamic mutual fund and first Shariah compliant index were launched in 2002 and 2013, respectively. The first Islamic Term Finance Certificate, based on musharakah, was issued in 2002, and by modarabas were allowed to to float them in the same year. The Water and Power Development Authority (WAPDA) issued Pakistan's first local currency Sukuk, based on ijarah, in 2006, while its first international sukuk was issued by Pakistan International Sukuk Company Limited in 2005. The Islamic capital market is governed by the Securities Exchange and Commission of Pakistan, which set up its own Islamic Finance Department and a dedicated Shariah board and issued Sukuk rules in 2015. At the end of 2015, there were US$2.92 billion worth of Sukuk and Rs 139 billion (US$1.32 billion) worth of Islamic mutual fund assets outstanding in Pakistan.

An important goal of Islamic finance is to promote socially conscious economic growth, and the SBP has therefore issued draft guidelines on Islamic microfinance in 2007 and encouraged the Islamic banking sector to finance small and medium enterprises (SME), agriculture and housing sectors. Islamic microfinance in Pakistan is offered by at least 14 institutions, which include conventional and Islamic microfinance companies, rural support programmes and non-governmental organizations, microfinance banks, cooperatives, foundations and waqf institutions. In July 2015, the National Rural Support Programme (NRSP) Microfinance Bank became Pakistan's first conventional microfinance institution with an Islamic microfinance licence, meeting the demand of interest-free financing solutions and deepening Pakistan's financial industry.

Dam in Pakistan.

STRONG REGULATION WILL REDUCE RISK AND IMPROVE PUBLIC CONFIDENCE

Bilal Rasul | Executive Director and Head of Islamic Finance Department
Securities and Exchange Commission of Pakistan (SECP)

MR. BILAL RASUL is Executive Director and Head of the first Islamic Finance Department at the Securities and Exchange Commission of Pakistan (SECP). A British Council (Chevening) Scholar, Mr. Rasul holds a Master's of Economics and Finance from Leeds University, as well as a Masters of Public Administration from Quaid-e-Azam University. He has 23 years of varied experience in capital market regulation, including Modarabas, the securities market, NBFIs (non-banking and finance institutions) and enforcement. Mr. Rasul is a Technical Member of the Shariah Advisory Board of SECP. As Registrar of Modaraba Companies and Modarabas from 2005 to 2009, he was responsible for spearheading this Islamic finance initiative for the capital market in Pakistan. He has contributed as a speaker at many international Islamic finance and banking forums. His work has also been highlighted in several local and international publications.

The Securities and Exchange Commission of Pakistan (SECP) is the regulator of the Islamic capital market responsible for the regulation and supervision of Modarabas, Islamic mutual funds, Takaful, Islamic REITs, other Islamic NBFIs (Non-Banking Financial Institutions) as well as issuance of Shariah-compliant instruments such as Sukuk. In February 2015, the Islamic Financial Department (IFD) was established for the first time at the SECP in order to provide a coordinated and holistic approach for governing and promoting Shariah-compliant companies and Sukuk. Under the visionary leadership of Mr. Zafar Hijazi, Chairman of the SECP, the IFD has embarked on the mission to eliminate riba from the financial market.

In the short period since its inception, the IFD has focused on achieving stability and growth of the Islamic capital market through efficient and effective oversight. At the outset, the IFD reviewed the prevailing regulatory framework for the industry, and it is in the process of proposing the required changes for Shariah-compliant companies and instruments. These are expected to be released in the near future after obtaining and incorporating feedback from industry stakeholders.

As a member of the Steering Committee on the Promotion of Islamic Banking in Pakistan formed by the Finance Minister of Pakistan, the IFD is responsible for ensuring the implementation of recommendations of this Committee. It keeps close and continued contact with the State Bank of Pakistan through a joint forum and other technical sub-committees of the Steering Committee. In November 2015, the IFD provided the support to launch the All Share Islamic Index at the Pakistan Stock Exchange (formerly Karachi Stock Exchange) in order to capture the Shariah compliance of companies in Pakistan.

The SECP considers exercising and maintaining both conventional and Islamic international best practices and standards a top priority in the pursuit of transparency and investor protections. On the Islamic side, the IFD recommended the adoption of AAOIFI Shariah Standards No. 3 Default in Payment by a Debtor, No. 8 Murabahah to the Purchase Orderer, No. 9 Ijarah and Ijarah Muntahia Bittamleek and No. 13 Mudarabah, which the SECP notified in January 2016. The adoption of these standards is aimed at bringing harmonization and standardization in business operations of Shariah-compliant companies across the

> IN FEBRUARY 2015, THE ISLAMIC FINANCIAL DEPARTMENT (IFD) WAS ESTABLISHED FOR THE FIRST TIME AT THE SECP IN ORDER TO PROVIDE A COORDINATED AND HOLISTIC APPROACH FOR GOVERNING AND PROMOTING SHARI'AH COMPLIANT COMPANIES AND SUKUK.

industry. Similarly, realizing the need for adhering to international principles and for being part of the international Islamic financial brotherhood, the SECP secured the membership in the Islamic Financial Services Board earlier this year.

Despite the best efforts of the regulators, the Islamic finance industry in Pakistan remains far behind the achievement of the conventional finance industry. It also lags behind the Islamic finance industry in major Islamic countries like Malaysia and GCC. The Islamic mutual funds industry in Pakistan has shown consistent growth, although the build up of financial assets remains low. The Shariah review of mutual funds and their various investment plans by the IFD has helped the industry attract underserved and unbanked clients to invest in profit- and risk-sharing Shariah-compliant products. 58 Shariah-compliant mutual funds were present in the market with Rs 139.32 billion net assets (29.1% of the total mutual fund industry) at the end of 2015. However, the investor base remains at approximately 100,000 investors.

Sukuk, which have become popular worldwide, have also struggled to reach the desired level in Pakistan. Companies prefer to place Sukuk privately, while public issuances are limited mainly because of tax anomalies leading to low yields. In the recent past, Treet Corporation Limited, K-Electric Limited and sovereign Sukuk were issued that were instantly oversubscribed, demonstrating the confidence and interest of faith-conscious general public in Shariah-compliant products. However, Pakistan's savings and investment ratio to GDP remains low, mainly as a result of interest-based products and non-availability of Shariah-compliant products, resultantly, impeding Islamic economic growth.

There are other challenges to Islamic finance as well, such as low level of economies of scale, legal and taxation issues, lack of availability of Shariah scholars with financial expertise and knowledge of accounting and auditing, limited outreach to small and rural investors, lower yields due to higher cost of funds, the issue of a level-playing field, among others. The gravest concern pertains to Shariah compliance risk. The structures of Islamic financial transactions mimic conventional ones. Market perception of Islamic financial products is mixed, as investors are not comfortable with claims of the Islamic financial institutions offering varied products and services. This is partially due to the fact that returns are calculated on expected returns based on benchmarks compatible with conventional benchmarks. Nevertheless, the SECP is aggressively pursuing awareness campaigns, investor education and collaborations with universities and other academic institutions for inspiring and broadening the investor base.

The SECP's future roadmap with regard to Islamic finance focuses on promoting takaful and Islamic microfinance in the rural areas, which remain untapped and excluded from the mainstream economic order. 'Access to finance' and 'financial inclusion' of the SME (small and medium enterprises) sector are terms heard in professional circles in Pakistan on a more frequent basis. The conduits for implementing the agenda of the government and multilaterals, of providing financial resources to the SMEs, will inevitably have to be the Islamic microfinancing institutions and takaful operators.

Unlimited opportunities await Islamic finance in Pakistan. Given the appropriate regulatory and business environment, it will not be long before the Islamic financial market will become a serious contender for the attention of investors.

The role of Islamic financial institutions in the economic development of Pakistan

The Islamic financial industry exhibited resilience and stability during the global financial crisis in 2008, which has led to its wider recognition as a competitive part of the world financial system. Its strengths lie in its connection with productive economic activities in domestic economies and its avoidance of the reckless risk taking and excessive leverage associated with the speculative branch of conventional finance. In Pakistan, Islamic finance provides ethical, socially responsible and inclusive financing solutions to its population.

Islamic Banking: According to the latest Islamic Banking Bulletin (IBB) issued by the SBP, lending by Islamic banks are mostly concentrated in the corporate sector (73.5% in September 2015), which is higher than the overall banking industry average (65.6%). The textile industry represents the largest single sector for Islamic finance (15.9%), which is in line with the overall banking industry in Pakistan, followed by electric power (9.3%), and chemicals and pharmaceuticals (8.7%). Pakistan has a large agricultural sector, and there is a considerable focus on financing farmers. However, Islamic banks are lagging behind conventional banks in their attempts to provide financing to agricultural clients.

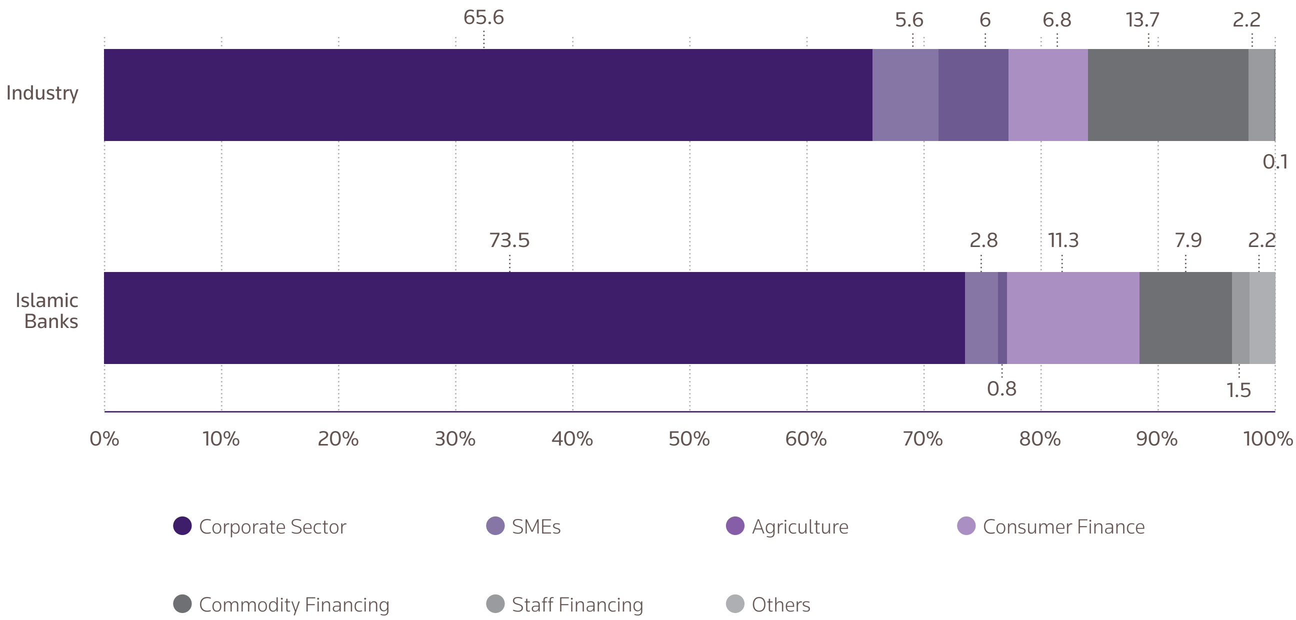
Islamic banks and financial institutions have the strong potential to assist the SME industry, as they are gaining more visibility and offer equity-based partnership schemes. However, SMEs receive a smaller portion of total financing extended by Islamic banks (2.8%) compared to the overall banking average (5.6%), indicating Islamic banks currently struggle in their outreach to SMEs.

According to SBP's Islamic Banking Department, SMEs could benefit from different Islamic financing products offered by Islamic banks in Pakistan, such as equity-based diminishing musharakah, which is useful in asset acquisition and business expansion for SMEs (diminishing musharakah consists the most or 34.2% of the overall financing mix offered by Islamic banks). Other modes of financing, like istisnaa, murabahah and ijarah, are appropriate for working capital financing, SME trade finance and development of rural infrastructure and housing. Salam is more appropriate to finance agricultural production.

Islamic Microfinance: Islamic financing has a broad appeal in microfinance, since it offers interest-free solutions favourable compared to conventional microfinance institutions and local moneylenders, which can offer up to 20% to 30% interest rates on loans. Even with 44 microfinance banks and institutions operating in the country, there is the potential that more providers will enter the market in Pakistan soon in order to diversify the funding bases offered by these institutions to Pakistan's population and to increase financial inclusion as part of central bank's strategy. This can be either achieved through the conversion of microfinance institutions to an Islamic basis or with separate window operations. Murabahah and qardh-e-hasana are the most suitable services to be offered by these institutions. Other products with potential are microtakaful, branchless banking and micro-savings.

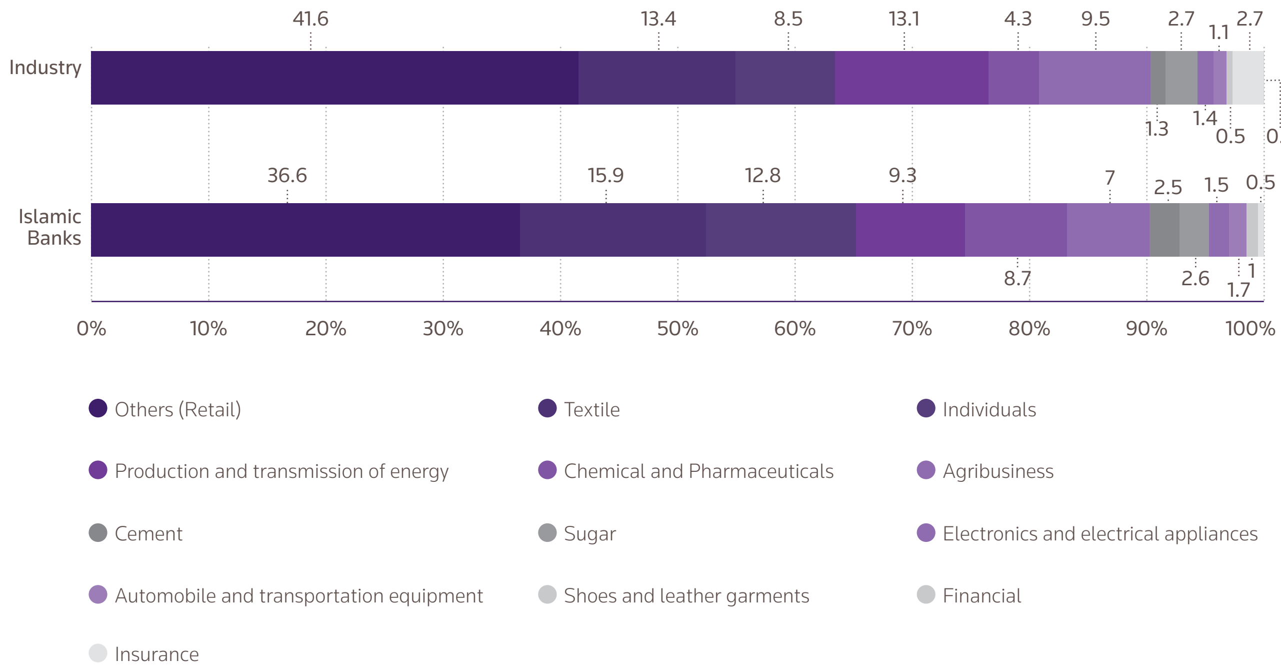
Modarabas: The inception of Modarabas in the 1980s brought Islamic-structured financing to the public's attention before the emergence of full-fledged Islamic banks in Pakistan, proving that such institutions could fulfil financial requirements across business sectors while conforming to Shariah. These companies provide short-, medium- and long-term and working capital financing to their borrowers along with diversified earning opportunities for investors with surplus funds. It provides diversification in manufacturing, trading, portfolio management,

FINANCING PORTFOLIO BY TYPE OF CLIENT



Source: SBP Islamic Banking Bulletin, September 2015

FINANCING CONCENTRATION BY SECTOR



Source: SBP Islamic Banking Bulletin, September 2015 imports and exports, equipment-rental and property development better than many Islamic investment vehicles. Among the other benefits offered to Modaraba companies are the income tax exemption for non-trading Modaraba certificates (provided that 90% of income earned by Modarabas is distributed among certificate holders), and a 25% maximum tax rate for trading Modaraba certificates. The investors of such may expect to get a maximum dividend of 90% of the income of the Modaraba.

Takaful: Islamic insurance operators mobilize savings in a safe and profitable manner by creating contingency or retirement funds similar to conventional co-operative mutual insurance vehicles, that make Islamically approved investments. The Pakistani takaful operators offer a diverse range of family products such as health coverage, savings plans and education saving plans. With the continued development of Islamic banking in Pakistan, there is an increased need for asset financing to have takaful coverage. Takaful companies will play a bigger role in increasing the insurance penetration rate in the coming years since the passage of new regulations for takaful windows at conventional insurance companies in 2012. This in turn will open more business for the existing full-fledged takaful operators as the public learns more about the takaful concept from conventional institutions and the regulator.

Islamic Capital Markets: Sukuk have been distinguished as an important liquidity management tool in the growth of the local Islamic finance industry. Since the issuance of sovereign Sukuk in 2008 and the introduction of open market operations in 2014, they have provided a Shariah-compliant investment device for Islamic banks to avoid a build up of non-remunerative deposits. For the government, they have mobilized funds worth trillions of Rupees to reduce the budget deficit and for developmental projects, particularly in infrastructure such as Pakistan's Water and Power Development Authority (WAPDA) Sukuk.

Meanwhile, Islamic mutual funds, like conventional funds, offer an array of benefits while abiding by Shariah restrictions. Such benefits range from professional money management, diversification, liquidity, transparency to affordability for smaller investors.

EFFORTS TO STRENGTHEN THE INDUSTRY

The regulator and financial experts still consider the Islamic finance industry in Pakistan in its evolutionary phase, despite its many ongoing contributions to the economy. The government is working to further strengthen the industry. Pakistan's Islamic banking strategy aims to improve the regulatory framework, public awareness, and product offerings, which should move from being overwhelmingly debt-based to Shariah-compliant profit and loss sharing structures that guarantee the equitable distribution of economic gains. The Islamic capital market roadmap, meanwhile, aims to centralize Shariah-compliant capital market activities, and it introduces regulations for different sectors governed by SECP such as takaful, Modarabas, Islamic mutual and pension funds, and other Islamic non-bank financial institutions.

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An employee counts currency notes at a money changer in Karachi. REUTERS/ Athar Hussain

3 Islamic finance infrastructure

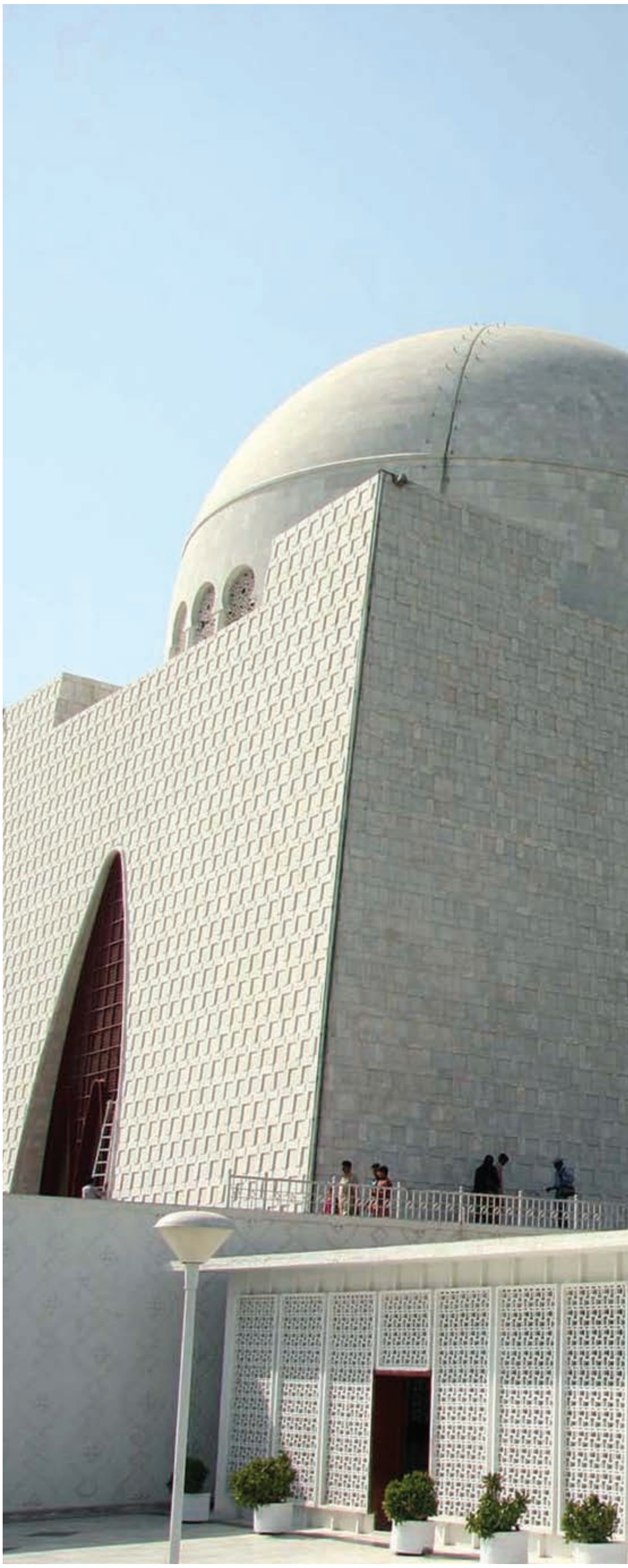
People say their prayers under the leadership of Saudi Arabian Imam of the Grand Mosque Sheikh Khalid al Ghamdi during evening prayers at the Badshahi mosque in Lahore, Pakistan. REUTERS/Mohsin Raza

INSIDE THIS CHAPTER

Infrastructure Overview

A strong and robust financial infrastructure is the key prerequisite for the proper functioning of an Islamic financial system in any country. Regulation and supervision of the Islamic banking and finance industry is important to ensure proper functioning of industry players in order to protect the interests of both funds providers and customers. In Pakistan, the regulatory and supervisory authorities strive to effectively work towards achieving a stable Islamic financial system.

As early as 1948, Quaid-e-Azam Muhammad Ali Jinnah called for the adoption of Islamic principles in Pakistani social and economic life. The Council of Islamic Ideology (CII) was proposed in the first constitution of Pakistan in 1956[18] in order to develop a comprehensive framework for the implementation of economic doctrines of Islam. The CII was recognized in 1962, the same year when some adjustments have been made for interest free transactions in the Banking Companies Ordinance.[19] The elimination of interest from the banking system reached its greatest extent under the leadership of General Zia ul-Haq during the 1980s. After a period of legal challenges to this financial regulatory regime, the government established a new framework in 2001 permitting the return of conventional financial institutions, and a changed focus on gradual and market-based efforts to introduce formal Islamic financial Institutions.



View of newly installed Solar System at Quaid-e-Azam Mausoleum. Asianet-Pakistan/ Shutterstock.com

AN AGENDA FOR REVIVING ISLAMIC FINANCE[20]

Ishrat Husain | Chairman, Centre for Excellence in Islamic Finance (CEIF)

DR. ISHRAT HUSAIN, in his capacity as the Governor of the State Bank of Pakistan, played a pioneering role in the introduction of Islamic Banking in Pakistan in 2001. Along with nine other central bank governors of Islamic countries, the Islamic Development Bank and International Monetary Fund (IMF), he was one of the founders of the Islamic Financial Services Board (IFSB), the standard setting body for Islamic finance at the global level. He also served as one of the founding members of the Governing Board of INCIEF, Malaysia for five years. He is currently member of the Presidential Advisory Council of Islamic Development Bank and Chairman, AAOIFI Board on Governance and Ethics; a member of the Middle East and North Africa Advisory Group of the IMF; and a member of the IMF Advisory committee on Islamic Finance. He is invited regularly as a speaker and panellist on Islamic Finance industry conferences. More recently, as the Dean and Director of the Institute of Business Administration (IBA), Karachi he has set up the Centre for Excellence in Islamic Finance (CEIF) of which he is the first chairman.

The vision for Islamic finance is to become a source of stability in a global financial system that is coming out of a crisis of gigantic proportions second only to the Great Depression of 1930s. Islamic finance has convincingly demonstrated its potential to reduce the fragility and volatility of the financial system because of its unique and distinctive feature of asset-backed transactions made on a risk-sharing basis. Globally, a good deal of interest has been generated in Islamic finance as a serious alternative to conventional finance. However, to gain credibility in international financial markets, policymakers, regulators, and industry players have to work together to resolve a wide set of issues in Islamic finance in an objective and dispassionate manner. There are at least four main areas that require dedicated efforts before Islamic finance will be able to prove its robustness as a universally accepted dominant mode of financing.[21]

Awareness: There are serious misconceptions, misunderstandings and misplaced notions about Islamic finance. There is hardly any shared understanding across the industry about the objectives, underlying principles, mechanics and expected outcomes of Islamic finance. Islamic banks are often criticized for imitating conventional banking assets by making them Shariah-compliant through financial reengineering. There is a strong need to discover innovative solutions for Islamic bank customers, particularly in neglected customer segments. Innovative products and services meeting the requirements of productive economic agents are the only tangible answer to this. It is often not realized that some of the sectors and sub-sectors neglected by traditional banks such as agriculture, agri-business and produce marketing, small and medium enterprises, and low-cost housing offer enormous opportunities for Islamic banks to step in and meet this unmet demand. Unless this 'innovation gap' is filled, and we desist from the temptation of blindly following the conventional banks, Islamic Banking will not be able to translate its competitive advantage into real gains.

One of the reasons for lower innovation in Islamic finance is that the current growth rates of 15-20% per annum have lulled all of us into a false sense of complacency that the market demand is being adequately met by the current supply off-the-shelf. But if we analyze closely, most of the Islamic financing products are based on contracts of exchange dominated by murabahah, which is a cost-plus structure. The contracts of participation that form the essence of Islamic finance represent only about 20% of all transactions. The Islamic

> CORPORATE GOVERNANCE STRUCTURE FOR AN IFSI SHOULD INCORPORATE THESE STAKEHOLDERS (IAHS) AND BETTER DEFINE THE ROLE OF THE SHARIAH BOARDS.

banking industry remained passive in finding new products that enhance equity participation, which are badly needed to give a socially and financially inclusive image to Islamic finance products.

After all, starting from a low base, the potential for picking low hanging fruit in attracting business to Islamic finance has not yet been exhausted. But if Islamic finance has to assert itself for presence in the international financial market space on a sustained basis, not only the packaging of products but their contents as well must be continuously changed to suit the demands of buyers and to fulfil the true competitive advantage of Islamic finance.

A shortage of qualified and trained staff: One of the most acute bottlenecks preventing the growth and professionalization of the Islamic financial services industry is the inadequate supply of qualified, skilled, well-trained and competent employees. Islamic banks currently hire conventional bankers for their expertise, but who, by their background and training, are unable to comprehend the differentiation between the two. They therefore perpetuate the re-engineering and imitation approach in Islamic financial products. This may be beneficial in the short term, but it has very detrimental long-term consequences for the industry as a whole. By doing this, we may unwittingly overprice Islamic banking products and services and make them non-competitive compared to the conventional banks due to an additional layer of cost of Shariah compliance. We must bridge this talent gap, or else the Islamic Financial service industry will not be able to make the leap it is aspiring to make.

Another challenge facing the industry is the lack of trained Shariah scholars. The current group of Shariah scholars advising the industry is very small. They must have the unique distinction of familiarity with the English language, mastery over Islamic jurisprudence and knowledge of modern banking. But their horizon is often restricted to the traditional modes of financing, such as musharakah, murabahah, mudarabah, ijarah, salam, etc. It has not extended beyond this limited range of product offerings. An international institute of quality should be set up to produce Shariah scholars of high calibre who are well versed in modern finance, accountancy, taxation, economics, law and Islamic jurisprudence. These individuals are our best hope to design a continuous supply of new Shariah-compliant products. As long as we do not meet this challenge, we are likely to remain trapped in a low-level equilibrium, despite current impressive growth rates. Perhaps the emergence of London as the global hub of Islamic finance, and the consequent pressure on the universities and research institutes in the United Kingdom, will help us move in this direction.

Corporate governance, risk management, and financial innovation: Ethical values are not add-ons but rather are embedded in Islamic finance. Ethical and socially conscious asset classes have expanded globally to US$8 trillion and are growing rapidly. Ethics-embedded Islamic financial products have transformational features that are relatively more attractive to many consumers. For example, the asset-based nature of Islamic finance can reduce the volatility inherent in contemporary complex and advanced financial products. But investors will only opt for Islamic products if they are assured that corporate governance, risk management, transparency and disclosure, and internal cost control requirements are at least as stringent as those followed by conventional providers, while adapted to meet the specific needs of Islamic banks and compliant with Shariah principles. With strong regulation, the opportunities for unscrupulous elements to take advantage of any arbitrage should be minimized.

Islamic banking is a hybrid of commercial and investment types of banking, just like conventional

> SHARIAH SCHOLARS SHOULD ENCOURAGE ISLAMIC FINANCE PRACTITIONERS TO EXPERIMENT AND INNOVATE PRODUCTS THAT ENHANCE EQUITY PARTICIPATION AND RISK SHARING SUCH AS MUSHARAKAH AND MUDARABAH.

universal banks. However, there are no firewalls to separate their investment and commercial banking services legally, financially or operationally. Co-mingling of funds can lead to difficulty in identifying the sources of funds invested at the time of the distribution of profits and losses. Although the regulators have succeeded in separation of funds of conventional and Islamic banking windows and subsidiaries, the further separation between investment and commercial banking operations requires strong scrutiny.

In today's world, where conventional finance is devising and marketing new products every month, such as hedging instruments and more refined risk management techniques, the response of the Islamic finance has not been equally innovative. The way forward in my view is that the basic restrictions imposed by Islamic finance on both assets as well as liabilities should be taken as a starting point. Without violating those restrictions, Shariah scholars should encourage Islamic finance practitioners to experiment and innovate products that enhance equity participation and risk sharing such as musharakah and mudarabah, which accounts for less than 20% of products offered by Islamic banks. The growing competition in the industry and the attraction of the big players towards Islamic finance provides some assurance that if they are given this kind of guidance the manufacturing of new Islamic products and techniques will be accelerated. Uncertainty about the Shariah compliance of such activities and the huge costs of innovation without assurance that they will bear fruit have slowed progress in this area.

Shariah reports are important part of public awareness. However, these reports are not made available to the public, and they are full of inconsistencies across sectors and across jurisdictions. This situation is antithetical to one of the principles of good governance—disclosure. How can this problem of inconsistency in disclosure or less than full disclosure be handled to maintain the integrity of the corporate governance structure of Islamic financial system?

The legal infrastructure for Islamic finance: The shareholder or owner-centred corporate governance system dominates English commercial law with little participation of other stakeholders such as individuals, firms, the community or the state in the governance structure of financial firms. The Islamic principles of property rights, true sale, bankruptcy, insolvency, foreclosure, collateral security, sanctity of contracts, and other incentives to enforce Shariah are missing from the companies law, banking company laws and other statutes available under English legal system. There is also a need to protect the rights of investment account holders (IAH) of Islamic financial institutions. While respecting the rights of shareholders to maximize profits, legal arrangements should also ensure the rights of other stakeholders, particularly the IAHs, in legal arrangements in civil code jurisdictions. The incompatibility of the existing commercial laws and codes with Islamic principles poses a fundamental conflict between reality and the ideal operations of Islamic finance. If the legal foundations are weak or unclear, regulators will be at a loss to design adequate prudential regulations for Islamic finance.

Another important question that may arise: what is the nature and the legal force behind Shariah boards? Are they part of the governance structure because they protect the rights of the depositors, investors, and borrowers who have put their faith and trust in the financial institutions to perform activities according to their beliefs? In practice, the issuance of transaction-based fatwas by the Shariah boards leads to lack of transparency and unpredictability. As stated earlier, IAHs occupy a peculiar position in the Islamic financial institution. They are neither shareholders in the traditional sense, nor are they passive depositors. They are, however, not represented in the governance of the IFSIs and thus they do not have much of a voice in the governance of IFSI institutions. Therefore, any corporate governance structure for an IFSI should incorporate these stakeholders and better define the role of the Shariah boards. How can the regulators perform customer protection functions when the rights and obligations of this category of stakeholders are not clearly defined?

In conclusion, the spread of the Islamic financial services industry has so far been uneven across industry segments, products and geography. It is highly encouraging that the momentum has indeed been accelerated in the GCC countries in the last couple of years, which augurs well for the industry. But the concentration so far has been on Islamic banking and asset management funds. The other complementary parts of the financial services value chain such as takaful, capital markets, microfinance, and non-bank financial institutions have not made much headway so far. Malaysia, Bahrain, Pakistan, Iran and Sudan are the early movers in the industry, but the coverage ratios in the first three countries are still low, although their growth rates are impressive. I expect Islamic capital markets to grow more rapidly in future, as the issues of Shariah-compliant Sukuk are becoming more standardized and their transaction costs are lowering with the passage of time. The debt capital market in Islamic finance is making some headway, but there is a need to nurture and develop equity capital markets as the structures of Islamic finance have a stronger affinity to this form of capital.

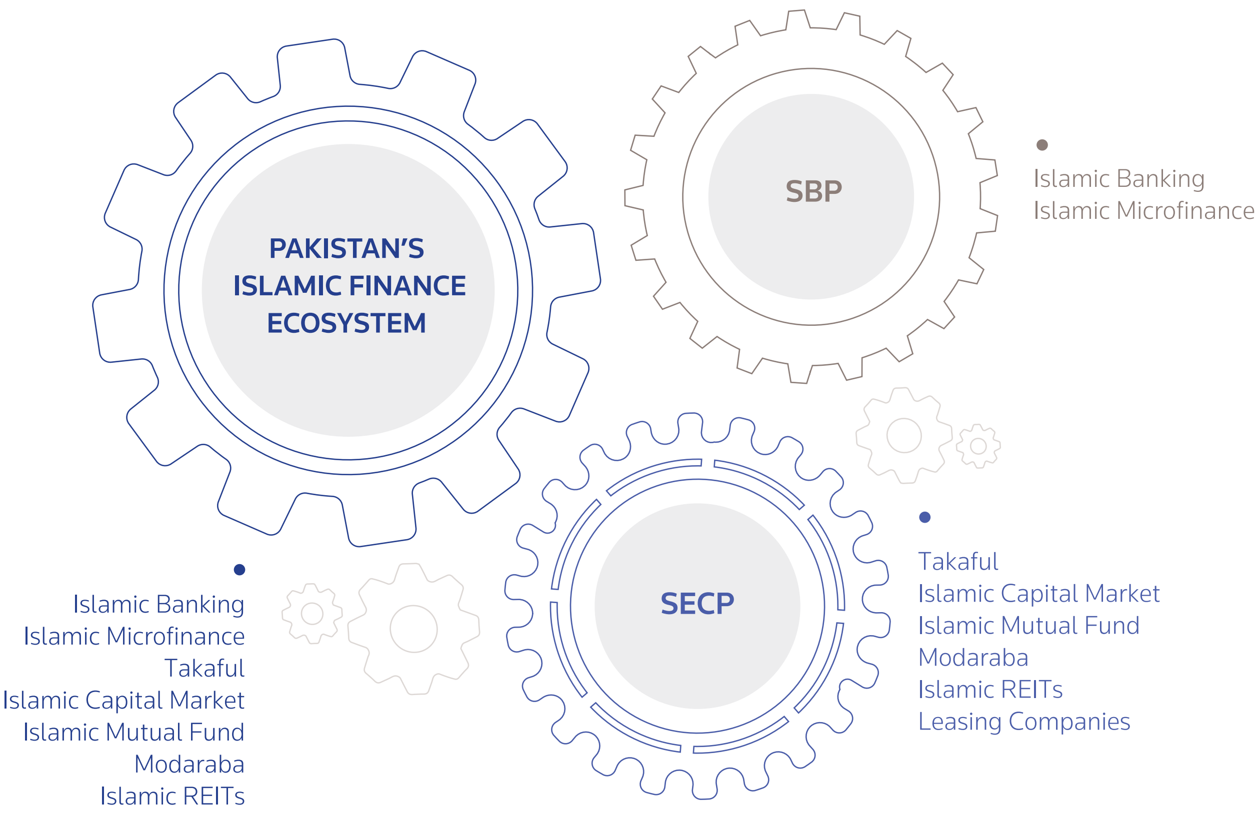
> THE INCOMPATIBILITY OF THE EXISTING COMMERCIAL LAWS AND CODES WITH ISLAMIC PRINCIPLES POSES A FUNDAMENTAL CONFLICT BETWEEN REALITY AND THE IDEAL OPERATIONS OF ISLAMIC FINANCE. IF THE LEGAL FOUNDATIONS ARE WEAK OR UNCLEAR, REGULATORS WILL BE AT A LOSS TO DESIGN ADEQUATE PRUDENTIAL REGULATIONS FOR ISLAMIC FINANCE.

Shariah Ecosystem

In Pakistan, the regulation of the financial system is divided between banks and non-bank financial institutions (NBFIs). The State Bank of Pakistan (SBP) regulates the banking industry in the country as its central bank, while the regulation of the non-banking industry is undertaken by the Securities and Exchange Commission of Pakistan (SECP). All Islamic banks operate under the purview and supervision of the SBP while the SECP oversees and regulates takaful companies, mutual fund management companies, Modaraba companies, leasing companies and investment banks. The SBP and SECP work in collaboration to ensure the continuous stability of the financial industry in Pakistan. These institutions also play a crucial role in the development of prudential and Shariah standards for the Islamic banking and finance industry.

The government of Pakistan is committed to the development of Islamic banking and finance as an effective financial system, and indeed, to the eventual Islamisation of the entire financial system. The minister of finance stated in his budget speech in 2002 "Government is committed to eliminating riba and promoting Islamic banking in the country."[22] In view of the large Muslim population in the country, the government endeavours to provide the appropriate mechanisms to ensure that industry players are Shariah-compliant and to develop its linkages with the global economy and worldwide Islamic finance industry.

PAKISTAN'S ISLAMIC FINANCE ECOSYSTEM



STATE BANK OF PAKISTAN (SBP)

Islamic banking and finance activities fall under the Banking Companies Ordinance 1962, State Bank of Pakistan Act 1956, Banks Nationalization Act 1974, Foreign Exchange Regulations Act 1947, Financial Institutions (Recovery of Finances) Ordinance 2001, and Companies Ordinance 1984. Apart from its core functions, which include regulation and supervision of financial system, regulation of liquidity, exchange rate management and balance of payment and soundness of financial system, the SBP also provides guidance, described in detail in this report, on the establishment of Islamic banks in the private sector, which include the eligibility conditions, licensing requirements, Shariah compliance and other operational matters. On July 12, 2015, the SBP allowed the NRSP (National Rural Support Programme) Microfinance Bank Limited to begin its Islamic microfinance operations.[23] Apart from its core functions, which include regulation and supervision of financial system, regulation of liquidity, exchange rate management and balance of payment and soundness of financial system, the SBP also undertakes initiatives to increase the professionalization of the Islamic banking industry by offering certificate courses and training programmes.[24] A subsidiary of the SBP, the National Institute of Banking and Finance (NIBAF) conducts training programs and courses for central bankers, commercial bankers, directors, and research officers for local and foreign institutions in the field of banking and finance. It has partnerships with institutions such as the Institute of Bankers Pakistan (IBP) and Pakistan Institute of Development Economics (PIDE), and it offers training modules in Karachi and Islamabad.[25]

COUNCIL OF ISLAMIC IDEOLOGY (CII)

To further complement the roles of the Shariah Board of SBP and Islamic banking institutions (IBIs), any draft laws relating to Shariah are referred to the Council of Islamic Ideology (CII) for legal advice. The CII recommends laws conforming to Islamic jurisprudence to the Parliament as well as the Provincial Assemblies. The CII has to ensure that all existing and proposed laws by the Parliament, Government of Pakistan, President of Pakistan, or Governor are in accordance with the Islamic injunctions.

SECURITIES AND EXCHANGE COMMISSION OF PAKISTAN (SECP)

The SECP has its own Shariah Advisory Board to provide Islamic jurisprudence opinions on matters relating to the Islamic capital market. In order to bring uniformity in the Shariah compliance regulatory framework, it regularly reviews the current regulatory framework of Shariah compliance and evaluates Islamic financial accounting standards in consultation with industry stakeholders. The Shariah Advisory Board of the SECP also prepares the rules and regulations for Shariah-compliant companies on qualifications for their Shariah advisors, operation of their Shariah advisory boards, requirements for internal and external Shariah auditors, the Shariah screening process for investments in securities, Shariah reporting and disclosure requirements, mechanisms for Shariah ratings in the country, registration requirements for Shariah rating companies, as well as enforcement mechanisms for any violations of Shariah.

Pakistan has been an active member not only at the national level but also at the global level through participations in leading international Islamic financial institutions or organizations such as the Islamic Financial Services Board (IFSB), the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the International Islamic Financial Market (IIFM).

LAWS RELATED TO ISLAMIC BANKING AND FINANCE ACTIVITIES

The relevant laws for Islamic banking and finance to ensure the stability of the system and Shariah compliance are: Banking Companies Ordinance 1962; State Bank of Pakistan Act 1956; Banks Nationalization Act 1974; Foreign Exchange Regulations Act 1947; Financial Institutions (Recovery of Finances) Ordinance 2001; Companies Ordinance 1984; Modaraba Companies and Modaraba (Floatation and Control) Ordinance 1980; Modaraba Companies and Modaraba Rules 1981; Microfinance Institutions Ordinance 2001; Takaful Rules 2005; Government of Pakistan ijarah Sukuk Rules 2008; Sukuk Regulations 2015; and REIT Regulations 2015.

MUFTI MUHAMMAD TAQI USMANI

Justice (Retd.), Shariat Appellate Bench, Supreme Court of Pakistan

JUSTICE (RETD.) MUHAMMAD TAQI USMANI is a renowned figure in the field of Shariah, particularly in Islamic Finance. He is an IDB prize winner in Islamic Economic and Finance for 1436H. He currently holds advisory positions in a number of financial institutions practicing Islamic Banking and Finance. He has vast experience in Islamic Shariah, teaching various subjects on Islam for 39 years. He served as a Justice of the Shariat Appellate Bench, Supreme Court of Pakistan from 1982 to 2002. He is also the Editor of the magazine Albalagh (a weekly publication of Jamia Darul Uloom, Karachi) as well as an active contributor of articles in leading Pakistani newspapers. He graduated from Punjab University, Pakistan in 1970 and holds an LLB from Karachi University, Pakistan. Prior to this, he completed the Takhassus course, which is the specialization course of Islamic Fiqh and Fatwa (Islamic Jurisprudence) from Jamia Darul Uloom Karachi, Pakistan. In March 2004, Dubai Crown Prince and UAE Minister of Defense His Highness Sheikh Mohammad Bin Rashid Al Maktoum presented a special award to Justice (Retd.) Muhammad Taqi Usmani in recognition of his lifetime service and achievement in Islamic finance on the occasion of the International Islamic Finance Forum, Dubai.

1. Shariah scholars are considered mastermind of present day Islamic finance. How do you see the role of Shariah scholars for the growth of Islamic banking and finance industry?

The growth of Islamic finance is primarily the responsibility of businesspeople. Shariah scholars' prime responsibility is to ensure the Shariah compliance of the products, processes, arrangements and agreements used in the Islamic finance industry. It is not necessary that a thing that is ideally and logically perfect attains success as well. There may be cases, and in fact there are examples, that certain products just could not hit the tipping point and failed to gain success, despite adhering to highest quality Shariah standards. Although Shariah scholars are partially responsible for the perception of Islamic finance, which in return is likely to impact the growth of the industry, I think that Shariah scholars' performance should not be gauge on the basis of growth of the industry.

2. As one of the pioneer Shariah scholars in the Islamic finance industry, what do you think are the key challenges faced by Islamic banks in Pakistan from the point of view of Shariah? How do you see the resolution of these issues?

The key challenges faced by Islamic banks in Pakistan, I think, are:

i. The undocumented economy, which allows business organizations to hide their income, to evade liabilities and to misrepresent their business affairs. This hinders equity-based investments at Islamic banks, which is the ideal mode of finance from an Islamic perspective. It also puts obstacles in the way of financial inclusion;

ii. A judicial structure which is incapable of providing prompt justice. This prevents Islamic financiers from undertaking projects that are desirable from a social and economic perspective but risky from a credit perspective;

iii. A regulatory regime that treats Islamic banks at par with conventional banks when making prudential standards. For example, the Capital Adequacy Requirement for Islamic banks is same as for conventional banks without regard to the fact that Islamic banks' remunerative accounts are partners with banks in profit and loss and do not require capital protection;

iv. A parallel system of conventional banking is the biggest challenge, in my view, to Islamic banks. Since the Islamic banks hold assets near 12% of the total banking industry, they face competition from conventional banks, which are free to undertake any financial arrangement without regard to Shariah rulings. This situation puts Islamic banks at competitive disadvantage, and the corporate world sees these banks less flexible. The parallel system is also harmful to Islamic banks, as they have to interact with conventional banks in financial dealings. In these dealings, conventional banks usually dictate their terms from a better bargaining position by virtue of their size.

3. Islamic finance is growing rapidly around the globe. Recently, the State Bank of Pakistan was ranked second in the world for the promotion of Islamic banking. How satisfied are you with the current state of Islamic banking and finance in Pakistan?

Islamic banking in Pakistan is a relatively nascent industry. Despite this, it has witnessed robust growth, but I think the parallel system should now come to an end. We have successfully experimented with Islamic finance, and it has become evident that Islamic finance has the capacity to cater to all the genuine financial needs of a society. I think that Islamic banks have experienced growth up to the present because of the support of Shariah-conscious customers. If we need penetration in the corporate world, we have to close the doors to their access to interest-based financing. It is now the time for Islamic finance to start the journey to qualitative growth by increasing their portfolio of participatory modes of financing, by having fewer dealings with conventional banks, and by relying less on debt-based financing.

4. In Pakistan, Shariah scholars have divergent opinions on some of the issues that may confuse public. What steps should be taken to bring harmony among Shariah scholars about Islamic finance?

Divergent Shariah opinion is neither a new phenomenon nor a disliked one. Since the very early days after the passing of the Prophet, SallallahoAlaihiWasallam, his companions too became divided while opining on a matter. Even during the life of the Prophet, natural things such as the division of opinion occurred. We cannot avoid the emergence of a divergence in opinions. However, we can neutralize its undesirable effects by standardizing products and practices. For this purpose, forums and organizations like AAOIFI can play a vital role.

5. How do you see the future of Islamic finance in Pakistan? Also, what are the key steps that you will recommend for the State Bank of Pakistan, the Islamic banking industry and the Shariah scholars of the country?

The future of Islamic finance is very bright in Pakistan. But we should not fall prey to complacency. We have to move further and work harder. The State Bank should start a gradual phasing out of the conventional banking system and make logical capital standards for Islamic banks. Shariah scholars should be very vigilant towards the ever-innovating finance world, and they should keep a close eye on banking activities to ensure their compliance to Shariah rules.

Regulatory, supervisory and shariah compliance development

The SBP aims to provide a sound regulatory and supervisory framework and to develop Shariah compliance guidelines for the Islamic banking and finance industries in Pakistan. The Islamic Banking Department of the SBP has been issuing circulars to develop the industry since 2003.[26] However, the current policies of the SBP regarding Islamic banking and finance are based on a different approach than the previous policies. The reintroduction of Islamic banking in Pakistan in 2001 has been more successful than the mid-80s reform attempt because it aims for the gradual and market-based, rather than compulsory, spread of Islamic financial values.

The SBP issued a new Shariah compliance mechanism in 2008 (IBD Circular No. 2, 2008). This mechanism consists of a detailed set of guidelines governing the appointment of Shariah advisors, duties and responsibilities of Shariah advisors, reports made by Shariah advisors, conflict resolution in Shariah rulings, Shariah compliant modes of banking and finance, essentials of Islamic modes of financing, the use of charity funds, the introduction of new products and services and the schedule of service charges.[27]

In addition, in 2012, the SBP issued instructions for profit and loss distribution and pool management in order to improve transparency and standardization in Islamic Banking Institutions (IBIs). Earlier, Islamic banks were using different pool management practices, and there were no well defined, transparent, and standardised policies and practices for the calculation and distribution of profit and loss to depositors across the Islamic banking industry in Pakistan.[28] To further strengthen the Shariah compliance environment of Islamic banking institutions in Pakistan SBP issued a refined Shariah governance framework for IBIs in April 2015.

Some important circulars and instructions issued by SBP that govern the Islamic banking industry are as follows:

No.	Title	Issuance details
1.	Three pronged Strategy for Islamic Banking Industry	▪ 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.
2.	Fit and Proper Criteria for Shariah Advisors	▪ IBD Circular 2 of 2007 and 3 of 2008
3.	Instructions for Profit and Loss Distribution and Pool Management for Islamic Banking Institutions	▪ IBD Circular 3 of 2012
4.	Adoption of AAOIFI Shariah Standards	▪ IBD Circular 1 of 2010 ▪ IBD Circular 1 of 2013 (Standard No. 12) ▪ IBD Circular 3 of 2013 (Standard No. 17)
5.	Shariah Governance Framework for Islamic Banking Institutions	▪ Instructions and Guidelines for Shariah Compliance in IBIs (IBD Circulars 2 and 4 of 2008) ▪ IBD Circular 1 of 2015
6.	Introduction of New Products and Services	▪ IBD Circular 2 of 2013
7.	Islamic Banking Windows	▪ IBD Circular 1 of 2014

THE SHARIAH GOVERNANCE FRAMEWORK OF THE SBP

The Islamic Banking Department of the SBP released its most recent Shariah governance framework for Islamic banking institutions in 2015. The governance framework is important in establishing the confidence of the general public in the Shariah-compliant products and services that the Islamic banking and finance industry offers. The SBP has formally issued a detailed set of regulations, instructions and guidelines on Shariah compliance for Islamic banking institutions operating in Pakistan. In this framework, the roles and responsibilities of various organs of Islamic financial institutions have been defined including the board of directors, executive management, Shariah board, Shariah compliance department, and internal and external auditors towards meeting Shariah compliance.

However, the final responsibility for the conformity of Islamic bank operations with Islamic jurisprudence lies within their board of directors. There is a need for boards to be more aware of their fiduciary responsibilities. According to the Shariah governance framework:

- The board of directors of Islamic banks will appoint Shariah boards to develop measures for the introduction and implementation of an effective Shariah compliance framework.

- They will meet the Shariah Board every six months to conduct a detailed briefing on the Shariah compliance environment and for the effective enforcement of decisions, Fatawa, observations and recommendations of the Shariah Board.

- The duty of the executive management is the implementation of the Shariah compliance framework by ensuring the availability of all approved procedure manuals, product programmes and structures, process flows, related agreement and contracts.

- There must be at least three Shariah scholars in the Shariah Board of Islamic banking institutions who can supervise all Shariah related matters.

- The Shariah compliance department will be held accountable for the Shariah compliance review. It will be the conduit between management and the Shariah Board, ensure enforcement of the Shariah audit reports, and conduct the training of employees in Shariah compliance under the guidance and supervision of the Shariah Board.

- Each Islamic banking institution must have an internal Shariah audit unit and the audit report must be submitted to the Shariah Board for consideration and to find the appropriate corrective actions.

- An independent assessment by an audit firm is essential for each Islamic banking institution to assess the conformity of its operations with Shariah rules and principles.

Role of the Islamic Banking Department in the State Bank of Pakistan

To facilitate and catalyze the development of Islamic banking, the SBP established the Islamic Banking Department in 2003. This department plays a leading role in promoting and developing Islamic banking and finance. The mandate of the Islamic Banking Department is to develop and strengthen the regulatory and Shariah compliance framework for the Islamic banking industry of Pakistan, and to undertake initiatives to promote Islamic banking as a parallel and compatible banking system in line with best global practices.

The role of the Islamic Banking Department at the SBP is to enable the implementation of the legal, regulatory and Shariah compliance framework. It also seeks to promote Islamic finance as a distinct and competitive system that will serve the financial services needs of the masses and to undertake targeted research initiatives to better explore the market dynamics. Finally it collaborates with local and international stakeholders for competitive and innovative solutions. Re-launched in 2001, Islamic banks grew their market share to 10% of banking assets by 2014, with a growth rate twice of that of conventional banks.[29]

The Development and Role of the SECP Islamic Finance Department

In February 2015, the Securities and Exchange Commission of Pakistan (SECP) established a full-fledged Islamic Finance department to conduct consultation and provide advice on all Shariah related matters. The Shariah Advisory Board at SECP comprises three Shariah scholars—Justice Khalil ul Rehman, Mufti Muneeb ur Rehman and Prof. Dr. Tahir Mansoori—and one technical member, Mr. Bilal Rasul. They provide opinions on Shariah-related laws, rules, regulations, agreements and documents.[30]

The Islamic Finance Department of SECP has an important role in the approval of an entity, activity or product, or for any regulatory change/proposal (e.g. circular, guidelines, and amendments). The mission of the department is to provide a regulatory environment that is solely based on the principles of Shariah with an elimination of interest from the corporate sector of Pakistan.

The Islamic Finance Department has developed a Shariah compliance framework and index, and it conducts research and development to introduce new Shariah compliant products. It also is working to implement of Islamic financial accounting standards across the industry, and has taken steps to train, educate, and inform the public about Islamic finance.

In addition, there is a very active SBP-SECP joint forum on Islamic finance, which was formed to take joint steps Islamic financial institutions and to identify the impediments that hinder the growth and development of the Islamic capital market and Islamic banking in Pakistan. This venture recommends plausible solutions, finds ways to facilitate the access of small and medium enterprises to Islamic banking and finance, and collaborates with other stakeholders to increase market awareness.

In 2015, the Islamic Finance Department of the SECP reviewed several capital markets issues for regulatory and Shariah compliance, including:

the trust deed and offering document of the National Investment Trust (NIT) Islamic equity fund; the document of advertisements of NIT Islamic equity fund; the offering document of Al-Ameen Islamic financial planning fund; the prospectus to issue Sukuk for K-Electric Limited; the draft of Mudarabah regulations 2015; the supplemental trust deed of HBL Islamic Mustahekum Sarmaya fund; Pakistan Mercantile Exchange Limited (PMEX) proposed commodity murabahah transactions; Proposed PMEX regulations governing murabahah financing transactions; the trust deed of BMA Zaamin income fund; and the trust deed and offering document of National Investment Trust Limited-Islamic Pension Fund.

Challenges in the Islamisation of the Financial System

There are several risks and gaps that have to be mitigated to spur the growth of Islamic banking and finance in Pakistan. The first challenge that the Islamic banking industry in Pakistan faces is the lack of public awareness about the objectives, underlying principles, and the operations of Islamic banking and finance. According to a nationwide survey conducted by

A labourer attaches iron rods to a column at the construction site of a flyover in Lahore. REUTERS/ Mohsin Raza

Reuters (2014), more than 83% of customers of all types of banks did not understand the services offered by the Islamic banking industry. Unbanked respondents were even more ignorant of these services.[31]

Second, there is an innovation gap. Islamic banks in Pakistan are not offering new products and services. The Islamic banking industry in the country needs to diversify its product portfolio in order for Islamic finance to gain traction.

Third, it is recommended that banks and their clients follow the Islamic values of honesty, truthfulness, justice, transparency and fairness in true spirit, and that educational campaigns stress these values.

Fourth, the low supply of qualified Islamic banking professionals is also a hindrance for Pakistan to establish a riba-free economy. There is a shortage of workers who are not only trained in modern banking and finance but also knowledgeable about Shariah. Therefore, in order to establish and expand Islamic banking and finance, the business will need to recruit more skilled and trained individuals that can expand its product portfolio.

Fifth, the legal and taxation frameworks are not compatible with Islamic principles of property rights, true sale, bankruptcy, collateral security and others. Thus, amendments in the frameworks are required to further expand the development of Islamic banking and finance in Pakistan. The current legal framework in Pakistan does not differentiate between conventional and Islamic banking. For the recognition of Islamic finance as a distinct enterprise, the SBP is working hard to draft of separate provisions in the Banking Companies Ordinance (BCO) 1962, important amendments in SBP Act 1956, the recovery of Finance Ordinance 2001, Microfinance Institutions Ordinance 2001 and other related laws. Once these drafts are ready, then SBP will work with government for the enactment of the proposed changes.

A COMPARISON OF ISLAMIC FINANCE: PAKISTAN AND MALAYSIA

Pakistan is a key player in the contemporary global Islamic finance industry. As it bridges two major markets of Islamic finance—the GCC and Southeast Asia—it is instructive to evaluate Pakistan together with Malaysia, which shares an almost identical Islamic finance ecosystem and infrastructure. Pakistan once held the lead in the development of many Islamic finance institutions and regulations, although internal challenges have since slowed down the pace of their development.

Both Malaysia and Pakistan gained independence in the span of a decade: Pakistan won its independence in the year 1947, adopted its constitution as an Islamic republic one year before Malaysia declared its independence in 1957.

Pakistan's orientation toward Islamic economic principles was established as early as 1948, in President Muhammad Ali Jinnah's speech at the inauguration of the SBP. Pakistan generally has opted for a top-down approach to Islamising the state economy and the banking system. The push for Islamic banking in Malaysia first came at a later stage. In 1969, Tabung Haji was established, a government agency to assist Muslims plan for their pilgrimage with deposit savings. Demand from Malaysian Muslims emerged later for the National Economic Congress (NEC)'s resolution in 1980 to establish Islamic banking in Malaysia.

Malaysia therefore licensed its first Islamic bank, Bank Islam Malaysia Berhad, in 1983. Because of Pakistan's long period with a compulsory ban on interest at all Pakistani banks, it was only 40 years after the establishment of the CII and its goal of Islamising the financial industry that Pakistan adopted an Islamic banking sector parallel to conventional banks.

As a result of longer experience and longer government strategic plans, Malaysia's Islamic banks have surpassed 20% of total industry assets in 2013, while Pakistan's Islamic banking has only captured 11.4%. It is also clear that Pakistan struggles with lower awareness of and demand for Islamic finance from consumers. To date, only of five full-fledged banks, one subsidiary and 17 Islamic windows have been opened in Pakistan. On the contrary, Malaysia has managed to create better awareness amongst its consumers and 16 full-fledged Islamic banks and 12 Islamic windows currently operate.

This presence has allowed the Malaysian Islamic banking industry consistent double-digit growth

^ People use automated teller machines (ATMs) in Kuala Lumpur, Malaysia. REUTERS/ Samsul Said

since 2000. It is expected to have an average base of 13% to an optimum of 18% in the next couple of years, while Pakistan is projected to grow 11.2% in 2016.

The ruling fiqhi madhhab (jurisprudence school) of Pakistan is Hanafi, while Malaysia is mainly Shafi'i. In Islamic commercial law (fiqh mu'amalat), however, Malaysian scholars at the regulatory level or at the industry are open to adopting of other juristic schools deemed suitable and appropriate to current market conditions.

Even though Pakistani Shariah scholars are known to their strict adherence to the Hanafi school, they have been also open to other fiqhi opinions. For example, the SBP Shariah Board has adopted several AAIOFI standards while Malaysia, only uses AAIOFI standards as references for proprietary national laws and regulations.

A widely-used financing structure in Malaysian Islamic finance is bay' bithamanin ajil (BBA – Inah), a sale- or debt-based instrument. In contrast, Pakistan's market is more open to profit and loss sharing products such as diminishing musharakah, which holds a major market share in Islamic lending structures. As for Islamic capital markets, Pakistan first issued ijarah Sukuk in 2008, while Malaysia issued Sukuk starting much earlier in 1990, structured by Bank Islam, Malaysia's first Islamic bank.

Islamic finance awareness and education

Islamic financial institutions are now operating in 45 countries all over the world, either directly or indirectly. The Islamic Finance Country Index (IFCI), produced by Edbiz Consulting, has designated these countries as Established Leaders, Emerging Leaders, Potential Leaders and Tail-enders. The inclusion of finance courses at Shariah educational institutes as a key goal in the SBP 2014-2018 Strategic Plan, and the creation of new Centres of Excellence in Islamic Finance at prominent Pakistani institutions of higher education, signifies the of increasing awareness about the role of education in growing the Islamic finance industry.

The established and emerging leaders of the Islamic financial industry have been dedicated in the task of educating industry specific talent. They have developed education, training and awareness programmes to ensure the positive development of the sector. The initiatives also include university degrees, vocational training and education courses. For example in the case of Malaysia, institutions like Chartered Institute of Islamic Finance Professionals (CIIF), IBFIM, INCEIF, IIUM, and AIF are working hard in this regard.

The IFCI ranks Pakistan as a potential leader for the Islamic finance industry. The basic literacy rate of Pakistan is 56%, according to the World Bank, of which only a small proportion is financially literate, and 13% hold a bank account. Only 23% of the banked population use Islamic finance products and only a few such individuals report understanding Islamic financial models and contracts.

These findings indicate a strong need for greater awareness and education about Islamic finance. The historical trend for the promotion of Islamic finance awareness and education in Pakistan however remains industry specific. Commercial banks and the central bank have taken the initiatives for the creation of developing the profession. They have also played important roles in increasing the general awareness among consumers through marketing techniques such as print media and social media awareness campaigns.

Consumer awareness has been restricted to consumers' religious beliefs and their personal interest to learn about the specific aspects of financial affairs. To be precise, there are two types of consumers:

- The first are religiously inclined and will seek to use Islamic banking under any circumstances, regardless of the fact that they do not understand the working, concept and contracts of Islamic finance.
- The second are not religiously inclined. Industry professionals work to attract the attention of these consumers and prospective consumers by creating greater awareness about Islamic finance. Different marketing tactics can promote the use of Islamic finance

ISLAMIC INSTITUTION'S WORLD MARKET SHARE OF COUNTRIES

Established Leaders	Iran, Malaysia and Saudi Arabia
Emerging Leaders	UAE, Kuwait, Bahrain, Indonesia and Qatar
Potential Leaders	Sudan, Pakistan, Bangladesh, Turkey, Egypt and UK
Tail-enders	Jordan, USA, Brunei Darussalam, Siri Lanka, Oman, Yemen, Lebanon, Kenya, Singapore, Switzerland, South Africa, Syria, Canada, Tunisia, Thailand, India, Algeria, Afghanistan, Australia, Nigeria, Azerbaijan, Kazakhstan, Palestine, France, The Philippines, Germany, Gambia, China, Senegal, Ghana and Mauritius

Source: Islamic Finance Country Index (IFCI), 2015 offerings and contracts. Religious and ethical awareness may therefore play its role in persuading the consumers to use Islamic financing modes that offer greater product differentiation and quality services.

Currently the development of Islamic finance professionals occurs through training on the job, vocational training, short courses, workshops and seminars. Pakistani religious scholars, who are the backbone of education at most Islamic financial institutions, have initiated all these activities. This trend also includes new courses at the tertiary level in the form of formal university degrees to MBAs and BBAs specializing in Islamic Finance, although they are still not being conducted by trained finance academics. The industry has organized conferences recently, and it has published bulletins and reports written industry specific people in coordination with finance academics. However, the roles and participations of academics remain to be very limited and low.

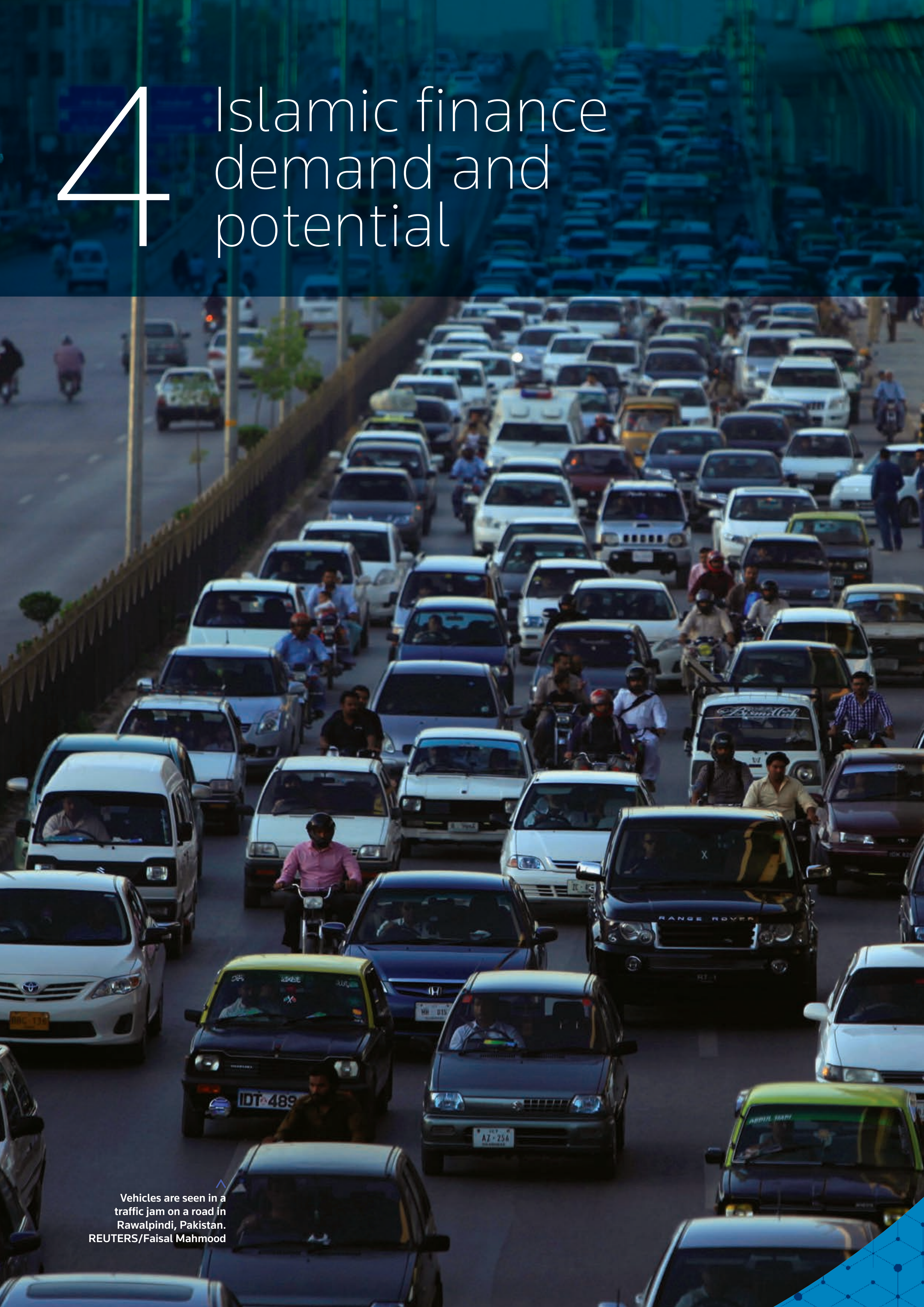
With the increasing awareness about Islamic finance, more professionals have studied Islamic finance in countries with better-developed Islamic finance industries. The task of Islamic financial education has therefore shifted towards academics. A number of higher education institutions are now offering education in Islamic finance. However, the subject either has a minor position in these institutions or such initiatives are undertaken only by religious scholars.

Last year, the SBP held a signing ceremony for the Financial Innovation Challenge Fund (FICF) round three for promoting excellence in Islamic finance in Pakistan under its financial inclusion programme funded by the UK's Department for International Development (DFID).

The signing ceremony marked the starting of implementation phase of the FICF innovative Islamic finance education and research projects in partnership with leading higher education institutions, which was launched on January 9, 2015 by Finance Minister Ishaq Dar and Deputy Governor of the SBP and FICF Advisory Committee Chairman Saeed Ahmad. At this ceremony three projects were signed with Institute of Business Administration (IBA), based in Karachi, Lahore University of Management Sciences (LUMS), based in Lahore, and Institute of Management Sciences (IM Sciences), based in Peshawar.

All three Centres for Excellence in Islamic Finance (CEIFs) started their operations last year. For the first time in Pakistan, academic institutions and the industry have started working in collaboration with the SBP to offer Master's and PhD degrees in Islamic Finance. Academics and industry experts will jointly organize classes and curricula to create truly industry-specific professional development. These centres will play a crucial role in the development of existing employees as well as the preparation of prospective employees.

4 Islamic finance demand and potential



Vehicles are seen in a traffic jam on a road in Rawalpindi, Pakistan.
REUTERS/Faisal Mahmood

INSIDE THIS CHAPTER

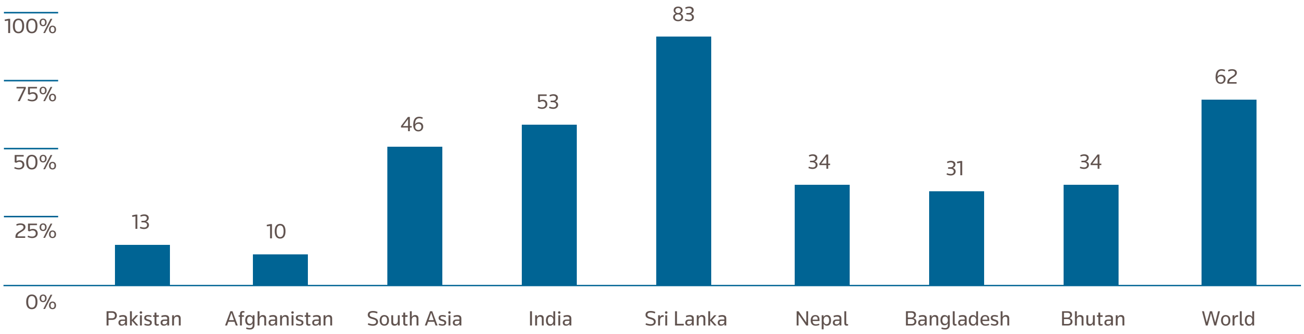
Consumer financial profile

FINANCIAL INCLUSION

The government of Pakistan is making efforts to improve the financial profile of its population by increasing financial access and by bringing suitable financial services to more of its citizens. Despite continuous efforts by the government and other concerned parties over the years, the level of financial inclusion in Pakistan remains limited. According to the World Bank's Global Financial Inclusion Database, Pakistan's financial inclusion remains below average both by world standards and in South Asia. Among South Asian countries, Pakistan has one of the lowest rates of bank account ownership, at 13% of the population. Only Afghanistan has a lower rate of inclusion, where 10% hold a bank account.

The minimal reach of lending from commercial banks reflects the low general financial service penetration in Pakistan. Only 23 adults per 1,000 obtained credit from commercial banks. In this regard, its neighbour Bangladesh is doing far better, as 81 adults per 1,000 used credit instruments from commercial banks. Bangladesh also has twice as many depositors per 1,000 adults compared to Pakistan.

POPULATION HOLDING BANK ACCOUNTS (AGE 15+)



Source: Global Findex 2014 (Global Financial Inclusion Database) - Last Updated: 04/15/2015

DEPOSITORS AND BORROWERS PER 1,000 ADULTS

Indicator	Period	Pakistan	World	Afghanistan	Bangladesh
Depositors with commercial banks (Per 1,000 adults)	2014	295	-	185	592
Borrowers from commercial banks (Per 1,000 adults)	2014	23	147	3	81

Source: World Development Indicators 2015, The World Bank. Last updated date 16/12/2015

According to the Access to Finance Survey 2015 (A2F) conducted by the State Bank of Pakistan (SBP), the proportion of adults holding bank accounts (including mobile wallets) has increased from 11% to 16% since 2008. Overall, 23% of adults have access to any kind of formal financial service, including deposit and credit accounts, m-wallets, National Savings Schemes, leasing, pensions, and over-the-counter and life insurance services offered by branchless banking, increasing from 12% in 2008.

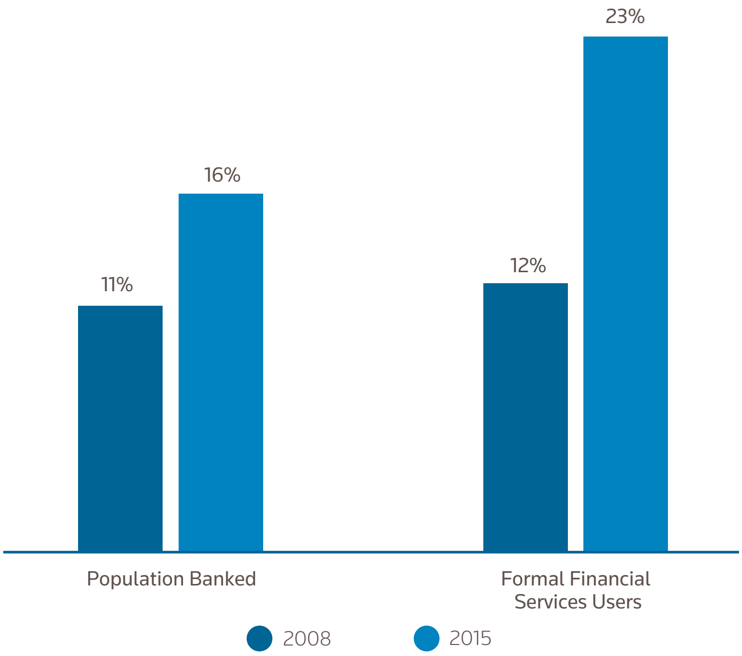
However, informal financial services, including money lending from cooperatives and local committees (a form of interest-free crowd funding used in Pakistan primarily for household consumption, businesses and projects) and loans offered by shopkeepers and others, reach 24% of the population. Pakistanis who use such services exceed those who are formally included (e.g. owners of bank accounts and mobile accounts).

The Financial Inclusion Survey determined women are less likely to use financial services than men. Only 11% of women use formal bank services compared to 21% of men. Despite the gender gap in banking, women's banked population and overall financial inclusion improved remarkably from 2008 to 2015, increasing from 4 to 11% in the formal sector and 33 to 43% in the informal sector. This is the result of increased female workforce participation and the Benazir Income Support Programme, which provides women with access to formal payment channels.

The survey found that the lower use of financial services by women (of whom 90% are housewives) is mainly due to their below-average participation in economic life and not because of their lack of knowledge or understanding of financial services. The study found 17.4% of women are illiterate or have very limited financial literacy while the 36% are very literate or good financial literacy and 46.5% had limited financial literacy.

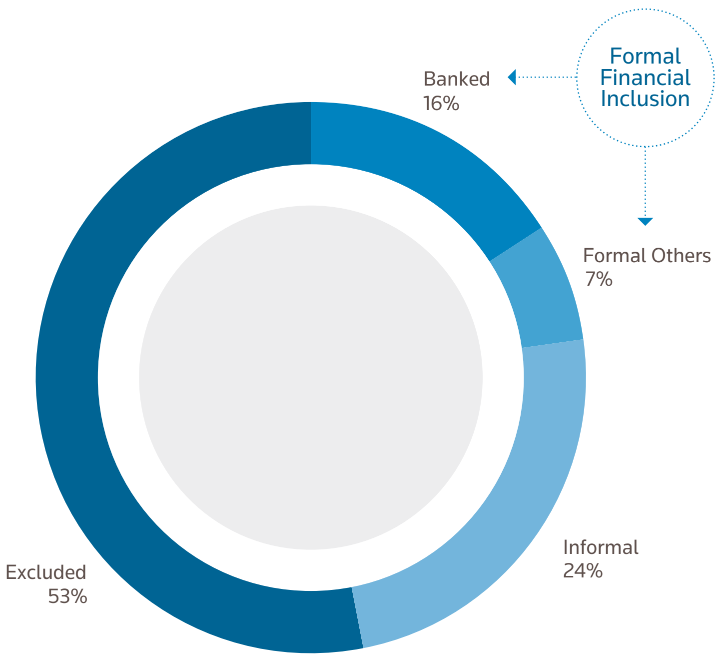
The reach of financial services to the urban population has improved better than in rural areas both in terms of banked population and overall financial inclusion. The report found the urban population had formal bank and total financial inclusion of 21% and 51% respectively, compared

FINANCIAL INCLUSION IN PAKISTAN



Source: Financial Inclusion Survey 2015, SBP

2015 FINANCIAL INCLUSION IN PAKISTAN

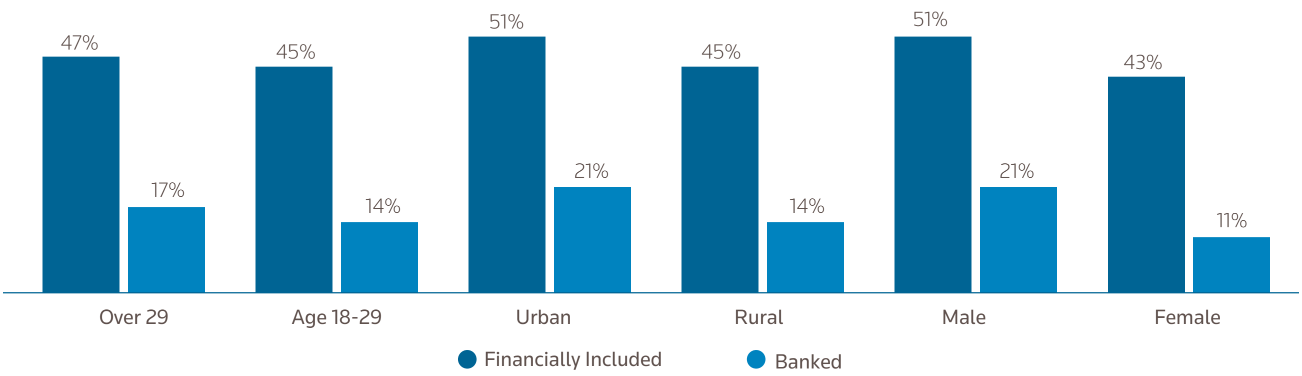


Source: Financial Inclusion Survey 2015, SBP to a ratio of 14% and 45% in rural areas. Although Pakistanis in rural areas are not less likely to use financial services, they are more likely to use informal providers like moneylenders because of their distance from formal service providers such as banks.

Financial inclusion increased across all of Pakistan's provinces since 2008, excluding Khyber Pakhtunkhwa (KPK) where 90% of the population remains unbanked only 32% use any financial services. Baluchistan was the most improved province as the banked population jumped from 4% to 20% and financially included population increased from 16% to 33%.

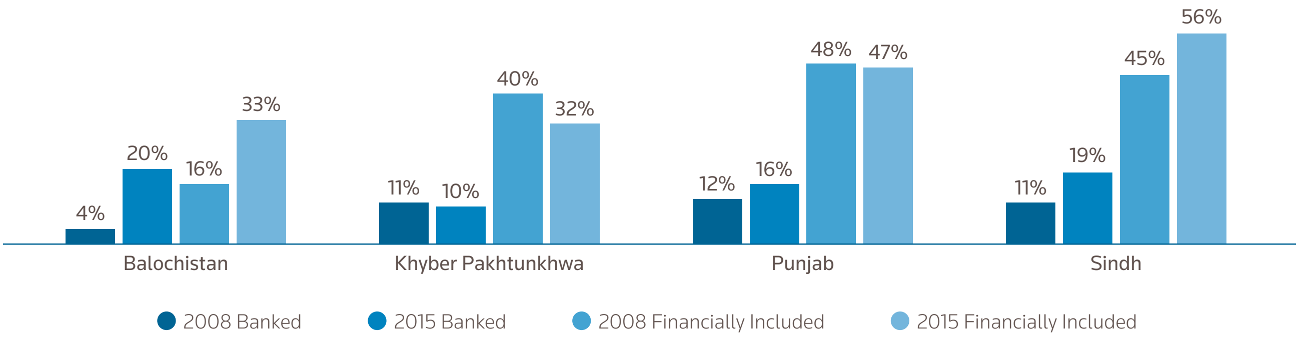
Banks have a long way to go in improving the use of savings accounts. The majority of Pakistanis put money aside mostly to address unexpected expenses, to provide families' emergency funds in case of the incapacity of breadwinners, to buy household goods, or for marriage. However, only 12% use formal saving schemes as most to keep savings at home in cash. Three-quarters of the population said that they do not use credit, either formally or informally. Retail credit from formal sources like banks reach a marginal 2.4% of Pakistanis, as most customers prefer to borrow on account from retailers. For example, rural Pakistanis are purchasing increasing numbers of appliances like televisions, computers and washing machines in rural areas a result of the spread of the electric grid. This has led many manufacturing companies to provide credit directly for inexpensive home appliances, while banks have been slow to cash in on this trend.

FINANCIAL INCLUSION BY DEMOGRAPHIC PROFILE



Source: Financial Inclusion Survey 2015, SBP

FINANCIAL INCLUSION BY PROVINCE (2008 AND 2015)



Source: Financial Inclusion Survey 2015, SBP

FINANCIAL ACCESS

Although the number of formal access points for transactions have increased in 2015, including ATMs, point of sale (POS) machines, branches or cards, Pakistan remains well below South Asia and the world in terms of the number of these access points per 100,000 adults, especially in rural areas.

In order to empower Pakistan's population and to create more opportunities for businesses, the SBP, along with the Ministry of Finance, the Securities and Exchange Commission of Pakistan (SECP) and the World Bank launched the five-year National Financial Inclusion Strategy (NFIS) in 2015. The strategy outlines a plan to increase and deepen formal financial inclusion to spread the use of savings accounts and access to credit, payment and insurance services with both conventional and Shariah-compliant structures. The strategy is an important part of the government's Vision 2025 plan, which calls for increasing retail financial inclusion and improving access to credit for SMEs.

One of the key goals of the NFIS is the digitalization of payments and branchless banking. This includes Government-to-Person (G2P) payments to individuals, including the National Income Support Programme (NISP) and Bait-ul-Mal, and the collection of Person-to-Government (P2G) payments such as fee and tax payments. It also prioritizes increasing financial services access points such as ATMs, branches, agents and POS.

Financial literacy programmes for consumers and SMEs play a big role as well in the NFIS. In 2012, SBP launched the Nationwide Financial Literacy Programme (NFLP) to spread knowledge and understanding of financial concepts and specific financial products and services to segments of the underserved population in both urban and rural population. The programme included workshops on money management skills and the use of formal banking system. It aimed to target 50,000 low-income beneficiaries, then expand to more than 500,000 beneficiaries from all over the country.

FINANCIAL ACCESS INDICATORS

Indicator	2014	2015
Commercial Bank Branches	11,937	12,073
Online Branches	11,315	11,437
Number of ATMs countrywide (On-site and Off-site)	9,597	10,099
Debit Cards	25,024,235	25,871,230
Credit Cards	1,369,958	1,391,571
ATM-only Cards	900,270	901,888
Point of Sale (POS machines)	41,183	44,383
Online Branches per 100,000 Population	6	-
POS per 100,000 Population	22	-

Source: SBP Payment Systems Statistics for FY16 and FY15

Indicator	Period	Pakistan	World	South Asia	Afghanistan	Bangladesh	India	Sri Lanka
Commercial Bank Branches per 100,000 adults	2014	9.4	13.5	8.9	2.5	8.2	13	18.7
ATMs per 100,000 adults	2014	7.3	44	9.1	0.8	9.2	18.1	17.1

Source: World Development Indicators 2015, The World Bank. Last updated date 12/16/2015

SBP study on knowledge, attitude and practices of Islamic banking in Pakistan

The State Bank of Pakistan conducted a KAP Study titled "Knowledge, Attitude and Practices of Islamic Banking in Pakistan" based on a nationwide survey of 9,000 households and 1,000 corporations to assess the demand for Islamic financial services in Pakistan. Furthermore, 100 interviews with senior and middle managers of Islamic banks gauged expert opinions and efforts in the financial industry to improve products and services.

The SBP survey discovered an overwhelming demand for Islamic banking in a Pakistan, evenly distributed between rural and urban areas. 94.5% of banked and 98% of non-banked respondents believed that Riba or interest is impermissible in Islam.

In 26 districts out of 41 in the country, more than 95% of the respondents expressed a preference. The further analysis carried out by SBP reflects a higher demand for Islamic Banking among households (95%) than corporations (73%).

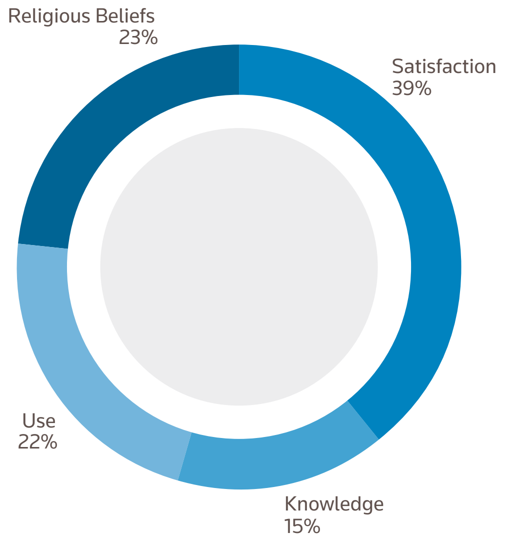
The significant factors that drive this demand include use and knowledge of financial services, and religious beliefs and satisfaction. The most noteworthy demand driving factor is the satisfaction (39%) derived from the products and services offered by the Islamic banks, which provides Islamic banks the best opportunity to compete with the conventional banks. Religious motivation alone contributes 23% to the demand for Islamic banking, while knowledge of the model, practices and products leads to 16% of the demand. The remaining 22% of respondents use Islamic banking services because of ease of accessibility, rather than loyalty or religious reasons.

TYPE OF BANKING USED BY RETAIL RESPONDENTS

	Banked	Non-Banked	Total
Fully Fledged Islamic Bank	487	4	491
Islamic Banking Window	144	4	148
Conventional Bank	3,095	324	3,419
Both	302	0	302
Never Used	0	4,640	4,640
Total	**4,028**	**4,972**	**9,000**

Source: KAP Study, 2014

DEMAND DETERMINANTS



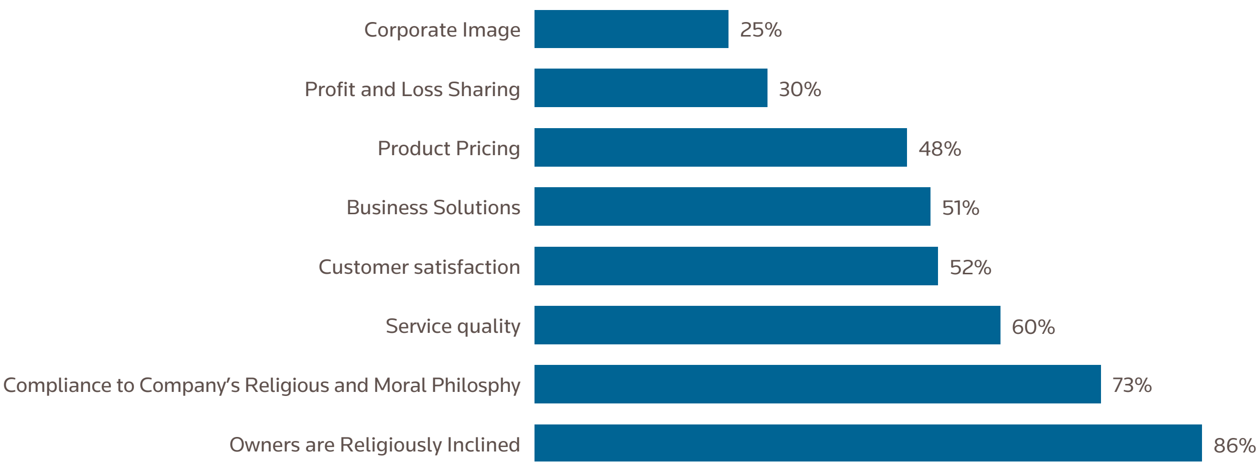
Source: KAP Study, 2014

SERVICE QUALITY OF ISLAMIC BANKING SECTOR IN PAKISTAN

According to the KAP study, 86% of respondents chose Islamic banking because the owners were religiously motivated and controlled the policies of the company. 73% of respondents expressed that Islamic banking is in line with the religious and moral philosophy of the company. The third most common reason was service quality, where 60% of the business respondents believed that Islamic banks provide better service quality than conventional banks.

For customers, the high quality of service at Islamic banks means better response time, the helpfulness of managers, better service quality, convenient locations, a good overall environment, and the presence of Shariah scholars and advisory boards. 89% of the Islamic banked were satisfied with their banking services. The three most important factors contributing to the satisfaction were Islamic products are not based on interest; they provide religious satisfaction and comfort, and Islamic banking employees are helpful. Religious adherence and better service quality holds greater value for clients than commercial reasons for using a bank.

CORPORATE REASONS FOR CHOOSING ISLAMIC BANKING



SATISFACTION INDICATORS OF ISLAMIC BANKING

CUSTOMER PERCEPTION OF ISLAMIC BANKING SECTOR IN PAKISTAN

Awareness of Islamic banking in Pakistan is growing quickly, with 78% of banked respondents and 51% of non-banked respondents aware of Islamic banking. The general understanding of the model of Islamic banks is fairly obscure to non-banked population as expected, considering this population lacks basic education. The most familiar concept was of qard-e-hasana (charitable interest- and profit-free loans) and respondents unanimously believed that Islamic banks should offer this service. Among the banked businesses, there was a greater understanding of the range of Islamic financial contracts. The understanding of both the banked and unbanked population with respect to Islamic financial contracts is very low.

Of those who were familiar with Islamic banking, there was mixed acceptance of the authenticity of the present model of Islamic banking. While some welcomed it, others were cautiously optimistic and many were sceptical. 40% of the respondents were convinced a bank would be Shariah compliant with only one Shariah scholar, whereas 60% were only confident with a full Shariah board.

According to the survey, 74% of the banked population was interested in switching to Islamic Banking, primarily to achieve religious satisfaction and because of the belief that bank interest was riba and thus haram, among other less significant factors.

The customer perception towards Islamic banking is categorized in three main indicators, in the KAP study.

a) Negative perceptions of riba.

b) Differentiation between full-fledged Islamic banks, Islamic subsidiaries, Islamic branches and windows and conventional banks.

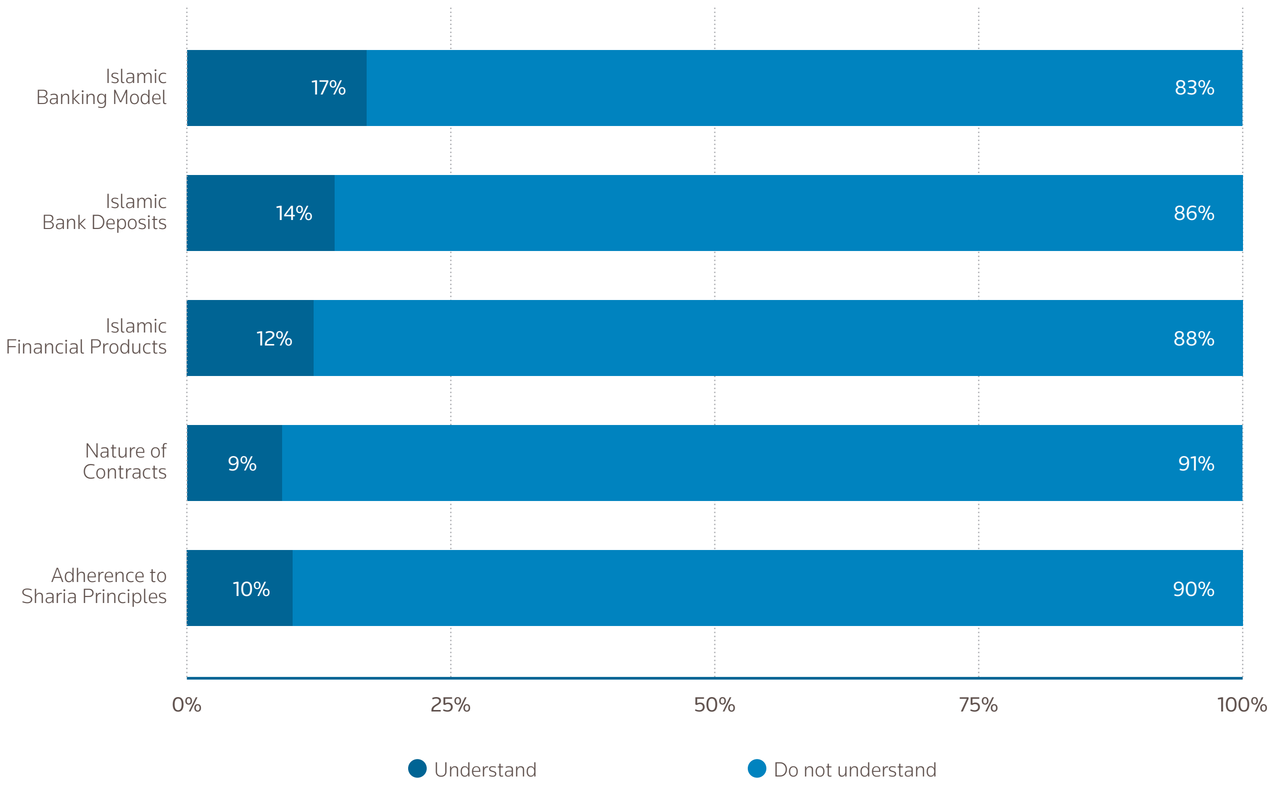
c) Objectives of Islamic banks.

On the first indicator, the response was overwhelmingly in favour of Islamic Banks. 94.5% of banked and 98% of unbanked respondents consider riba prohibited according to Shariah. 88.41% of banked and 93% of unbanked respondents consider interest charged by conventional banks as riba.

AWARENESS OF ISLAMIC BANKING CONTRACTS (IN PERCENTAGE)

Contracts	Corporate	Banked	Un-Banked
Qardh-e-Hasana	56	47	20
Musharakah	33	9	3
Ijarah	13	9	3
Mudarabah	15	10	2
Murabahah	7	4	1
Istisnaa	5	3	1
Salam	5	3	1
Diminishing Musharakah	4	3	1

UNDERSTANDING OF THE ISLAMIC BANKING PRODUCTS AND MODEL



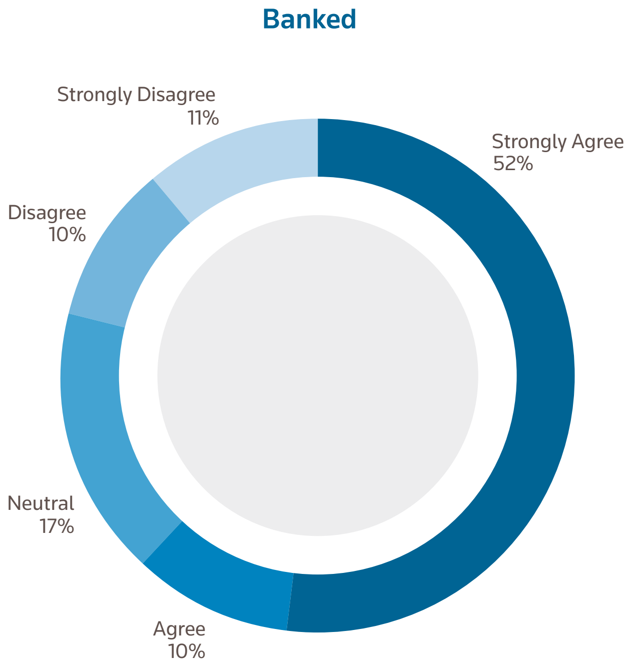
Source: KAP Study, 2014

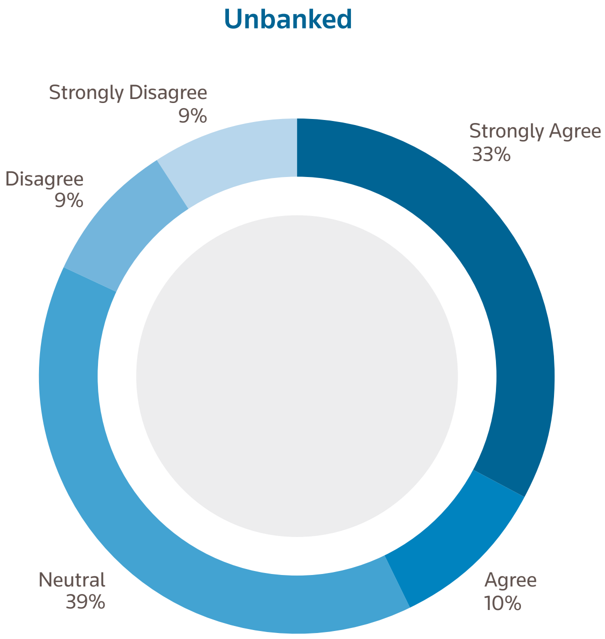
REASONS FOR SWITCHING TO ISLAMIC BANKING (IN PERCENTAGE)

	Banked		Non-Banked	
	Important	**Less Important**	**Important**	**Less Important**
Religious satisfaction and comfort	98.4	1.6	98.8	1.2
Not based on Interest	98.7	1.3	99.1	0.9
Solutions to my personal needs	81.0	19	76.3	23.7
Better service	72.7	27.3	68.1	31.9
Better reputation	66.4	33.7	61.4	38.6
Principle of profit and loss sharing	84.1	16	83.5	16.5
Shariah-compliant products are available	69.4	30.6	65	35

Source: KAP Study, 2014

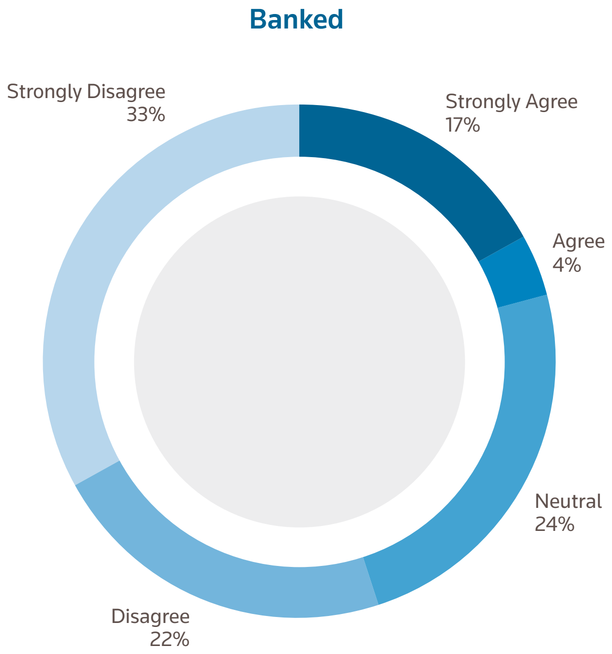
WILLINGNESS TO DEPOSIT IN AN ISLAMIC SAVINGS ACCOUNT DESPITE THE RISK OF LOSS

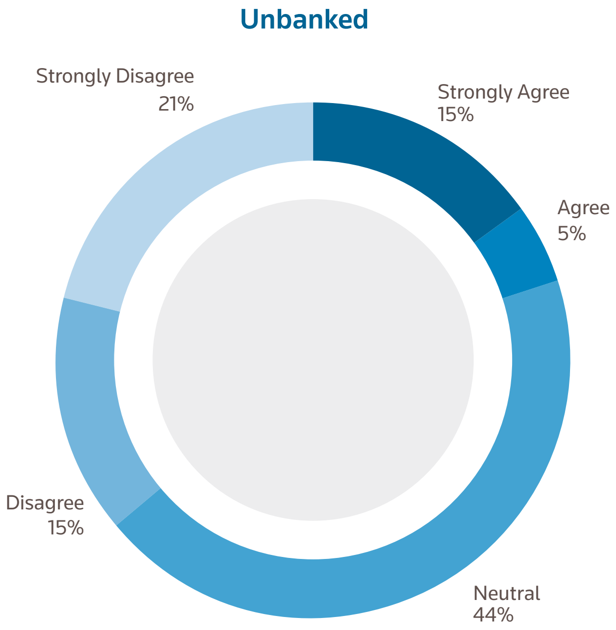




Source: KAP Study, 2014

INTENTION TO WITHDRAW OF MONEY IF LOSS IS ANNOUNCED





Source: KAP Study, 2014

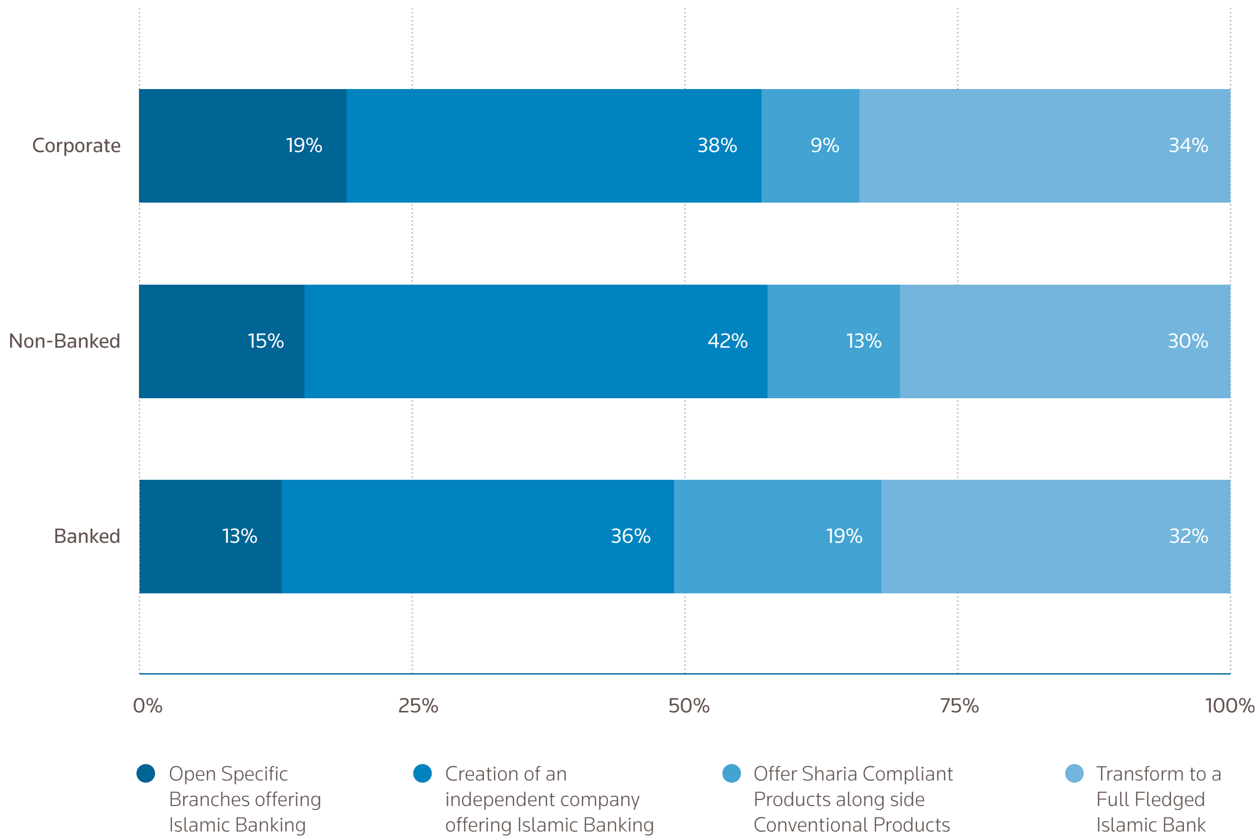
Moreover, potential demand for Islamic banking is driven by the perception that the products offered by Islamic banks are Shariah-compliant. In this regard, 88.4% of banked and 93% of unbanked respondents believe that Islamic bank operations currently comply with Islamic law.

The perception that Islamic banking is mostly linked to profit-and-loss-sharing operations is an attractive feature for potential customers. 64% of respondents revealed a preference for profit-and-loss-sharing financial services. A significant majority of the banked population said they were willing to place funds in an Islamic savings account even if the Islamic bank handed out a loss.

Given a choice between full-fledged Islamic banks and conventional windows, respondents tilted towards dealing with full-fledged banks as they felt these institutions provided better and more holistic Shariah-compliant service.

62% of banked respondents were willing to pay more for Shariah-compliant products as compared to 45% non-banked respondents.

PREFERENCE ON THE INVOLVEMENT OF CONVENTIONAL BANKS IN ISLAMIC BANKING



Source: KAP Study, 2014

PRODUCT INNOVATION OPPORTUNITIES, OUTREACH OPPORTUNITIES

A majority of the non-banked have never used financial services, with only 7% having any exposure to some interaction with banking. 5% of the surveyed population are using microfinance and only 2% of the non-banked have used these services in the past. It is widely observed that the Islamic banks are also more focused on low risk investments. However, the unbanked segment is the major segment of the economy, and if banks find a way to attract new clients from it, this will be mutually beneficial for banks and the public.

43% of SBP survey respondents felt new financial products should be marketed to the rural poor. These may include specifically structured agricultural financing or microfinance loans associated with this sector. This research uncovered the need to provide more small and medium enterprise financing opportunities and better long-term savings products. The SBP survey reveals that there is a need for Islamic banks to increase their presence in smaller cities in Pakistan to increase their visibility and improve interaction with local businesses and communities.

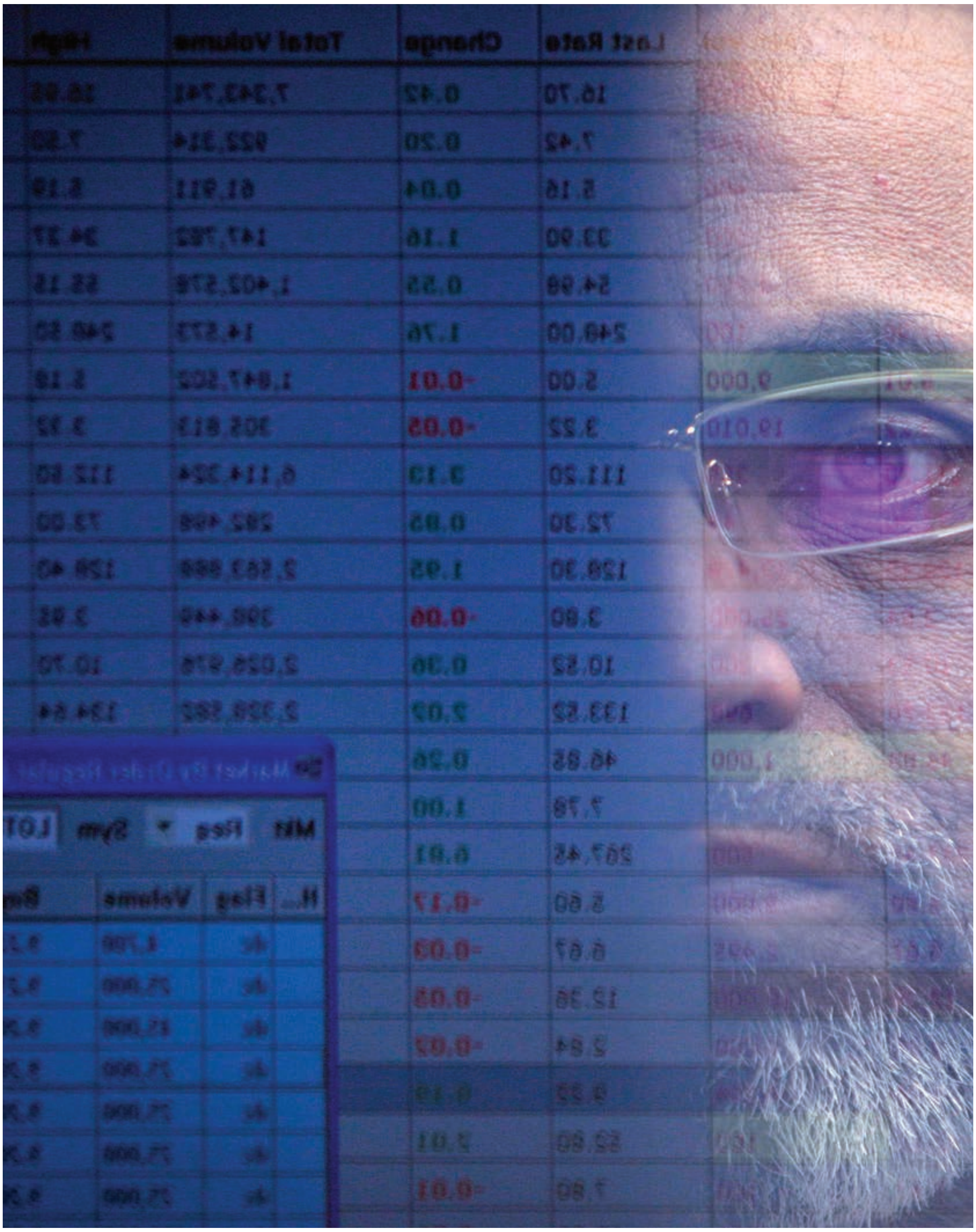
The survey reveals that 30% of corporate respondents and 67% of private individuals are interested in profit-and-loss-sharing structures. 79% of the respondents were comfortable (neutral to strongly agree) with keeping money in an Islamic bank even if loses money and can't pay back the principal. The results of the survey are contrary to the common industry perception that people shy away from losses. The study therefore indicates the opportunity for financial institutions to experiment more with their product offerings.

A huge opportunity lies in convincing Pakistan's ulema (religious scholars) to build awareness about Islamic banking. 41% of the population feels the presence and credibility of Shariah boards makes a bank Islamic. The SBP KAP survey assessment reflects that Islamic financial awareness campaigns should obtain the approval of local imams in religiously sensitive regions like KPK and Baluchistan before they are be run on a mass scale. At the same time, banks should offer training of to these and other Shariah scholars to broaden the knowledge base of the religious community about financial issues and to build stronger social connections to it.

The SBP survey reveals a perception of Islamic banks as community-oriented institutions. Respondents expressed a desire for alternative institutions where banks are given the responsibility of collecting charity (zakat, donations, sadqa, govt contributions), managing the charitable funds and distributing them among the needy.

Islamic finance executive survey analysis

To add to the intensive insights obtained from the SBP KAP study, IBA-CEIF, Thomson Reuters and IRTI conducted a survey of 70 executives in Pakistan to obtain the perspective of CEOs, Shariah advisors and senior management of banks.

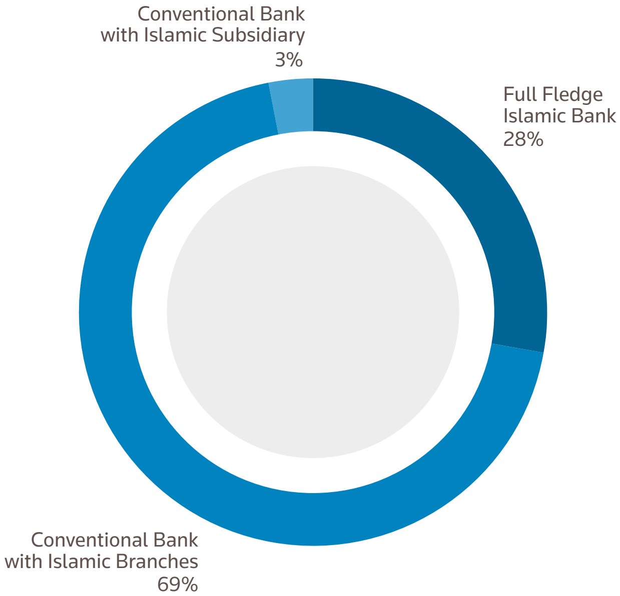


A computer screen is reflected in the glass window of a booth where a broker monitors the market at the Karachi Stock Exchange. REUTERS/ Akhtar Soomro

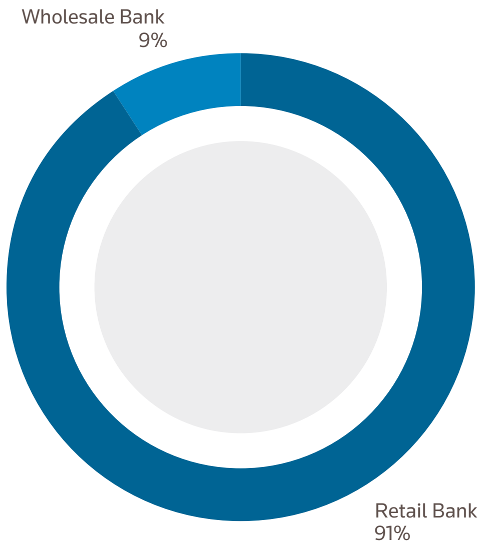
SURVEY METHODOLOGY

The Executive Survey was conducted in March 2016. 70 responses were collected from Pakistan's Islamic bank executives including CEOs, senior managers and Shariah advisors from 18 banks. Apart from responses to the survey questions, we also gathered data about their roles, jobs, and the types of banks at which they are employed.

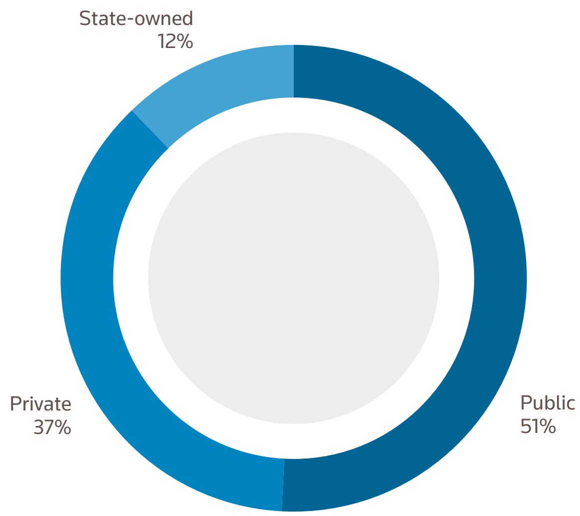
BANK OPERATIONS



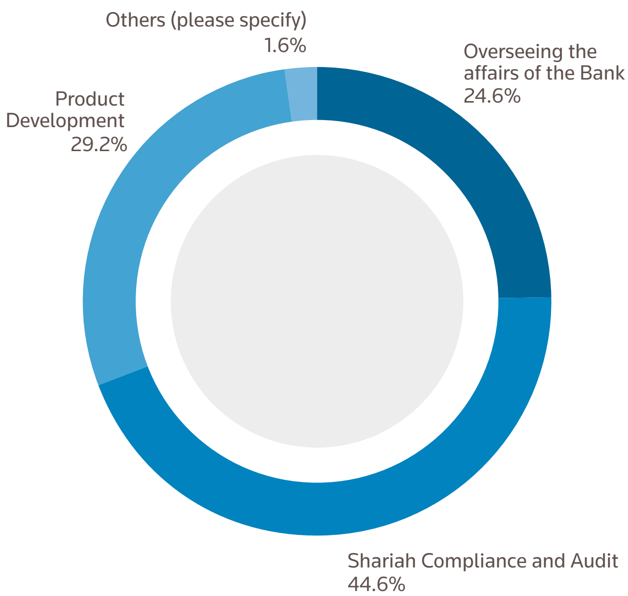
BANK BUSINESS TYPE



BANK OWNERSHIP TYPE



RESPONDENT'S ROLE

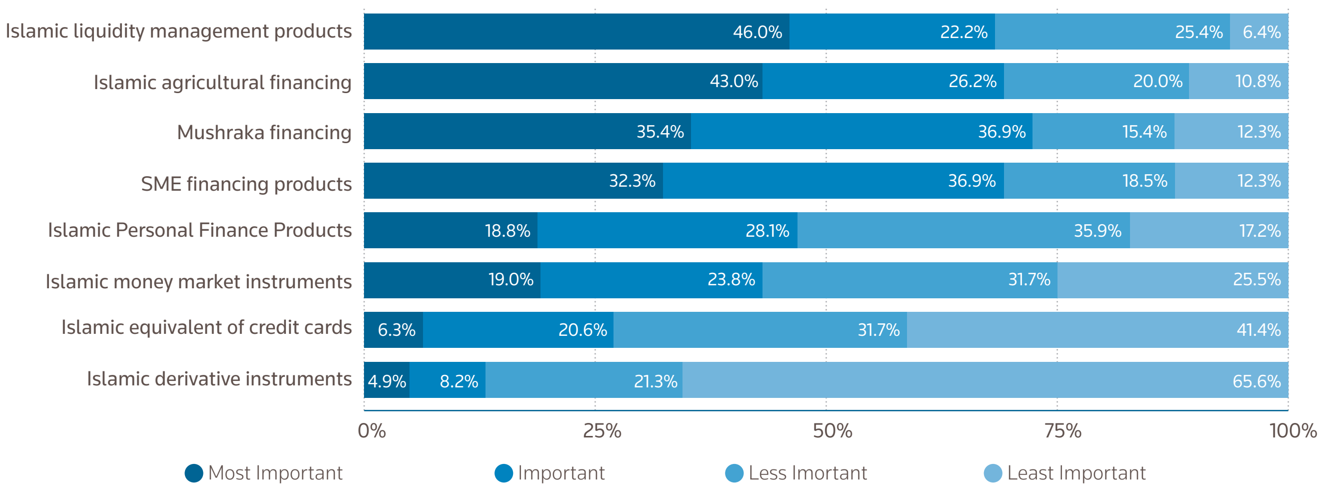


INNOVATION IN ISLAMIC FINANCIAL PRODUCTS

Executive Survey respondents emphasized a need for the development of Islamic liquidity management products (46%) and further highlighted the need for Islamic agricultural financing (43%). The executives also showed their inclination towards musharakah (35%) and SME financing (32%). The other product gaps identified included Islamic personal finance products, Islamic money market instruments, Islamic equivalent of credit cards and Islamic derivative instruments.

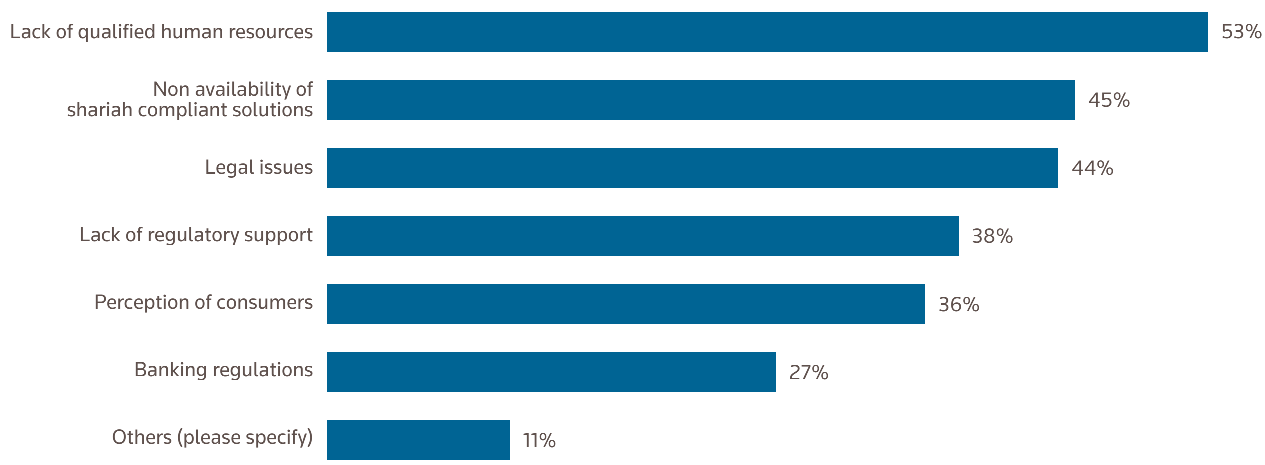
The major barriers in the development of Islamic financial products were also identified in the Executive Survey, where respondents said the most significant impediment remains the lack of trained professional workers (53%). 45% of the respondents felt the non-availability of Shariah-compliant solutions and 44% believed the lack of a supportive legal structure held back the development of new products.

POTENTIAL ISLAMIC FINANCIAL PRODUCTS



Source: Executive Survey, 2016

KEY BARRIERS IN THE DEVELOPMENT OF FINANCIAL PRODUCTS



Source: Executive Survey, 2016

EDUCATIONAL OPPORTUNITIES

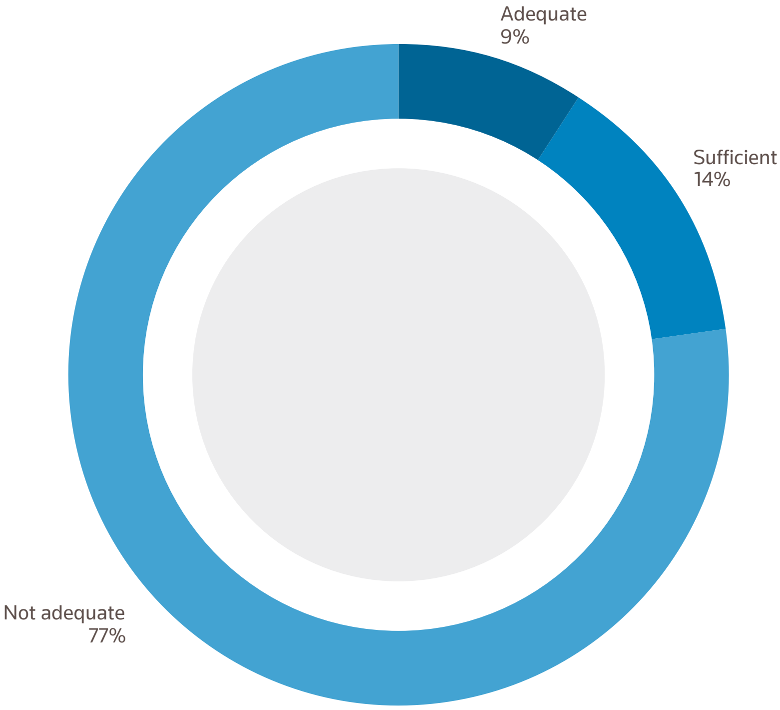
The educational system throughout Pakistan provides information only about the conventional financial framework, and 40% of the respondents believe that this is a source of lack of awareness among the public. 76% of the Islamic finance industry executives thought that the number of entry-level trained professionals in the current market is not sufficient. The Executive Survey respondents considered the most important skills in a candidate to be awareness of basic product concepts (74%), Shariah knowledge (58%), and understanding of Islamic financial transactions (58%).

Islamic finance is a specialized field with complex concepts. Having the right workers is a crucial element for the development, marketing and delivery of financial services. The Executives Survey respondents believe training (58%) and on-the-job practices (29%) are the most important factors in the development of finance professionals.

Perhaps because of the educational gap, 58% of Executive Survey respondents believed that current Islamic banking practices are not satisfactory despite the presence of the Shariah scholars and the Shariah Board.

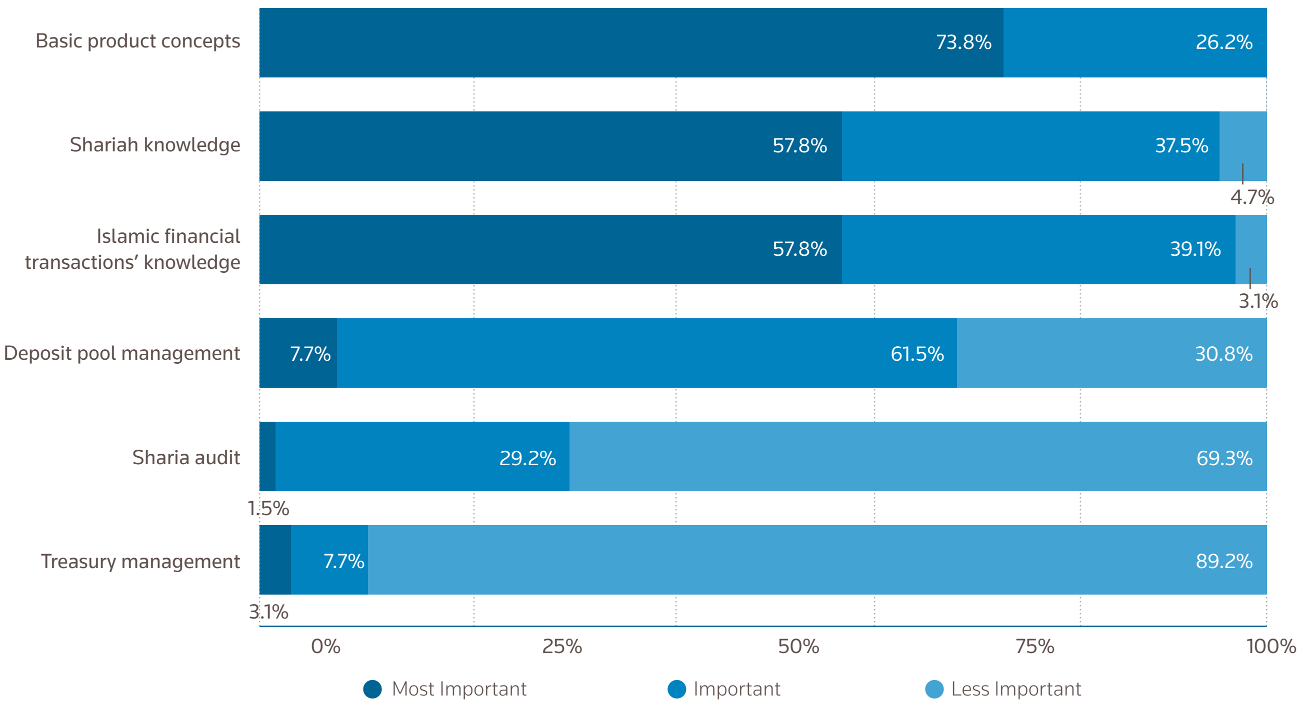
Visitors leave the main building of Pakistan State Bank in Karachi. REUTERS/ Zahid Hussein

HOW DO YOU SEE THE SUPPLY OF ISLAMIC FINANCE PROFESSIONALS AT THE ENTRY LEVEL?



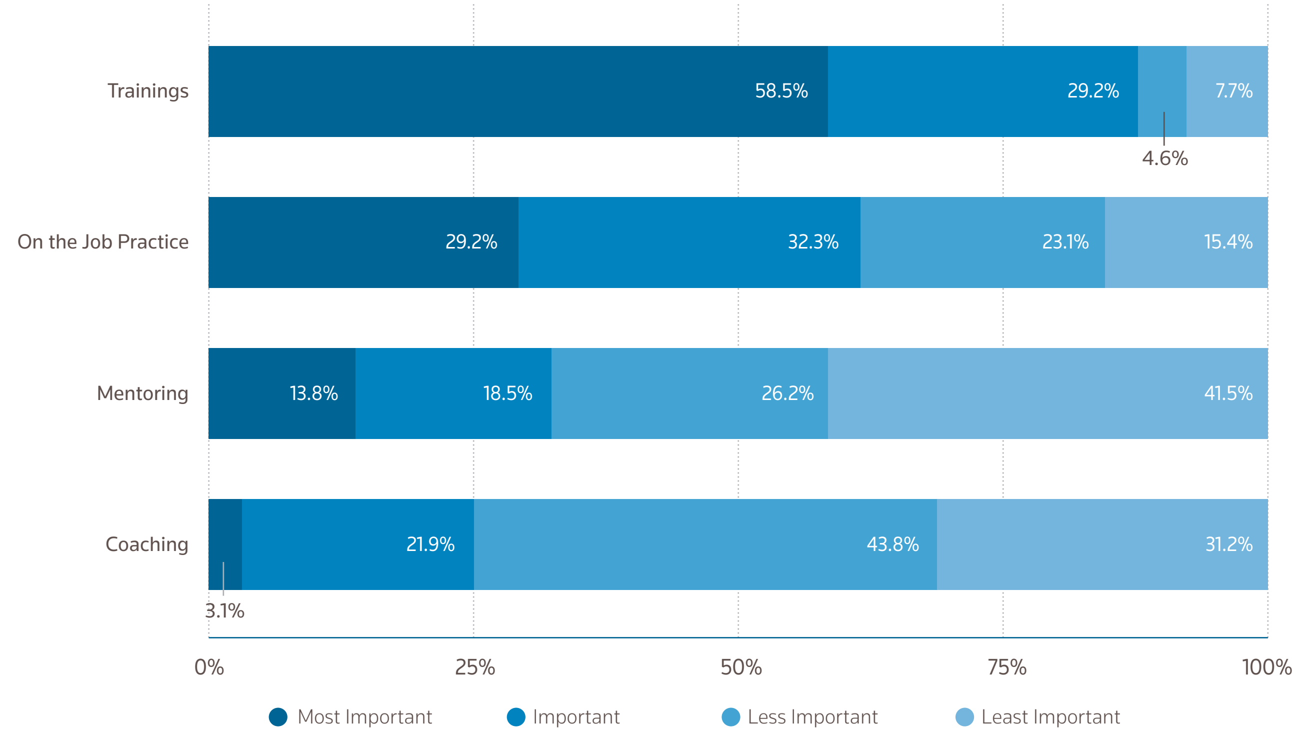
Source: Executive Survey, 2016

KNOWLEDGE REQUIREMENTS FOR ENTERING IN THE ISLAMIC FINANCE INDUSTRY



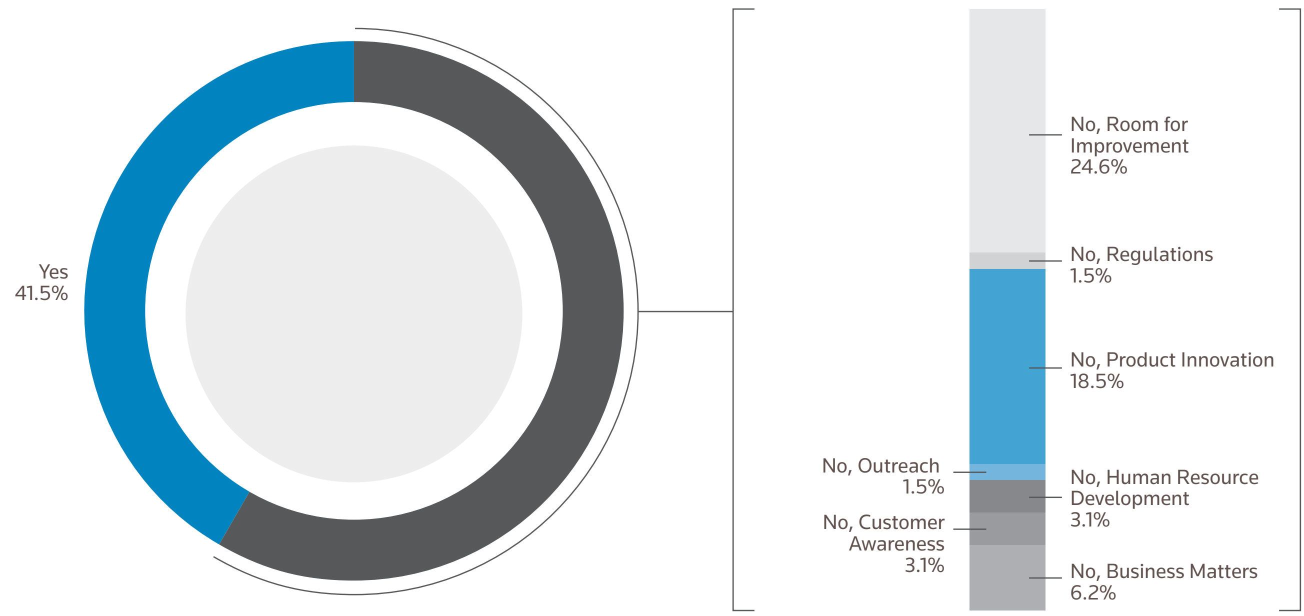
Source: Executive Survey, 2016

MEASURES FOR THE TRAINING AND DEVELOPMENT OF EXISTING EMPLOYEES



Source: Executive Survey, 2016

ARE YOU SATISFIED WITH CURRENT ISLAMIC BANKING PRACTICES?



Source: Executive Survey, 2016

REACHING OUT TO THE PUBLIC

The revived concept of Islamic finance is less than two decades old, and Pakistan is still a potential leader, struggling to create awareness among individuals. 54% of the Executives either disagree or strongly disagree that their customers understand their banking practices. The dominant reason for low levels of awareness and understanding at a very basic stage is due to lack of Islamic finance contents in curricula of both conventional and religious schools (40%).

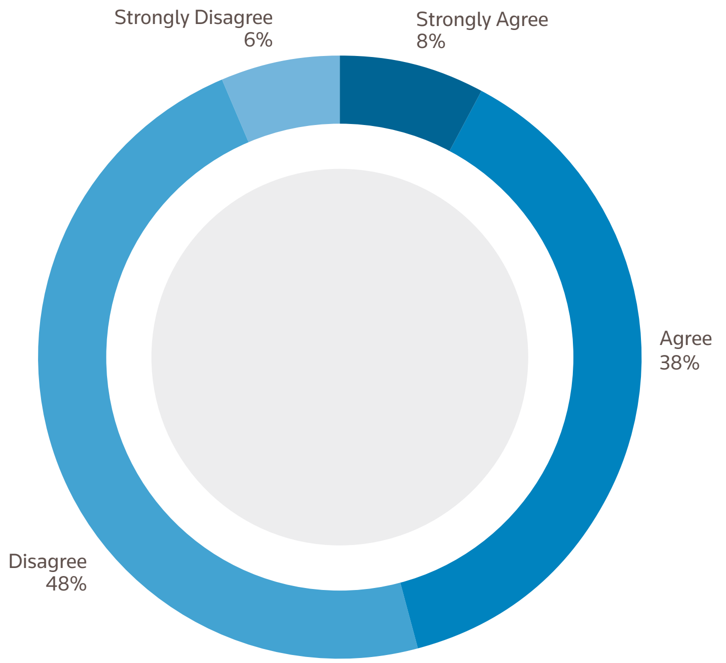
Each bank is playing an independent role in the promotion of Islamic banking practices and concepts to increase awareness. The major strategies employed by the banks vary between target group workshops. Advertisements through various channels are the most common, while opening rural branches and collaborating with social groups are the least common, according to the Executive Survey.

There is significant evidence to suggest that the religiously minded population is willing to experiment with profit-and loss-sharing mechanisms. This suggests that banks can run more musharakah financing and move towards a greater blend of sale-based and shirkat-based transactions.

The rural poor and low-income families have limited access to financial services. 67% of Executive Survey respondents agree the major focus is on the higher-level income groups. This presents an opportunity for Islamic banks to innovate products to attract the untapped rural population, which mainly works in the agricultural sector. Associated with this sector are other microfinance opportunities that are fairly restricted because of a lack of available capital and a social security net.

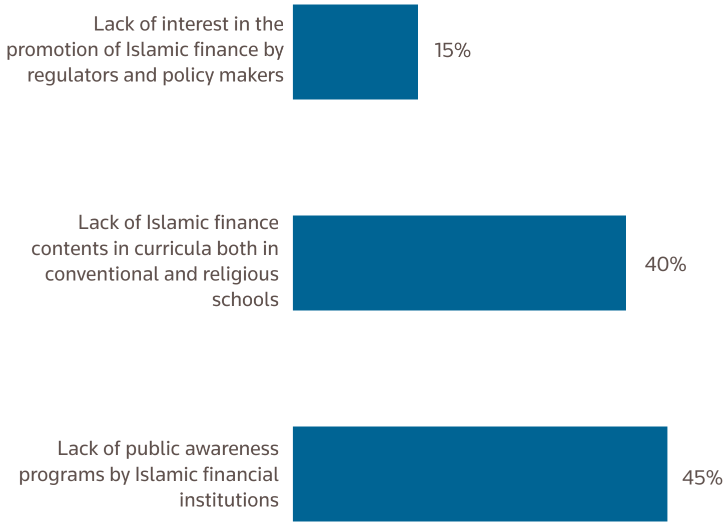
Executive Survey respondents said the most important potential areas for financing for the Islamic banking industry were Islamic microfinance (48%) and agriculture financing (23%). 35% reported that commercial and SME financing is important, followed by financial service/branchless banking and real estate financing.

ISLAMIC BANKING PRACTICES ARE EASILY UNDERSTOOD BY CUSTOMERS



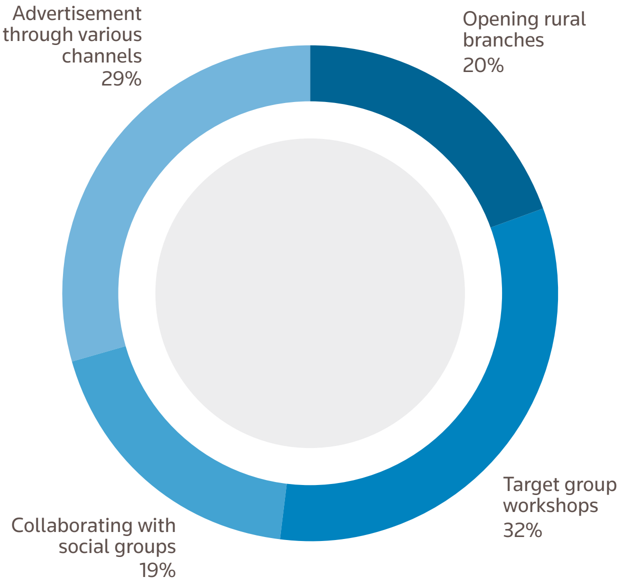
Source: Executive Survey, 2016

THE MOST IMPORTANT REASONS FOR THE LOW PUBLIC AWARENESS OF ISLAMIC FINANCE



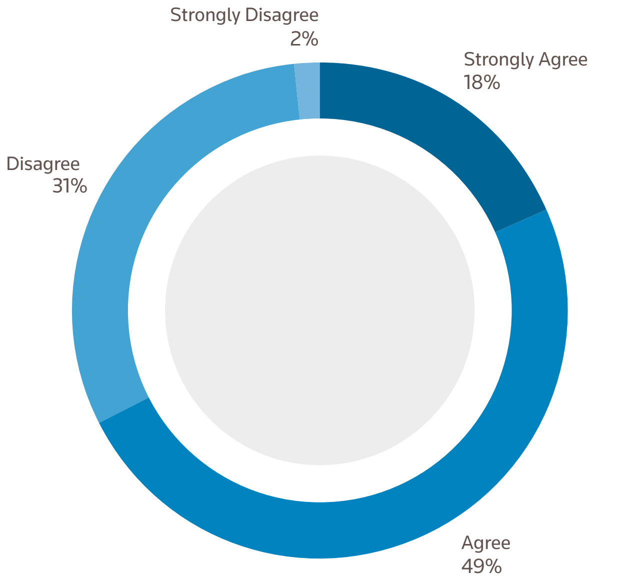
Source: Executive Survey, 2016

WHAT IS YOUR BANK'S STRATEGY IN PROMOTING ISLAMIC BANKING PRACTICES AND CONCEPTS, AIMING TO INCREASE AWARENESS?



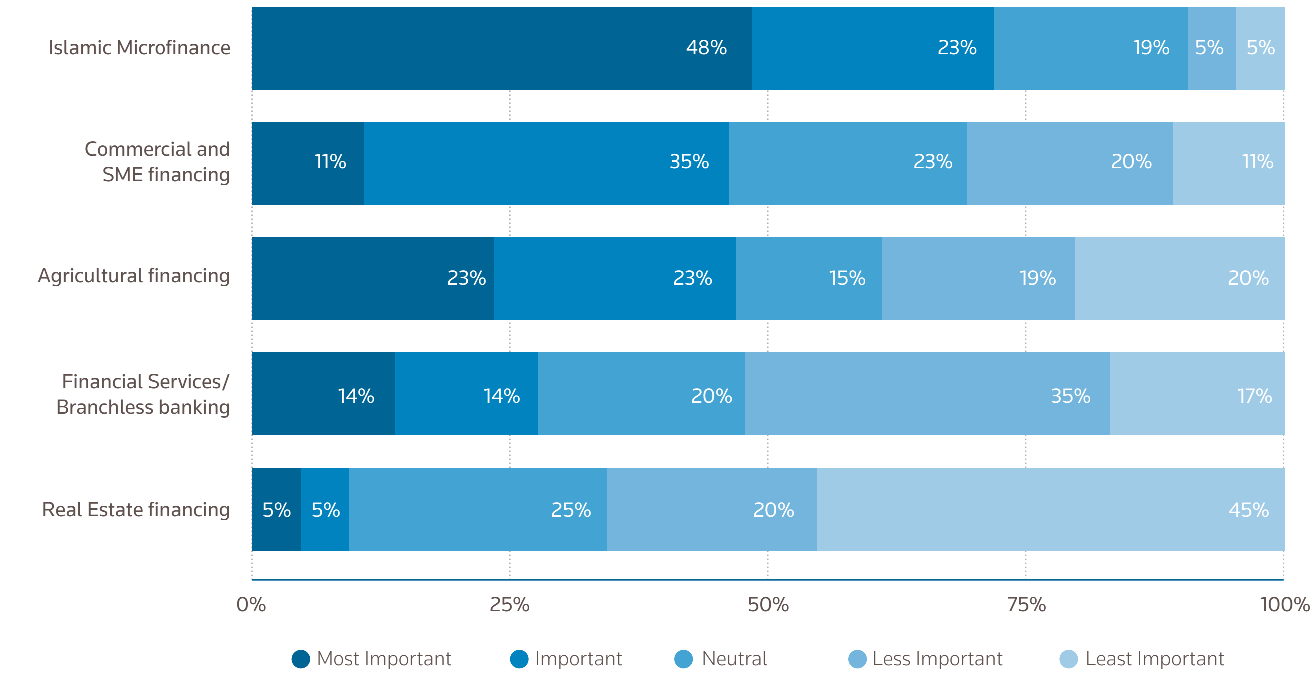
Source: Executive Survey, 2016

OPINION: ISLAMIC BANKING PRODUCTS ARE SIMILAR TO CONVENTIONAL BANK PRODUCTS, WHICH ONLY CATER TO HIGH- AND MIDDLE-INCOME CLIENTS



Source: Executive Survey, 2016

POTENTIAL AREAS FOR THE GROWTH OF ISLAMIC FINANCIAL INSTITUTIONS



Source: Executive Survey, 2016

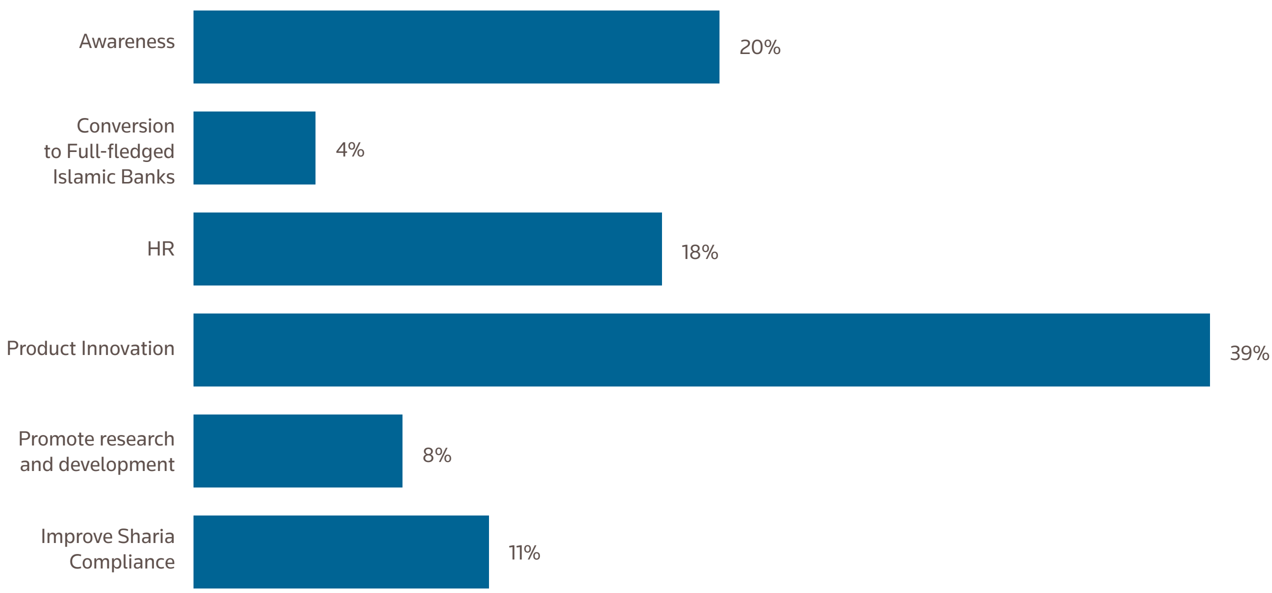
Recommended action plan for Islamic financial institutions

Creating awareness among individuals. 18% of SBP survey respondents indicated their voluntary self-exclusion from banking, and religious values were the foremost reasons for withdrawal. Among the religiously-motivated unbanked population, 65% were not convinced of the Shariah compliance of Islamic Banks and felt they were another marketing gimmick. The respondents, however, generally had very little understanding of the Islamic banking model. The industry, therefore, has a great opportunity to reduce public ignorance through awareness programmes about Islamic finance. Given the general level of education, a comprehensive plan to help public understand the Islamic banking model, the nature of contracts and the Shariah compliance mechanism will be an uphill task at best. Winning the confidence of the community of Pakistani ulema is crucial to conducting such a campaign, particularly to the less-educated.

The expansion of the potential Islamic banking market will come less from cannibalization from conventional banks and more from infiltration into the non-banked population. Therefore, carefully designed awareness campaigns and products tailored to this segment will yield positive results. The potential for expansion lies more with the retail as compared to the corporate sector.

We can conclude from the customer perception analysis that Islamic banking demand is driven by Islamic ideology and well-crafted marketing, rather than an in-depth understanding of the product structuring, contracts and professional procedures. The public prefers these services because of the potential for equity participation, cost effectiveness and the good reputation of Islamic banks. Specific promotion of these aspects has the potential to generate more demand.

RECOMMENDATIONS FOR ISLAMIC FINANCIAL INSTITUTIONS



Source: Executive Survey, 2016

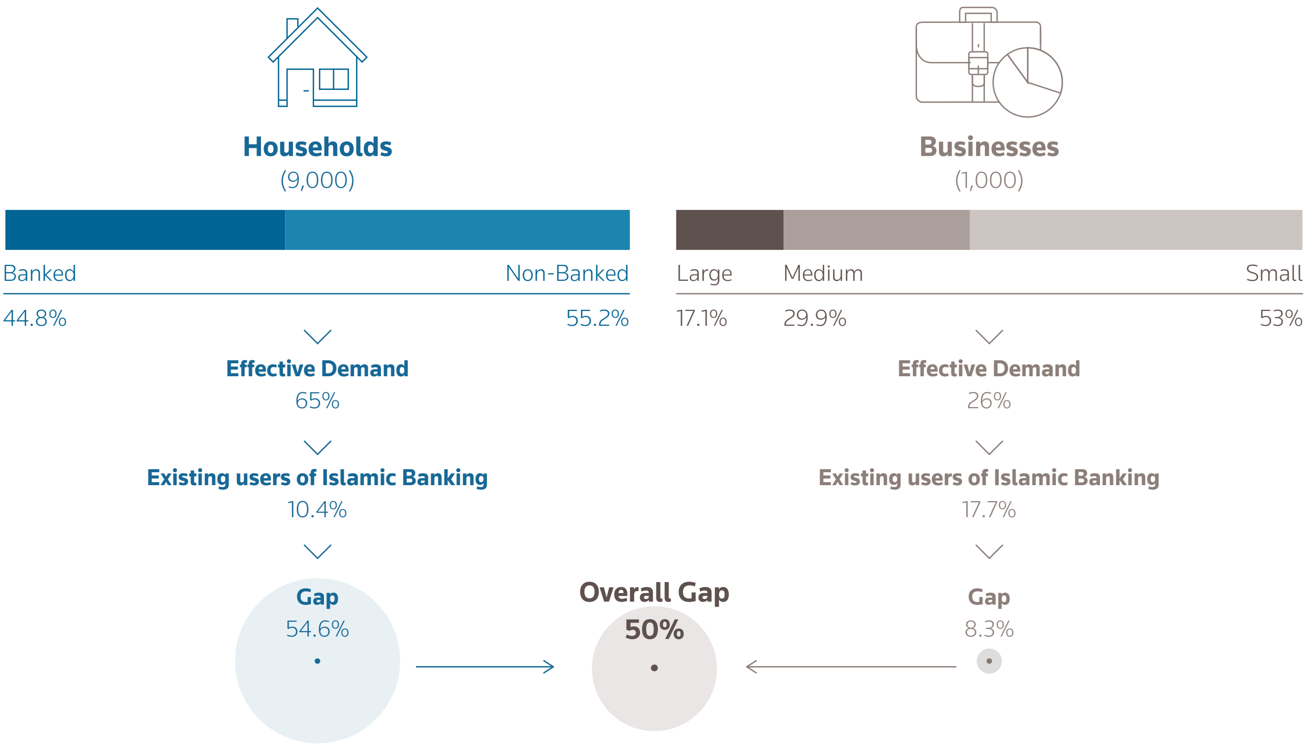
Focus on new sectors for financing e.g. SMEs and Agriculture. SMEs account for 90% of business establishments in Pakistan, contributing an estimated 30% of GDP and employing 78% of the non-agricultural labour force. Agriculture also plays a critical role in Pakistan's economy as it directly accounts for more than 40% of employment.[32] Given this critical role of these sectors in job creation, it is important to support their growth.

Encouragement of trading activities. Islamic banks should play the role not only of a financial intermediary but also of an active trader seeking to achieve profit from its efforts and ensuring equitable benefits to society.

Investment in Professional Development. Pakistan should more strongly encourage its experienced Islamic banking professionals to teach in training programmes in both undergraduate and post-graduate degrees in Islamic Finance and relevant professional qualifications for interested professionals at the country's leading educational institutions.

Strengthening of Research and Development Departments. The industry needs to innovate and introduce products that can be associated with Islamic Banking and finance. This will also pave way for the growth of Islamic banking as a vibrant alternative to conventional finance.

Increased investment in Shariah Compliance, Technology: Branchless Banking, and Product Innovation. It is imperative to ensure that Islamic Banking remains an efficient financial system that develops "clicks over bricks." For this purpose, IFIs must invest in the development, implementation and maintenance of the latest technological advancements such as online branchless banking. Technology will further the cause of financial inclusion along with improving customer experience.



Recommended action plan for SBP

Incentivise the conversion of conventional banks into full-fledged Islamic banks. The SBP should incentivise conventional banks with a significant number of Islamic branches to convert their operations into full-fledged Islamic bank subsidiaries. Survey results indicate 32% of respondents prefer the full-fledged Islamic bank model, while only 19% prefer the Islamic bank windows.

Strive towards financial inclusion schemes. Given that SBP has extensive expertise in providing assistance to the industry for developing micro-financing products, it should use its expertise to assist and support the industry with microfinance and SME products and help the unbanked segment of businesses.

Separate Prudential Regulations for IFIs to remove legal anomalies. Islamic banks have a different structure than conventional institutions, and the Prudential Regulations should address these differences. For an efficient and competitive financial system, a level playing field should be provided to Islamic banks. For example, capital calculations should reflect the nature of Islamic banks.

Better disclosure requirements for improving transparency. The regulatory framework should require more information disclosure about bank strategy and performance. Disclosures regarding Shariah governance, Islamic finance structuring, pool management and more should be reflected in Islamic Bank financial reports. The availability of this information would also benefit the supervisory authority in its prudential regulation.

Development of an Islamic Interbank Offered Rate and an Islamic Interbank Market. Currently, conventional and Islamic banks both use an interest-based benchmark to price their products and services. Although allowed by Shariah scholars, it is preferable to have a separate benchmark for Islamic banks. This will also address public suspicion about the true elimination of interest under Shariah supervision caused by the use of the common benchmark.

It will therefore be important to create a visible difference in the working of Islamic Banks and their conventional counterparts. A key step in this direction is the development of an Islamic interbank offered rate.

Development of an independent monetary policy. IFI monetary policy should be in line with Shariah principles, and fresh thinking and research is needed in this area.

Encouraging the Government to borrow with Shariah-Compliant structures. As of June 2015, the outstanding value of government securities was Rs 6.2 trillion, of which only Rs 326 billion were Shariah-compliant Sukuk eligible for Islamic bank liquidity management. The 5% share of Islamic banks in total government securities appears insufficient considering the size of the industry is 13% of the total banking industry by assets. Since cut-off yields on government securities are set after competitive bidding, low return on Sukuk (when compared with PIBs or T-Bills) explains its relatively short supply.

5 Banking sector landscape

A man displays Pakistani coins at his makeshift booth near a bus stop along a road in Karachi. REUTERS/Athar Hussain

INSIDE THIS CHAPTER

Growth, development and performance

OVERVIEW AND PERFORMANCE

The banking sector in Pakistan has recovered from the 2008 global financial crisis in tandem with the recovering national economy. A coordinated campaign by the regulator and private sector to reach unbanked clients has allowed banks to attract 15 million new depositors in the past five years alone. Meanwhile, high interest rates and spreads have allowed banks to improve their profitability even while maintaining portfolios of two-thirds government debt and securities. This trend, however, reflects the challenge of lending to private sector industries and consumers, which has declined since 2008 and remains a source of non-performing loans. Islamic banks are in a unique position to increase total credit to the private sector by targeting new clients who may never have used bank credit before, as well as Shariah-compliant structures appropriate for small and medium enterprises and farmers.

As of June 30, 2015, there were 35 banks operating in Pakistan with a total of 11,716 branches across the country. The five largest banks were all previously in the public sector. Four of them—Habib Bank, United Bank, MCB and Allied Bank—were privatized. National Bank of Pakistan, which is still state-owned, is currently the second largest bank in the country behind Habib Bank in terms of branches and deposits. Meezan Bank was the first full-fledged Islamic bank to be licensed by the State Bank of Pakistan in 2002. Since then, it has grown rapidly to become the seventh largest bank in the country by the number of branches, and 9th largest by deposits. The sixth largest bank, Bank Al-Falah, was formed from the state-seized Pakistan assets of the Bank of Credit and Commerce International, and subsequently privatized and sold to the Abu Dhabi Group of the UAE in 1997.

> A man takes his lunch outside a currency exchange shop in Karachi. REUTERS/ Athar Hussain

LIST OF BANKS IN PAKISTAN, BRANCHES, DEPOSITS AND PROFIT AFTER TAX (AMOUNTS IN RS BILLION)

	Number of Branches	Deposits (Rs)	Markup/ interest (Rs)	Profit after tax (Rs)	ROE (%)
Habib Bank Ltd.	1,611	1,634.9	144.2	35.1	22.2
National Bank of Pakistan	1,360	1,431.5	114.4	20.1	16.8
United Bank Ltd.	1,294	1,120.0	97.6	27.0	23.7
MCB Bank Ltd.	1,236	706.2	80.7	25.0	21.7
Allied Bank Ltd.	998	734.5	72.1	15.3	22.3
Bank Al-Falah Ltd.	625	1,634.9	144.2	35.1	22.2
Meezan Bank Ltd.	482	1,431.5	114.4	20.1	16.8
Zarai Taraqiati Bank Ltd.	418	1,120.0	97.6	27.0	23.7
Bank Al-Habib Ltd.	396	640.1	61.4	7.5	17.5
The Bank of Punjab	364	471.8	33.1	5.0	19.7
Askari Bank Ltd.	335	35.9	18.3	5.3	14.4
Faysal Bank Ltd.	276	516.2	50.3	7.3	23.0
Soneri Bank Ltd.	246	375.0	31.3	4.7	37.3
Sindh Bank Ltd.	217	433.1	36.6	4.9	22.5
Habib Metropolitan Bank Ltd.	204	292.1	32.3	4.2	16.2
BankIslami Pakistan Ltd.	193	185.2	18.3	2.2	13.5
Summit Bank Ltd.	187	83.9	10.1	1.2	8.9
JS Bank Ltd.	176	403.2	36.9	7.7	23.1
Dubai Islamic Bank Pakistan Ltd.	175	152.7	8.8	-0.1	-0.8
NIB Bank Ltd.	171	119.7	10.7	0.2	14.6
Other Banks	752	140.4	15.5	2.5	16.8
Total	**11,716**	**13,662.8**	**1,228.8**	**257.3**	

Sources: SBP Annual Report- Statistical Supplement FY15 (branches data as of June 30, 2015)
Financial Statements Analysis of Financial Sector 2011-2015, SBP (financial statement data for the year ending December 31, 2015)

Deposits

Total bank deposits in Pakistan as of December 31, 2015 stood at Rs 10.5 trillion (US$100.3 billion), and they have grown at a healthy average rate of 13.8% during the last 5 years.

A significant proportion of the growth in bank deposits and accounts in recent years has been the result of policies introduced by the State Bank of Pakistan (SBP) to reach Pakistan's large unbanked population. The total number of deposit accounts as of June 30, 2015 stood at 41.8 million, after growing at an average rate of 9.5% during the last 5 years. Reflecting strong growth in basic services for previously unbanked account holders, the largest growth has been registered in the number of current accounts, which doubled between 2010 and 2015. The distribution of deposits by type of account, as of June 30, 2015, is summarized below.

As a result of the large number of recently opened current accounts with relatively low balances, the median deposit amount for bank accounts in Pakistan remained around Rs 60,000 (US$ 571).[33] This is less than a quarter of the average amount per account as shown above, and indicates the significant potential for offering mobile banking and similar micro-scale solutions to the mass market. Since the launch

BANK DEPOSITS AND ACCOUNTS (2000-2015)

Source: Financial Statement Analysis of the Financial Sector 2007-2011, 2011-2015; Banking System Review 2006 (SBP)

BANK DEPOSITS (2006-2015)

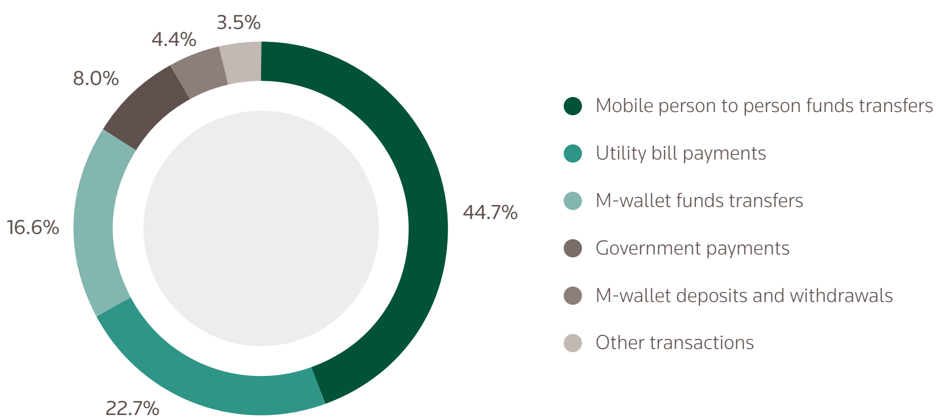
Source: Financial Statement Analysis of the Financial Sector 2007-2011, 2011-2015; Banking System Review 2006 (SBP)

BREAKDOWN OF BANKING SECTOR DEPOSITS (AS OF JUNE 30, 2015)

	No. of Accounts (million)	Amount (trillion)	Average per Account
Current Deposits	20.6	Rs 3.0	Rs 146,592
Savings Deposits	19.5	Rs 3.9	Rs 201,213
Fixed Deposits	1.4	Rs 2.0	Rs 1,449,462
Other Deposits	0.3	Rs 0.4	Rs 70,559
Total Deposits	**41.8 million**	**Rs 9.1 trillion**	**Rs 219,074**

Source: SBP Annual Report- Statistical Supplement FY15
Excludes interbank deposits of Rs 115.4 billion

SHARE OF BRANCHLESS BANKING TRANSACTIONS



Source: Quarterly Branchless Banking Newsletter Jul-Sep 2015, SBP

An employee counts currency notes at a money changer in Karachi. REUTERS/ Athar Hussain of Telenor's Easypaisa money transfer service in 2009, every mobile operator has introduced similar services. In just a few years, mobile phone-based person to person money transfers have grown to Rs 266.7 billion (US$2.54 billion), and they continue to experience high rates of growth. Telenor, Mobilink and Ufone have set up microfinance subsidiaries, licensed by the SBP, through which they are now providing a range of mobile banking services. Two other mobile operators, Zong and Warid, are providing services in collaboration with large commercial banks. With an average amount for person-to-person money transfers of only around Rs 4,500 (US$43), these mobile-based services are much more convenient for the mass market than conventional branch-based banking services.

Habib Bank and United Bank have also launched branchless banking options through which they provide competing money transfer services. There were a total of 13.2 million m-wallet and other branchless banking accounts as of September 30, 2015 with an average balance of Rs 521 (US$5). As shown in the chart below, mobile phone based person-to-person money transfers account for the largest share of branchless banking transactions in Pakistan.

Lending

Bank lending in Pakistan is relatively weak compared to bank deposits, standing at Rs 4.4 trillion (US$41.9 billion) as of June 30, 2015. This represents a ratio of loans to deposits of only 48%. The annual growth in loans has averaged 6.9% over the last five years.

There was a concerted effort by the government in 2007 and 2008 to reduce budgetary borrowing from the banking system. This was made possible by higher non-bank borrowing, especially through the National Savings Scheme, and higher external sector borrowing. However, government borrowing from banks has quadrupled since 2008. There has been an even larger increase in bank lending to public sector enterprises (PSEs) since 2008 as a result of the buildup of circular debt in the energy sector. The total value of bank lending to the government and PSEs reached Rs 1.1 trillion (US$10.5 billion) as of June 30, 2015. This represents a quarter of total outstanding loans.

The large increase in the number of borrowers between 2003 and 2007 occurred because of a four-fold increase in consumer financing resulting from regulatory reform. Banks rushed to cater to pent up demand for personal loans and automobile financing following the intro-

BANK LOANS AND BORROWERS (2000-2015)

Source: SBP Annual Report - Statistical Supplement

duction of a new set of prudential regulations by the SBP to facilitate consumer financing. However, this proved to be unsustainable in the face of rising interest rates and a higher proportion of non-performing loans. After reaching a peak of Rs 401 billion (US$3.82 billion, 16.9% of total loans) in 2007, the value of bank consumer financing declined to Rs 257 billion (US$2.45 billion, 5.8% of total loans) in 2015. As a result, consumer financing fell by almost half during in a period that the total number of bank accounts in the country doubled because of SBP policies to attract lower-income depositors. Bank management therefore has channelled a large proportion of these new deposits towards investment in government securities. Given the double-digit interest rates and wide spreads from 2008 to 2012, this has resulted in strong bank profitability.

Lending to private sector enterprises, which was almost flat between 2011 and 2013, has since registered a growth of 11.7% in 2014 and 6.1% in 2015. Loans to private sector enterprises currently represent almost two-thirds of total loans by banks in Pakistan.

According to the SBP, outstanding loans to public sector enterprises increased by Rs 80 billion (US$762 million) in the fiscal year ending June 30, 2015 to reach Rs 434.7 bililion (US$4.14 billion). The increased requirements of the power sector accounts for this growth, and it now receives for almost two-thirds of overall credit to public sector enterprises. This is largely attributable to the liquidity issues that the power sector is facing as a result of accumulating receivables.

Credit to the private sector expanded by Rs 208.7 billion (US$1.98 billion) in fiscal year 2015, after growing by Rs 371.4 billion (US$3.54 billion) in fiscal year 2014. With banks eager to invest in risk-free government securities, their willingness to lend to the private sector has become limited. This has been mitigated to some extent by the large inflow of private sector deposits of Rs 922.9 billion (US$8.79 billion) in fiscal year 2015, on top of Rs 788.3 billion (US$7.5 billion) in fiscal year 2014.

Given Pakistan's bank-dominated finance industry, the inadequate supply of bank credit to the private sector has been a source of concern for policymakers. With the lowest ratio of private sector credit to GDP in the region, and available credit highly skewed towards large manufacturers, large sectors of the economy are forced to rely on non-market sources of credit. The SBP has sought to address this with policies targeting SMEs and the agricultural sector in particular. This has been achieved

BREAKDOWN OF BANKING SECTOR LOANS (AS OF JUNE 30, 2015)

	Amount	**% of Total**
Government and Public Sector Enterprises	Rs 1.1 trillion	25.0
Private Sector Enterprises	Rs 2.9 trillion	64.6
Consumer Financing	Rs 275 billion	6.2
Other Loans	Rs 183 billion	4.1
Total Loans	**Rs 4.4 trillion**	

Source: SBP Annual Report - Statistical Supplement FY15 through the introduction of, and subsequent amendments, to specialized prudential regulations for SME and agricultural financing. In addition, the government launched SME Bank in 2002 to boost lending to the SME sector and introduced a lower "small company" income tax rate in 2005. Some additional measures proposed by the SBP to improve the effectiveness of such initiatives are laws mandating better financial documentation, clear titles, protection of property rights, effective enforcement of contracts and good governance.

The SBP has pointed out that demand for finance in the manufacturing sector has recently been limited, although this sector has the easiest access to bank credit of any private sector business. The SBP attributes this to an increase in the real cost of borrowing as a result of a steep decline in inflation without a corresponding shift in nominal rates. In addition, certain sectors have experienced a reduced need for working capital loans as a result of falling commodity prices.

While the working capital and trade financing slowed down in fiscal year 2015, the SBP notes that loans to fund fixed assets experienced healthy growth of 14% during fiscal year 2015 and 8.6% in fiscal year 2014. A large proportion of this growth has been for capacity expansion in the cement and construction sectors.

Non-Performing Loans

Perhaps surprisingly, banks operating in Pakistan have been able to enjoy higher ROEs without having to rein in their comparatively high proportion of non-performing loans (NPLs). As of June 30, 2015, total NPLs of Rs 630 billion accounted for 14.2% of outstanding loans. This is significantly higher than Pakistan's regional peers, with India's NPLs at only 4.2%, Sri Lanka's at 4.3% and Bangladesh's at 9.4%.[34] However, the proportion of NPLs has improved considerably in recent years, declining from 17.9% in 2011. This is partly attributable to the higher annual growth rate of 7.5% for overall bank lending, compared to only 1.6% for non-performing loans.

Investments in Government Securities

According to SBP statistics, net government borrowing from commercial banks (including sales of treasury bills and Pakistan Investment Bonds) during fiscal year 2015 amounted to Rs 1.6 trillion (US$15.2 billion). This represents a substantial increase from only Rs 370 billion (US$3.5 billion) during the prior year. This resulted from a combination of demand- and supply-side factors. On the demand side, banks took advantage of high interest rates by locking in their surplus liquidity at primary auctions. The government, which had previously relied on funding from the SBP to fill the gap resulting from limited external funding and low non-bank financing, took advantage of high bank demand at primary auctions by mobilizing significantly more funds than was targeted. This resulted in a major shift in borrowing from the SBP to commercial banks during fiscal year 2015.

Banks have therefore dedicated much of their new deposits since 2008 to increased budgetary support for the federal government through their purchase of government securities. With an average growth in investments in government securities of 31.3% registered over the last five years, total investments in government securities of Rs 5.2 trillion (US$49.5 billion) in 2015 now exceed the level of total bank deposits from 2010.

As of June 30, 2015, investments in government securities had reached 55.9% of total bank deposits.

Bank Profitability

Despite the relatively high level of investment in low-risk government securities, banks operating in Pakistan have enjoyed a significant improvement in profitability in recent years. Total revenues from markup and interest grew by almost 56% over the period, while profit after taxation experienced even more dramatic growth. These results reflect the high bank spreads prevailing in Pakistan, as well as an improvement in the amount of provisions and write-offs over the period covered.

BANK INVESTMENT IN GOVERNMENT SECURITIES (2000-2015)

Source: SBP Annual Report — Statistical Supplement

BANKING SECTOR PROFITABILITY IN 2010- 2015 (YEARS ENDING DECEMBER 31)

	2010 (Rs Billion)	**2015 (Rs Billion)**
Markup/interest earned	Rs 631	Rs 984
Net markup/interest income	Rs 288	Rs 498
Provisions and write-offs	Rs 78	Rs 41
Profit after taxation	Rs 71	Rs 195
Return on equity (ROE)	11.65%	17.48%

Source: Financial Statements Analysis of Financial Sector 2007-2011, 2011-2015, (SBP)

Explaining Pakistan's Low Private Sector Bank Credit-to-GDP Ratio

Pakistan has a bank-dominated financial sector, and private sector businesses rely on commercial banks as a major source of funding. A serious cause for concern among policymakers, therefore, and a sign of the large untapped potential in the local financial market, is Pakistan's unusually low ratio of bank credit to the non-financial private sector. Based on the SBP's Annual Report for the fiscal year ended June 30, 2015, total loans by scheduled banks less loans to the government, public sector enterprises and financial institutions was Rs 3.2 trillion (US$30.5 billion) or just 12% of GDP. As shown on the following page, this represents one of the lowest credit-to-GDP ratios anywhere in the world. In contrast, the non-financial private sectors in India and Bangladesh tapped into bank credit worth 56% and 35.3% of GDP respectively during the same period.

As shown in the chart below, the private sector bank credit-to-GDP ratio improved considerably from 2000 to 2008, and has fallen by half since then. The decline during the last seven years has been accompanied by a sharp increase in bank investment in government securities. Although government borrowing is clearly a major factor behind the current predicament of Pakistan's banking sector, it is by no means the only factor. It is interesting to note that during the period 2001 to 2003, there was a significant increase in private sector bank credit-to-GDP despite the fact that bank investment in government securities rose significantly as a percentage of deposits. This trend accelerated during the period 2003-2006, when bank investment in government securities was declining.

Although the services sector contributes to about 59% of Pakistan's GDP, it receives only 27% of the bank credit provided to Pakistan's industrial sector. In contrast, the amount of bank credit to the services sector ranges from 53% to 189% of bank credit to the industrial sector for a group of peer countries (Bangladesh, India, Sri Lanka, Malaysia and Philippines).

In its analysis of the causes of Pakistan's low private sector bank credit-to-GDP ratio, the SBP points to eight key factors, of which two relate to supply constraints and the remainder to issues on the demand side.[35]

RATIO OF PRIVATE SECTOR CREDIT TO GDP (2000-2015)

Source: SBP Annual Report - Statistical Supplement

Sector challenges

SUPPLY CONSTRAINTS AFFECTING BANK CREDIT TO THE PRIVATE SECTOR

1. The dominating role of the government as a borrower

As mentioned, investment in government securities absorbs 55.9% of Pakistan's bank deposits. In addition, around a quarter of loans by banks are to the government or to public sector enterprises. This translates into a total of Rs 6.3 trillion (US$60 billion) in bank assets at the end of fiscal year 2015 that support government borrowing, compared to only Rs 3.3 trillion (US$31.4 billion) which represent credit to the non-financial private sector.

2. Relatively high credit risk

Given the large borrowing appetite of the government, banks have apparently had little pressure to extend credit to the private sector. This situation has been aggravated by Pakistan's high level of non-performing loans previously mentioned.

DEMAND SIDE ISSUES AFFECTING BANK CREDIT TO THE PRIVATE SECTOR

3. Relatively high real cost of borrowing

One of the key demand-side factors hampering credit offtake by the private sector in Pakistan is the high real cost of borrowing relative to most other countries in the region. This is partly attributable to a higher level of interest rate spreads for commercial banks operating in Pakistan.

4. Low financial depth and lack of awareness

Available data indicates that less than 10% of registered firms and 2.5% of adults in Pakistan use credit from the banking system. Although there are currently 1.4 million issued credit cards in Pakistan, this represents a significant decline from a peak of 1.8 million in 2007. Outstanding credit card debt was Rs 24 billion (US$229 million) as of June 30, 2015, compared to Rs 44 billion (US$419 million) in 2007. Credit card use is primarily restricted to salaried professionals.

5. Issues with fixed capital formation in the private sector

Gross fixed capital formation by the private sector, at only 9.6% of GDP, is relatively low in Pakistan compared to more than 20% in India, Bangladesh, and Sri Lanka.

6. Presence of infrastructural issues

Businesses in Pakistan continue to experience numerous problems with the communications, transportation and finance infrastructure, which has resulted in sub-optimal operational results. Pakistan also has a poor international ranking in terms of political stability and law and order.

7. Aversion towards formal borrowing channels

According to surveys conducted by the SBP, most Pakistanis avoid borrowing. Three-quarters of the population have not used credit from either formal or informal sources. The SBP points to lack of financial literacy, absence of credit histories and high costs as the main reasons for this situation.

8. Lack of responsiveness in financial product development

There is a significant unmet demand for consumer loans, automobile financing, leasing and house financing. However, banks have historically been reluctant to cater to this demand with competitive borrowing products.

Growth and development of Islamic banking in Pakistan

The Islamic banking industry has grown rapidly in Pakistan since it was relaunched in 2001 under the supervision of the SBP. The strategy developed by the SBP has permitted the introduction of Islamic banking services by full-fledged Islamic banks as well as Islamic banking subsidiaries and branches of conventional banks. In light of the government's reliance on the banking sector as an essential source of finance to cover its budget deficits, this market driven approach is intended to achieve the transformation of the financial industry towards Shariah compliance in a gradual and non-disruptive manner.

Meezan Bank was the first full-fledged Islamic bank to be granted a license in 2002, and now there are 6 such banks operating in Pakistan. The most recent entrant, MCB Islamic Bank, is a subsidiary of the fourth largest commercial bank in Pakistan. In addition, 17 out of the remaining 21 local commercial banks in the private and public sectors operate dedicated branches for Islamic banking. The following table provides a broad summary of the overall competitive landscape in Pakistan's Islamic banking industry.

GROWTH RATES IN DEPOSITS AND LENDING OF ISLAMIC BANKS

Islamic banking institutions (IBIs) in Pakistan have been experiencing high growth in deposits compared to the overall banking industry, and have thus been able to rapidly expand their lending portfolios. After crossing the 10% mark in terms of deposit market share in 2013, IBIs crossed this important threshold for lending market share in late 2015.

COMPETITIVE LANDSCAPE IN PAKISTAN'S ISLAMIC BANKING INDUSTRY (AMOUNTS IN RS BILLION)

	Number of Branches	Assets (Rs)	Deposits (Rs)
Meezan Bank Ltd.	547	532	472
BankIslami Pakistan Ltd.	338	175	153
Dubai Islamic Bank Pakistan Ltd.	199	157	137
Al Baraka Bank (Pakistan) Ltd.	150	87	72
Burj Bank Ltd.	74	33	26
MCB Islamic Bank Ltd.	6	10	0
Sub-total for Full-Fledged Islamic Banks	**1,314**	**994**	**860**
Islamic Branches of 17 Conventional Banks	761	616	515
Total	**2,075**	**1,610**	**1,375**

All figures are as of December 31, 2015. Number of branches includes sub-branches.
Sources: Islamic Banking Bulletin, December 31 2015 (SBP)

BANKING SECTOR GROWTH RATES 2010 – 2015

Years ending December 31	2010	2015	Annual Growth (%)
Deposits			
Islamic Banking	477.0	1,375.0	23.6
Conventional	5,036.8	9,160.9	12.7
Total	5,513.8	10,535.9	13.8
Islamic Banking Market Share	8.7%	13.1%	
Lending			
Islamic Banking	180.4	645.3	29.0
Conventional	3,227.5	4,234.1	5.6
Total	3,407.9	4,879.4	7.4
Islamic Banking Market Share	5.3%	13.2%	

Source: Islamic Banking Bulletin, December 2015; Financial Statement Analysis of the Financial Sector 2007-2011, 2011-2015 (SBP)

BALANCE SHEET COMPARISON OF ISLAMIC AND CONVENTIONAL BANKS

Total assets of IBIs, including Islamic branches, stood at 13.1% of the overall banking industry in Pakistan as of December 31, 2015. According to the SBP, the investments-to-deposits ratio for IBIs stood at 31.4%, significantly below the comparable figure of 64.7% for the overall banking industry. The financing-to-deposits ratio for IBIs of 46.9% is slightly higher than the industry average of 46.3%.

The SBP has also noted that a relatively larger share of financing by IBIs is being channelled towards financial institutions. Financing to financial institutions as of December, 2015 stood at 24% of assets for full-fledged IBIs, compared to only 3.5% for the overall banking industry. This has been attributed to the recently introduced Bai Mu'ajjal-based open market operations by SBP, along with lending to other commercial banks through the interbank market.

While financing for different industry sectors is roughly comparable between IBIs and the overall industry, there are significant differences in terms of the breakup of the financing portfolio across different economic segments as shown below.

As shown below, the mix of deposits of IBIs are generally comparable to the overall industry. According to the SBP, the weighted average return on deposits for IBIs was 3.7%, slightly lower than 3.9% for the overall industry.

BANKING SECTOR FINANCING MIX (AS OF DECEMBER 31, 2015)

	IBIs (%)	Industry (%)
Corporate Sector	74.4	67.0
Consumer Financing	10.0	6.6
Commodity Financing	8.6	12.1
SMEs	3.1	6.2
Agriculture	0.6	5.9
Other	3.3	2.2
Total	**100.0**	**100.0**

Source: Islamic Banking Bulletin, December 2015 (SBP)

Industry-wise Distribution of IBI Lending

As shown below, the industry-wise loan portfolios of IBIs is broadly diversified. As a percentage of overall lending, exposure to the textile, chemicals/pharmaceuticals and sugar industries is slightly higher than for the overall industry. Exposure to agribusiness and the power sector is somewhat lower.

BANKING SECTOR DEPOSITS MIX (AS OF JUNE 30, 2015; IN RS BILLIONS)

	IBIs (Rs)	IBIs (%)	Industry Amount (Rs)	Industry (%)
Current accounts	379.4	29.6	3,019.6	33.0
Savings deposits	468.3	36.6	3,924.9	42.9
Fixed deposits	352.8	27.5	2,019.1	22.1
Other	80.1	6.3	189.4	2.1
Total	**1,280.6**	**100.0**	**9,153.0**	**100.0**

Sources: Islamic Banking Bulletin, September 2015 (SBP);SBP Annual Report- Statistical Supplement FY15

LOANS PORTFOLIO OF IBIS (AS OF DECEMBER 31, 2015)

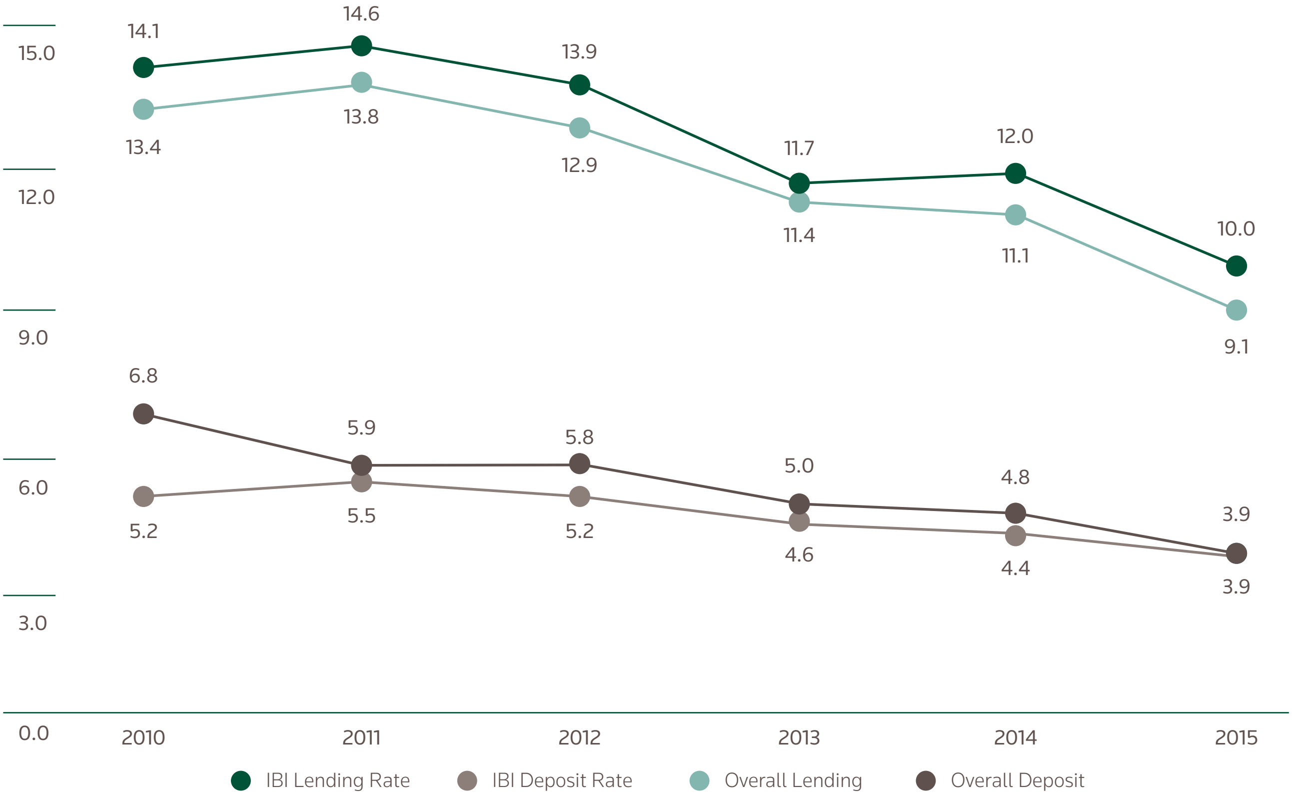
	IBIs (%)	Industry (%)
Chemicals and Pharmaceuticals	7.7	4.2
Agribusiness	5.8	8.9
Textile	18.0	14.3
Cement	1.8	1.1
Sugar	3.4	2.7
Shoes and leather garments	0.7	0.5
Automobile and transport equipment	1.5	1.0
Financial	0.7	2.8
Electronics and electrical appliances	1.9	1.5
Production and transmission of energy	9.4	12.8
Individuals	10.9	8.5
Other	38.1	41.7
Total	**100.0**	**100.0**

Source: Islamic Banking Bulletin, December 2015 (SBP)

Profitability of Islamic Banks

Statistics published by the SBP on bank deposit and lending rates demonstrate that Islamic banking is highly profitable relative to conventional banking in Pakistan. During the last few years, the spreads earned by IBIs have generally been 1% or more above that of the overall industry.

WEIGHTED AVERAGE LENDING AND DEPOSIT RATES (2010-2015)



Source: SBP Annual Report - Statistical Supplement

Commuters ride past the front of a bank tower in Karachi's business district. REUTERS/ Akhtar Soomro

IRFAN SIDDIQUI

President & CEO, Meezan Bank Ltd

MR. IRFAN SIDDIQUI is the founding President and CEO of Meezan Bank. He initiated the formation of Al-Meezan Investment Bank in 1997, which was converted into a full-fledged scheduled Islamic commercial bank in May 2002—the first ever Islamic Commercial Banking license given in Pakistan. Mr. Siddiqui is a Chartered Accountant from the Institute of Chartered Accountants in England and Wales and was trained at Coopers & Lybrand, London. He has held several senior management positions including Chief Executive Officer at Al-Meezan Investment Bank Limited, General Manager at Pakistan Kuwait Investment Company, Manager Finance and Operation at Abu Dhabi Investment Company and Senior Business Analyst at Exxon Chemical (Pakistan) Ltd. Mr. Siddiqui is Member of the Government of Pakistan Steering Committee for 'Promotion of Islamic Banking in Pakistan'; Board of Trustees of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), Bahrain; and Chairman of IBP Sub Committees for Academic Board and Finance Committee.

1. As the pioneer in the Islamic banking industry in the country, Meezan Bank has played a major role in the promotion of Islamic banking in Pakistan. How do you describe this journey?

Meezan Bank was launched in 1997 as an investment bank with an initial capital of Rs 1 billion. Our main objective was to introduce the concept of riba-free banking as an alternative to conventional banking.

The bank was envisaged and established without first considering its financial feasibility, since the purpose behind the creation of Meezan Bank was to establish and promote Islamic banking in Pakistan. However, Alhamdulillah, the bank has been profitable since the very first month of its operations.

For the first five years of our operations as an investment bank, we functioned with a workforce of only 30. In 2002, the State Bank of Pakistan issued us Pakistan's first Islamic commercial banking license and concurrently, we took over the operations of Societe Generale in Pakistan. Converting Societe Generale's four-branch conventional banking operations into a Shariah-compliant bank at that time was also an achievement for us. We operated as Pakistan's only Islamic commercial bank for the next two years.

Alhamdulillah, Meezan Bank has witnessed an average of 40% to 50% growth in the size of its branch network each year ever since its inception, beginning with four branches in 2002 and reaching a nationwide network of 551 full-fledged commercial banking branches today. In its fourteenth year of operations, the bank is not only the largest Islamic bank in Pakistan, but it is now also the seventh largest commercial bank in Pakistan in terms of its branch network. Meezan Bank has also been recognized as the best Islamic bank in Pakistan by numerous local and international organizations consistently over the past several years.

Meezan Bank has always worked with a vision of establishing 'Islamic banking as the banking of first choice'. Keeping true to this vision, we have never consciously tried to differentiate ourselves from the Islamic banking industry. We believe that Islamic banking offers a distinct customer-centric value proposition and complete transparency must underlie these operations. Our aim and wish is that the Islamic finance market in the country should grow. I believe that the Islamic banking industry in Pakistan is well poised to expand. Instead of seeing other Islamic banks or windows as competition, we work with them and support them. We share good assets with our peer Islamic banks, which is how the market will grow and gain depth.

Since the choice is up to the consumer, we grow as the industry grows. Some consumers choose their bank based on pricing, for others it is accessibility or environment—it all depends on the consumer. We would never advertise saying how we are different from other Islamic banks.

2. The growth in Islamic banking has been tremendous over the past decade, but the challenges are huge. How do you view the current state of the Islamic banking industry in Pakistan? Walk us through some of the key challenges that Islamic banks are facing in the country and how these can be resolved.

As with any new industry, especially one that is as unique and based on religious principles, there are a number of challenges that need to be overcome. I believe that Islamic finance in Pakistan faces three main challenges. The first is raising awareness and education about Islamic banking. Secondly, the creation and adoption of a harmonious set of international best practices and corporate governance is still a major issue for Islamic banking. Last but not least, Islamic banking faces the challenge of creating 'last mile connectivity' in translating Government support for Islamic finance into reality. It is worth mentioning here that the Government of Pakistan has shown a keen interest in the development of Islamic banking in this region through its strategic five-year plan. However, there is still a dearth of Islamic capital market instruments, and this needs greater government support. For Islamic banks, there is a critical need for the provision of adequate liquidity tools, an area where the government can play a major role by offering Islamic banks with instruments to place the excess liquidity of the entire Islamic finance sector at the same rate that offered to conventional banks. There still exists an asset/liability gap management problem for this industry, given the dearth of these instruments. This challenge does not merely pertain to Islamic banks but to Islamic mutual funds, to Islamic takaful and to Islamic investors. In Pakistan, the government and regulators have taken great strides for the expansion of Islamic finance in the region, but much work still needs to be done.

On the question of Shariah compliance, I can safely say that we are 100% Shariah-compliant. Whether we can do even better is another matter, but that does not take anything away from our present level of complete Shariah compliance.

> “GOVERNMENT OF PAKISTAN HAS SHOWN A KEEN INTEREST IN THE DEVELOPMENTOF ISLAMIC BANKING IN THIS REGION THROUGH ITS STRATEGIC FIVE-YEAR PLAN. HOWEVER, THERE IS STILL A DEARTH OF ISLAMIC CAPITAL MARKET INSTRUMENTS, AND THIS NEEDS GREATER GOVERNMENT SUPPORT.

3. How do you foresee the future of Islamic banking in the overall banking system in Pakistan?

Currently, the Islamic Banking industry is growing at approximately 1.1%[36] per annum, which might increase to 2% to 2.5% as the smaller Islamic banks start growing. At present, Islamic bank assets and deposits form approximately 11.2% and 13.1% respectively of the total banking industry in Pakistan. Keeping in view the number of Islamic banks and their growth, this could grow to 15% over the next few years. The overall banking industry is growing at a rate of 7%, while the financing portfolio of Meezan Bank grew by 18.4% in 2015. Other than Meezan Bank, there are now 22 other Islamic banking institutions in the country and it is healthy for the economy to have such an expansion in this industry.

Meezan Bank holds around a 60% market share of the dedicated Islamic banking industry in Pakistan. One of the advantages we have had was being the first Islamic bank in the country. Our heavy focus on developing our Shariah expertise, expanding our product menu to cater to the diverse banking needs of our customers, and our focus on providing quality service has enabled us to maintain our leadership position in the industry, grow rapidly and give a decent return to both our depositors and our shareholders. With the passage of time, other Islamic banks are growing, and this is introducing healthy competition in the industry. It is making Islamic Banking available to an even larger section of the country's population. We see this as a positive trend and wish success to all Islamic banks since they are all playing a role, and hopefully, they will flourish and give a boost to the economy.

4. The scarcity of qualified Islamic finance professionals and Shariah scholars is one of the key issues in the world for the growth of Islamic Finance industry. Do you think there are enough professionals who can lead Islamic banking industry to the next level? What role has Meezan Bank played in developing quality resources?

This is a challenge! However, at Meezan Bank, we run a rigorous training plan for our staff to enhance their knowledge and skills about Islamic banking. The learning initiatives include a comprehensive orientation programme for all new staff that makes sure that they understand the concepts underlying Islamic banking as well as the various products of Meezan Bank. We also conduct specialized functional modules on various business products and processes. These are supplemented with comprehensive short- and long-term certificate programmes on Islamic banking as well as refresher programmes on both Islamic banking products as well as their underlying concepts.

The bank also provides learning opportunities to its staff through in-house, external and international training programmes to improve their knowledge and skills. The bank has four dedicated learning centres, located at Karachi, Lahore, Islamabad and Multan, where learning sessions are conducted round the year under an organized learning calendar developed to address the learning needs of the staff in each region. In addition to classroom-style learning facilities, the bank also has mock branches at Karachi, Lahore and Islamabad, where technical training programmes are conducted on a regular basis. The

MEEZAN BANK MARKET SHARES

Overall Market Share of Revenues (Islamic Scheduled Banks only)	60%
Overall Market Share of Revenues in Financial Services (across the whole banking industry in Pakistan)	3%
Overall Market Share of deposits (Islamic Scheduled banks in Pakistan)	55%
Overall Market Share of deposits (among Islamic Banking windows of conventional Banks and dedicated Islamic Scheduled banks in Pakistan)	35%
Overall Market Share of deposits (across the whole banking industry in Pakistan)	5%

learning facilities are also equipped with libraries, which help employees stay abreast of developments in the field of banking. The bank has also employed a robust Distance Learning System in which video-based training courses are rolled out to the staff who can complete these from either home or the office.

The bank is also taking measures to alleviate the dearth of human capital in at the entry level by providing 500 to 700 fresh graduates the right opportunities and training through its Batch Training programmes each year. This training focuses on promoting human capital development and on developing dynamic and well-rounded executives equipped with the knowledge of banking and the core principles and regulations of Islamic banking. We also regularly arrange public awareness seminars on Islamic banking across various cities and in various institutes of Pakistan. The Bank also supports institutions such as Centre for Islamic Economics (CIE), SBP and National Institute of Banking and Finance (NIBAF) in conducting Islamic banking training sessions. Staff of Meezan Bank taught Islamic banking courses and degree programmes at different institutes, including IBA-Karachi, Sheikh Zayed Islamic Centre, and Commecs, as a personal contribution towards spreading knowledge about Islamic finance.

Meezan Bank has also been able to develop strong relations with various educational institutions exerting an influence towards the education of Islamic finance through mutual cooperation. This process, however small, has created a butterfly effect where a number of institutes are now attracted towards giving Islamic finance courses. Our support doesn't end here—we make our expertise readily available, be it in the form of syllabus design, case study formulation or by providing some of our most skilled employees as faculty.

I also serve as the Chairman of the academic board at Institute of Bankers of Pakistan (IBP), which is offering courses on Islamic Finance and Banking.

The Bank also supported IBA, LUMS and IMSciences to establish Centres of Excellence in Islamic Finance under the guidance of State Bank of Pakistan. Areas of collaboration include curriculum revision and development, jointly arranged executive trainings, joint research on Islamic finance and human capital development.

5. What are the potential markets in Asia where Pakistan's expertise in Islamic banking can contribute and take a lead role in the development of Islamic Finance?

- Sri Lanka
- GCC – especially Oman
- CIS states – emerging markets

6. What are your views on the China-Pakistan Economic Corridor (CPEC)? Do you think Islamic Banking can go beyond this region via CPEC?

We are very hopeful about this mega project, since it will put Pakistan on the path to stability. For every Pakistani, the importance of CPEC is crystal clear. As for Meezan Bank, we are cognizant to this opportunity and have multiple plans in the pipeline. We are identifying the routing of CPEC and have definite plans for establishing Meezan Bank branches in these areas. We are also in the process of setting up

“ THE SMALL AND MEDIUM ENTERPRISES (SME) SEGMENT REPRESENTS THE BACKBONE OF PAKISTAN'S ECONOMY AND IS A KEY CONTRIBUTOR TOWARDS ACHIEVING SUSTAINABLE ECONOMIC GROWTH.

Chinese speaking desks in Karachi and Islamabad to be able to provide better support where required.

As far as the spread of Islamic banking is concerned, I certainly think this shall favour the growth of this industry further. But being a bank that is currently operating in Pakistan, we have to consider the question of availability of internal resources for expansion anywhere other than Pakistan.

7. We are aware that the support of the Government of Malaysia towards Islamic banking and finance is unparalleled. Despite this, the share of Islamic finance in this region is stagnant at around 20%. Do you feel that the growth in this sector might therefore be dependent on some factors other than religious motives?

Despite what the numbers indicate, it is important to remember that Pakistan is predominantly a Muslim population; more than 96% of the population are Muslims. In Malaysia, the Muslim population is roughly 60%. A large majority of the people in Pakistan believe that, given the presence of Shariah-compliant alternatives, they would certainly opt for these to meet their banking needs. A proof of this is evident in the consumer finance industry, particularly for auto finance and home finance, where Islamic banks have taken the lead in this sector. So yes, religious motivation is certainly a great influencer for customers, but it doesn't just end there. We provide our customers the right product at the right time with superior service quality.

8. Lack of financial inclusion is one of the key issues faced by Pakistan. Islamic microfinance has huge potential in Pakistan. What initiatives have Meezan Bank taken to help the micro-entrepreneurs such as farmers, SMEs, etc.?

Pakistan harbours a population of almost 220 million, out of which 70% remains essentially unbanked. The extent of the barrier this creates in socioeconomic development of the country is indeed massive. In order to accomplish the financial inclusion goals set by the State Bank of Pakistan, Meezan Bank has moved towards Islamic branchless banking services, a strategy which will prove to be transformational for the Islamic banking sector across the globe.

Pakistan has witnessed phenomenal growth in the usage of mobile phones in both the urban and rural sections of the population. Keeping in view the surge of mobile subscribers across the country, it is worth noting that mobile banking has not yet matched this rate in delivering banking services to the underprivileged population and to individuals in far-flung locations. While Islamic banking promises good growth, spurred by its ethical and economic values as well as religious orientation, mobile banking is still considered a sluggish sector among other approaches of e-banking. With the launch of Islamic branchless banking in Pakistan, Meezan Bank aims to play a major role in reducing poverty and improving the living standards of individuals belonging to the unbanked segment and living in underdeveloped regions.

We are working with a vision to empower low-income population in this country through microfinance principles governed by Shariah. The implications of this service are huge. We are talking about flexible financing, addressing of monetary problems of financially strained populations and even larger opportunities for small businesses.

The Small and Medium Enterprises (SME) segment represents the backbone of Pakistan's economy and is a key contributor towards achieving sustainable economic growth. Meezan Bank has employed a dedicated team to cater to the banking needs of this segment of the economy.

Meezan Bank has also entered into a Vendor and Distributor Financing Programme with Karandaaz Pakistan, a private company that promotes access to finance for small businesses through a commercially directed investment platform. The company has financial and institutional support from leading international development finance institutions—principally the United Kingdom Department for International Development (UKAid) and Bill & Melinda Gates Foundation. The Consultative Group to Assist the Poor (CGAP), a member of the World Bank Group, managed the start-up phase of the company and continues to provide technical support.

The objective of the Vendor and Distributor Financing Programme is to provide risk capital to small and medium enterprises by providing short-term and long-term funded facilities to the clients, vendors and distributors of corporate clients through a cash-flow-based lending model. Meezan Bank is keen to facilitate small- and medium-size customers through this structured financing programme by taking leverage from its existing corporate portfolio. The bank anticipates that this programme will provide healthy returns and also contribute towards the society by strengthening the small-scale industries in Pakistan.

An overview of Bara market as people shop for supplies ahead of Ramadan in Rawalpindi, Pakistan. REUTERS/ Faisal Mahmood

SBP INITIATIVES TO FACILITATE THE DEVELOPMENT OF ISLAMIC BANKING

The SBP has sought to capitalize on the recent growth trend in the Islamic banking sector by creating programmes to encourage bank innovation. Pakistani finance professionals hope that this will enable the industry to move beyond conventional products to introduce a truly diversified and differentiated menu of financial products. One of the key initiatives taken by the SBP to facilitate the development of Islamic banking in Pakistan has been the launch of Shariah-compliant open market operations on the basis of credit sale (Bai Mu'ajjal) of Sukuk. This was specifically initiated to alleviate some of the problems faced by Islamic banks in managing short-term liquidity.

The Islamic Banking Department (IBD) of the SBP developed a five-year Strategic Plan for the Islamic Banking Industry of Pakistan in January 2014. A multi-stakeholder group including the industry, ulama and the government developed the plan. One of its recommendations was to put a comprehensive Shariah Governance Framework that would clearly specify roles and responsibilities for the governance of Islamic banks in Pakistan. An earlier set of guidelines, issued by the SBP in 2008, was less comprehensive and non-binding.[37] The SBP's Shariah Board developed the new framework, and it was put into force effective July 1, 2015 following a process of consultation and refinement.[38] It requires that any Shariah scholar appointed to a bank's Shariah board possess requisite academic qualifications from a recognized board of madaris or university. It further requires either four years of experience in issuing Shariah rulings or five years of teaching or research in Islamic banking and finance.

KEY AREAS FOR REFORM TO BE ADDRESSED UNDER THE STRATEGIC PLAN

The SBP's Strategic Plan aims to create value for all stakeholders in the Shariah-compliant banking system with the following key initiatives:

1. Research and development to create innovative financial products catering to the needs of all segments of society.

The SBP has identified Islamic financial institutions as one of the key vehicles for promoting financial inclusion in Pakistan. In collaboration with UK Aid, it recently launched a grant programme under the Financial Innovation Challenge Fund to develop the Islamic finance industry's human capital base. It is anticipated that improvement of the education and research infrastructure for Islamic finance will help spur innovations that increase access to financial services.

2. Housing finance products based on market prices and rentals.

Both conventional and Islamic financial institutions currently play a limited role in housing finance in Pakistan, accounting for only 1% to 2% of housing transactions in the country. Moreover, the Rs 52 billion (US$495 million) of residential mortgage loans in 2014 represented only 1% of total bank loans. Islamic banks already account for a significant share of this, as shown below.

The SBP is considering the development of new housing finance products with payments based on market prices and rentals, rather than market interest rates. With a rapidly increasing backlog of millions of housing units, there is a particular need for low-income housing. The SBP continues to emphasize the potential of Islamic banks in catering to this demand, and it is considering options to enable banks gain greater exposure to real estate assets.[39]

3. The mobilization of a separate pool of deposits, segregated from the payment system, for certain new initiatives.

In view of the risk management concerns raised by Islamic housing finance and other risk-sharing investment avenues for Islamic banks, the SBP is considering options for segregating bank deposits. Depositors will be given the option to earn higher returns (linked to capital gains based on property prices) without posing risks for the deposit base in the overall payments system.

4. Developing more musharakah and mudarabah-based products

As of September 30, 2015, only 13.6% of financing provided by IBIs was based on the profit-sharing structures musharakah and mudarabah. The SBP has expressed concern over the continued reliance of Islamic banks on debt-based financial products, which has undermined their credibility in the eyes of many potential customers. It envisages closer collaboration with industry to develop competitive financing products based on musharakah and mudarabah.

5. Targeting customers outside the major urban and semi-urban areas

Since the relaunch of Islamic banking in Pakistan under the SBP, the dramatic growth of IBIs has been largely confined to urban and semi-urban areas. To reach the 80% of Pakistan's population currently excluded from the financial sector, it will be necessary for Islamic banks to expand their operations in rural areas. As IBIs continue to compete for growth opportunities, they will pursue more opportunities within the rural economy.

6. Allocation of credit to the agricultural sector and SMEs

The SBP's Strategic Plan targets a minimum allocation of 5% of deposits or 10% of lending, whichever is higher, as credit to the agricultural sector. This would bring IBIs in line with the overall industry. In the SME sector, the SBP cites evidence that SME owners have a religious preference for Islamic banking productions. It projects regulatory measures, along with collaboration with industry, will help achieve a similar allocation of credit as conventional banks for the agricultural sector.

7. Development of the Islamic Microfinance industry

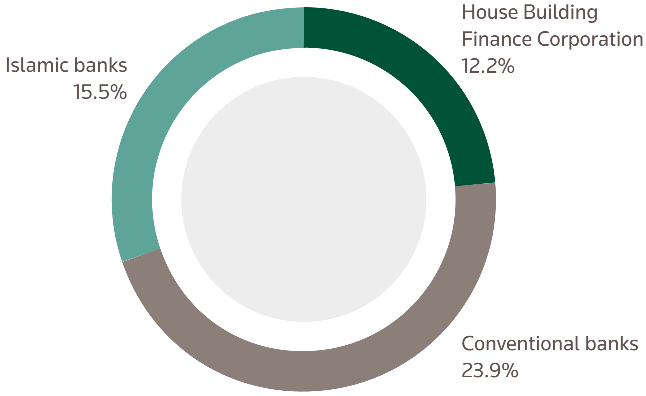
The SBP has issued a total of twelve licenses to microfinance banks (MFBs) since the introduction of legislation for the separate regulation of deposit-taking microfinance institutions in 2001. In addition, the SBP issued detailed guidelines in 2007 for the Islamic microfinance in Pakistan. Like other banks, MFBs have the advantage of being able to access funding through the mobilization of deposits. The minimum paid up capital for MFBs operating on a nationwide basis is only Rs 1 billion, compared to Rs 23 billion for other banks regulated by the SBP.

Although a number of Pakistani NGOs have developed innovative models for providing Islamic microfinance to grass roots entrepreneurs, they are operating outside the scope of the SBP's regulatory framework. As a result, they do not have access to deposit funding and rely on grants and donations. The SBP is encouraging existing MFBs to pursue growth by targeting the Islamic microfinance industry, and hopes that this will attract some of the NGOs already active in Islamic microfinance to register licensed MFBs. The SBP is planning significant capacity building initiatives to facilitate this transition.

8. Building awareness about Islamic finance to address some of the key causes of confusion and misperception

The SBP launched a media campaign in 2013 to educate consumers and other key stakeholders about Islamic finance. Building on these activities, the Strategic Plan contemplates targeted educational programmes for senior management of conventional banks, chambers of commerce, academia and legal professionals.

RESIDENTIAL MORTGAGES (RS BILLION AS OF MARCH 2014)



Source: National Financial Inclusion Strategy Pakistan, May 2015 (SBP)

MEEZAN BANK LIMITED: OPENING THE GATEWAY TO ISLAMIC FINANCIAL INCLUSION

Arshad Majeed | Senior Executive Vice President, Group Head of Payment Services, Meezan Bank Limited

ARSHAD MAJEED is Senior Executive Vice President, Group Head of Payment Services, at Meezan Bank Limited. Mr. Majeed has been part of Meezan Bank before its inception (when Meezan Bank was Al Meezan Investment Bank). Mr. Majeed's banking career stretches over 30 years, during which he has held various senior positions at local and foreign banks, such as Deutsche Bank AG, Chase Manhattan Bank Ltd, and Muslim Commercial Bank and Mashreq Bank in both Pakistan and abroad. His last position before joining Meezan Bank was with Mashreq Bank Head Office, Dubai as Senior Methods Analyst for Operating Policies and Procedures for Local and Overseas Branch Operations and Internal Quality Audit for Head Office Operations-Dubai. Mr. Majeed holds a Master's in Business Administration and graduate degrees in Advanced Mathematics and Law from Karachi University. He is also a certified internal quality auditor from Bureau Veritas Quality International (BVQI), London. Mr. Majeed is a member of various senior-level internal committees of Meezan Bank and has also conducted numerous countrywide training courses as an internal trainer.

Overview

Pakistan has witnessed phenomenal growth in the usage of mobile phones in both urban and rural areas. However, mobile banking has not yet matched this rate of growth in delivering banking services to the underprivileged and remote rural population. While Islamic banking has demonstrated strong growth in Pakistan, spurred by ethical and economic values as well as religious orientation, mobile banking is still considered a sluggish sector among various e-banking approaches.

What Does IBB Offer?

The role of technology in providing cost effective and efficient banking solution is increasing in Pakistan. Almost 90 percent of bank branches are processing real time transactions across the country. With the launch of Islamic branchless banking (IBB) in Pakistan, it is hoped that financial access will increase to unbanked and underdeveloped regions. IBB will bring added convenience to both the banked and unbanked population, allowing Pakistanis to perform transactions without necessitating often a long trip to a distant town or city. For the rural population, tapping into the bank services will also eliminate their need for the physical security of cash.

IBB can break the social and economic barriers associated with weak traditional banking infrastructure in rural areas leading to increase financial inclusion. With the mobile platform, IBB can deliver flexible financing solutions addressing the monetary problems of financially strained populations and provide even larger opportunities for small businesses. These easy and cost-effective Shariah-compliant microfinance solutions can bring a whole new echelon of customers.

Pakistan's Booming Branchless Banking Potential

Pakistan's branchless banking sector has set remarkable precedents. Over the past two decades, a number of banking and cellular phone operators have entered the market, and they provide savings and easy transfer of funds services. The mobile banking platforms offer instant money transfer services and utility payments. However, whicle the branchless banking boom has occurred in conventional banking, IBB remains essentially untapped. Recently Meezan Bank and Ufone have come forward to launch IBB services with a strategic priority on financial inclusion.

Challenges and Limitations

There is little doubt that Islamic banking can reach many of the millions who are currently subscribers of mobile operators.

Without these partners, there are only a few banks in the world that have been able to develop agent networks so extensive, and typically only for specific services that do not extend their core business. IBB aims to provide a convenient service that can attract a high volume of transactions with a low-touch approach and will include the financially secluded masses in the country. IBB is likely to serve as a gateway for these clients to a fuller range of riba-free financial solutions.

The development of a robust payment infrastructure is necessary for promoting long-term development of IBB. Therefore, partnerships between banks and telecoms will play a key role in this domain for agent network expansion and accessibility of branchless banking solutions to common people.

“WHILE ISLAMIC BANKING HAS DEMONSTRATED STRONG GROWTH IN PAKISTAN, SPURRED BY ETHICAL AND ECONOMIC VALUES AS WELL AS RELIGIOUS ORIENTATION, MOBILE BANKING IS STILL CONSIDERED A SLUGGISH SECTOR AMONG VARIOUS E-BANKING APPROACHES.

< A girl smiles as she is carried by her father while walking through a brick kiln in the outskirts of Islamabad. REUTERS/Faisal Mahmood

6 Capital market landscape

An electronic board displaying stock prices and an index graph is seen as a journalist (L) from a local television channel reports during a trading session at the Karachi Stock Exchange. REUTERS/Akhtar Soomro

INSIDE THIS CHAPTER

SECP at a glance

The Securities and Exchange Commission of Pakistan (SECP) was established by the SECP Act in 1997. The parliament of Pakistan aimed to establish an efficient and dynamic regulatory body that could enforce sound governance in the corporate sector, ensure proper risk management in capital markets, and protect investors' rights. The SECP became operational in January 1999, and in the past two decades, it has developed competency, regulations and responsibilities. The SECP mandate has also increased over time as the market grew. Currently, it oversees a number of external service providers to the corporate and financial sectors, including chartered accountants, credit rating agencies, corporate secretaries, and brokers. The challenge for the SECP has grown in line with its broader mandate.

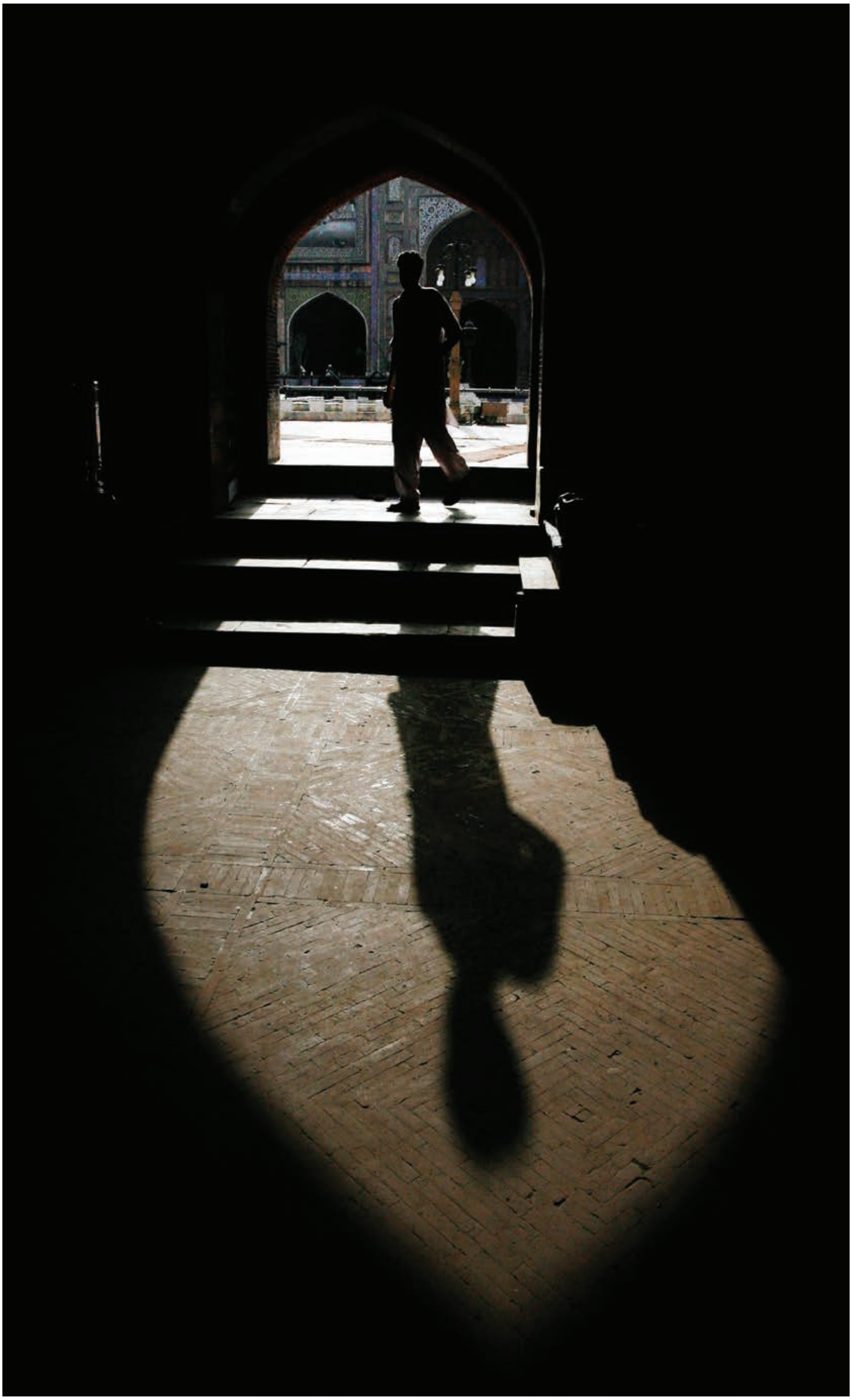
INTRODUCING THE IFD

The Islamic Finance Department (IFD) was introduced in February 2015 by the SECP, as the need for a dedicated department regulating Islamic finance has substantially increased with the growth of the sector. The IFD will foster and monitor Pakistan's Shariah regulatory environment and ensure that Shariah-compliant companies follow the principles of Shariah in their businesses. Currently, the department is putting together a roadmap for the Islamic financial and capital markets in consultation with market stakeholders and the operational departments of the SECP. In addition to being a regulator, IFD is also responsible for product development and innovation, Shariah screening, audit mechanisms, Shariah compliance rating methodology, proposing solutions for issues such as taxation, and coordinating between the Shariah Advisory Board of the SECP and the State Bank of Pakistan.

PAKISTAN STOCK EXCHANGE: PERFORMANCE (2012 -2015)

	2012	2013	2014	2015
Total No. of Listed Companies	651	560	557	554
Total Listed Capital – Rs Mn	814,478.74	1,129,787.32	1,168,484.88	1,269,703.53
Total Market Capitalisation –Rs Mn	2,705,879.83	6,056,506.03	7,380,531.74	6,928,497.81
KSE-100™ Index	9386.92	25261.14	32131.28	32811.89
KSE-30™ Index	9849.92	18808.86	20771.55	19309.82
KMI-30 Index	6665.55	42431.05	50735.12	55647.21
KSE All Share Index	8,755.73	–	–	15448.28

Source: Pakistan Stock Exchange



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A man arrives to pray at the Wazir Khan mosque in Lahore. REUTERS/ Mohsin Raza

ZAFAR HIJAZI

Chairman, Securities and Exchange Commission of Pakistan

MR. ZAFAR HIJAZI has been Chairman of the Securities and Exchange Commission of Pakistan since December 19, 2014. A chartered accountant by profession, he has extensive experience spanning 34 years in the private sector and as a senior regulator of the corporate sector and emerging capital markets. He has attended many international conferences, seminars and courses. From January 1, 1999 to December 31, 2003, Mr. Hijazi had served the SECP as Commissioner, Company Law Administration and Enforcement Division. He introduced significant legal and regulatory reforms to improve the quality of corporate disclosure, corporate restructuring and corporate finance. He has also held senior management positions in various private companies.

1. Since the establishment of the Islamic Finance Department (IFD) in February 2015 at the SECP, what has been its role in developing the industry?

At the outset, I would like to explain the reason for establishing the Islamic Finance Department at the SECP. A coordinated approach was required for regulating and supervising the Islamic capital market, which include the Modaraba operators, Islamic mutual funds, takaful, Islamic REITs, and other Islamic NBFIs (Non-Banking Financial Institutions), as well as Shariah-compliant instruments such as Sukuk. I believe that the growth and success of the Islamic financial industry, or of any industry for that matter, is dependent on efficient and effective regulation. After reviewing the prevailing regulatory framework, The IFD has proposed fundamental changes to the Draft Companies Bill 2016 pertaining to Shariah-compliant companies and instruments, which are expected to be released in the near future after obtaining and incorporating feedback from the stakeholders. In the meantime, in order to ensure Shariah compliance of the Islamic capital market constituents, I have directed all operational departments of the SECP to send all documents, prospective products or issues of companies pertaining to Shariah, for review by IFD to make them conform to the precepts of Shariah.

After the establishment of the IFD, we created a Shariah Advisory Board (SAB) at the SECP to adjudicate matters that require Shariah opinions. The objective of the SAB is to ensure that the activities and operations of Shariah-compliant companies are conducted in a manner that is not contrary to the injunctions of Shariah. This is critical to protect investors, to maintain the public's confidence and to prevent misunderstandings about Islamic finance. The SAB met several times over the last few months and has given its opinions on documentation, products, and other matters pertaining directly to the Islamic capital market.

Over the last few months, the IFD, along with the SECP's SAB, has reviewed several products, including issuance of Sukuk by K-Electric Ltd. and Treet Corporation Ltd. It also reviewed the documentation of Dolmen City REIT, South Asia's first Shariah-compliant REIT. IFD also reviewed a new "Commodity Murabahah Transaction" procedure and tailored its transactional layers in accordance with Shariah precepts.

The IFD has been a major advocate for decisions ultimately made in the Steering Committee on the Promotion of Islamic Banking in Pakistan, such as the All Share Islamic Index, and the recent adoption of several AAOIFI Shariah standards and IFSB principles for Islamic financial supervision and regulation.

2. What Islamic finance sectors in Pakistan are struggling to develop in particular and what initiatives are being taken to develop them?

Overall, the Islamic financial industry in Pakistan is far behind the conventional finance industry and requires strong regulatory support, specifically, for non-banking financial institutions (NBFIs). This sector includes specialized companies such as Islamic mutual funds, real estate investment trusts (REITs),leasing companies, housing finance companies, Modarabas, microfinance institutions and other versatile vehicles of financing and investment. However, they are dwarfed by the much larger commercial banks that offer similar financial services at lower costs, owing to their economies of scale and extensive outreach.
The NBFIs, especially the Islamic Microfinance Institutions (IMFIs), have a significant role to play in the development of the economy and in poverty alleviation. The potential for this, however, remains largely untapped principally because of a shortage of liquidity.

The SECP is striving to provide the support to micro, small and medium enterprises (MSMEs) through access to a faith-based and cheaper source of funds. In collaboration with the SBP and SECP, the government is developing structures and incentives for the NBFIs sector by ensuring the availability of cheap sources of funds to promote target lending to MSMEs such as the preferential (low-cost) agricultural credit facility offered by SBP. For this purpose, the Pakistan Microfinance Investment Company (PMIC) was launched on April 28, 2016, with the equity participation of the Pakistan Poverty Alleviation Fund, DFID/Karandaaz Pakistan and Germany's development bank Bank Aus Verantwortung (KfW). This will help the sector realize its potential and provide financial access to the underserved segment of the population.

Though the Islamic mutual funds industry has shown comparatively consistent returns, the growth of total assets under management remains low. The SECP is collaborating with higher education institutions and developing public promotional and investor education campaigns to spread awareness of fund. Mutual funds are an ideal investment product for increasing financial inclusion by offering the low-income and less informed investors with professional management, diversification and safe custody of assets. They can play an important role in the economic development of our country by pooling funds and making them available through the capital market in the form of equity and debt capital. The establishment of Capital Market Hubs across Pakistan (explained below) will offer the mutual fund industry, which represents 70% of the non-banking financial sector, the opportunity to offer their investment products to low-income investors in remote and underserved areas. By allocating resources to the establishment of hubs in underserved areas, new demand for investment products will emerge, which in turn will help increase Pakistan's investor base

"THOUGH THE ISLAMIC MUTUAL FUNDS INDUSTRY HAS SHOWN COMPARATIVELY CONSISTENT RETURNS, THE GROWTH OF TOTAL ASSETS UNDER MANAGEMENT REMAINS LOW.

> THERE ARE MANY CHALLENGES FOR THE GROWTH OF ISLAMIC FINANCE INDUSTRY, SUCH AS THE UNAVAILABILITY OF INNOVATIVE SHARIAH-COMPLIANT PRODUCTS, DEARTH OF SHARIAH SCHOLARS WITH ISLAMIC FINANCIAL SECTOR EXPERTISE AND KNOWLEDGE OF ACCOUNTING AND AUDITING.

and long-term savings. Higher savings will help with new capital formation urgently needed for the development of Pakistan's economy.

Similarly, the takaful sector has yet to make its appearance at centre stage of the Islamic finance industry. The sector requires capital formation and the strengthening of takaful operators. The SECP has instituted many reforms in this regard, including:

i. allowing window takaful operations to conventional insurance companies by promulgating Takaful Rules 2012, (under which 15 conventional insurance companies have been granted permission.

ii. regulatory guidance on financial reporting of window takaful operations by conventional general insurance companies (guidance for family takaful operators is under consideration).

iii. accounting regulations for dedicated takaful operators.

iv. approval of curriculum for training of managerial staff of the takaful sector.

v. approval of an educational institution for the training of managerial staff of the takaful sector, among others.

The SECP is taking strides to increase the number and size of Sukuk issues. Pakistani corporations currently prefer private placement to public issues of Sukuk because of the greater legal and tax compliance issues associated with public listing. To ensure the growth of Pakistan's debt market, the SECP has recommended amendments to simplify these regulations to the relevant authorities.

3. What are the main challenges facing the Islamic finance industry as of today? How do you go about these challenges?

There are many challenges for the growth of Islamic finance industry, such as the unavailability of innovative Shariah-compliant products, dearth of Shariah scholars with Islamic financial sector expertise and knowledge of accounting and auditing. Besides the legal and taxation issues, building a client base is challenging due to lack of investor education and limited outreach to small and rural investors merely due to absence of economies of scale. Yet another discouraging factor is that the expected returns are based on benchmarks pegged to conventional benchmarks.

The low level of financial awareness and limited distribution channels also poses a threat to the growth of the Islamic capital market. The effectiveness of corporate and financial sector reform is dependent on better outreach, investor awareness and the development of alternative delivery channels. In Pakistan, the providers of financial services are concentrated in the big cities, leaving investors in smaller cities and rural areas at a considerable disadvantage both in terms of financial access and in their awareness about investment products and services needed for improving their financial condition. In order to improve financial access in Pakistan, the SECP spearheaded the establishment of capital market business hubs in Pakistan by targeting cities that have small industries and residents receiving foreign remittances from relatives working abroad, such as Mirpur, Abbottabad, Sialkot, Dhadial and other remote areas. This places all capital market related services under one roof, allowing the investor to learn about financial products available and to execute the investment decision. The first such hub, Abbottabad Sarmayakari Markaz (Markaz), was established in Abbottabad on November 12, 2015. Currently, five asset management companies, two brokerage firms and a bank along with CDC and the Pakistan Stock Exchange have opened their branches in the Markaz In addition, the SECP has also established an office within the Markaz to answer visitors' questions about investment products, company incorporation and also to provide regulatory guidance.

In order to impart investor education, improve financial literacy and to extend the reach of the SECP's investor education programme across various segments of our society, there is need for a permanent funding source to run investor education activities on a continuous basis. The SECP, therefore, is contemplating to establish an Investor Education Fund as an endowment to finance and develop investors' education and awareness initiatives on permanent basis. The SECP has adopted investor education as a key strategy to enhance investor protection, promote investor confidence and foster investor engagement in financial planning and decision-making. These measures will help significantly broadening the retail investment base in the NBFI sector. A large number of the eligible population is currently unaware of investment avenues offered by the NBFI sector and particularly by the non-banking Islamic financial institutions. In general, surplus savings in the formal financial sector either flow to government-backed saving schemes or to banks. Most of the retail investors, especially those who live in underdeveloped areas or small towns, may be made aware of the risk and reward structure offered by NBFI sector entities leading to financial inclusion as well as strengthening the sector.

4. How high are the acceptance and awareness levels about Islamic finance in Pakistan? What is the role of SECP's Islamic Finance Department in raising awareness?

I am afraid public acceptance levels are not very high. Actually, the Islamic finance segment faces a serious image problem. It stems from a history of mismanaged investment schemes. In these schemes, the concept of Islamic finance was abused. Innocent small investors fell prey to the malicious designs of venal and unscrupulous individuals and as a result, lost their hard-won savings. There is always the possibility of such incidents recurring, which has led the regulators to be overcautious and tending towards over-regulation. Each of these circumstances is detrimental to the development of the Islamic financial sector. The legal framework is indeed again the single most important determinant of a sound Islamic financial segment. It is necessary to have a prudent regulatory and policy framework for a stable financial industry. This regulatory framework should, however, set the right balance. The development of modern financial institutions requires high-quality human capital with the appropriate financial skills. Islamic finance is a relatively new concept, and the exchange of ideas and cooperation between institutions across borders can help the growth of the industry.

The public image of Islamic finance is also affected by the lower level of innovation and a desire to imitate the conventional products, making it hard for public distinguish between the two. The challenges faced by the Modaraba companies in Pakistan highlight the difficulties in accessing sources of appropriate funds due to low level of investor confidence has led to a dearth of Islamic financial products and capital market support for such products.

Owing to a faith-conscious, Muslim-majority population, Pakistan is well placed to become the regional leader in the Islamic finance Industry. The robust growth of Islamic mutual funds speaks volumes for the acceptance of Islamic finance. However, the lack of awareness is the main impediment in the way of realizing the full potential of the industry. In this regard, the IFD has prioritised raising awareness amongst the public by arranging capacity-building workshops and training sessions, conferences, and workshops.

5. How does the SECP collaborate with the State Bank of Pakistan (SBP) in order to promote Islamic finance in Pakistan?

As the two apex regulators of Pakistan's financial industry, the SECP and SBP are closely collaborating with each other on various forums for the development of Islamic finance. Representatives of both regulators are members of the Steering Committee for the Promotion of Islamic Banking in Pakistan, which was constituted by the Finance Minister to transform the interest-based economic system into a Shariah-compliant economic system. A joint forum has also been created to oversee the challenges and opportunities for Islamic finance and also discuss practical problems being faced by their respective regulates.

The SBP and the SECP officers meet on a quarterly basis to coordinate activities and to discuss and resolve issues that impede the growth of the Islamic financial industry. They have an effective mechanism in place to ensure that solutions are provided expeditiously.

Pakistan Stock Exchange (formerly Karachi Stock Exchange), has been formed following the merger of the three stock exchanges of Lahore, Karachi and Islamabad. At the end of 2015, a total of 554 companies were listed on the consolidated exchange with a total paid-up capital of Rs 1.27 trillion.

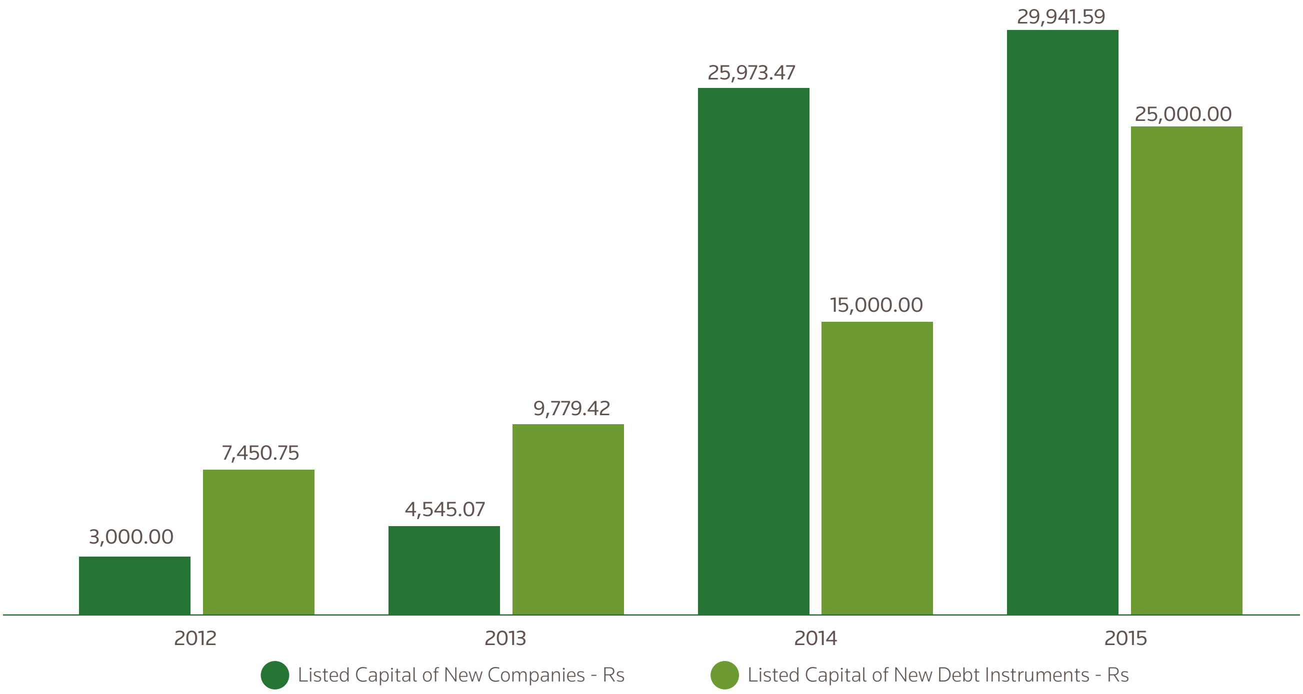
The Pakistan Stock Exchange maintains five stock indices. Three indices, KSE-100, All Share Islamic Index and KSE All-Share, are based on market capitalisation, while KMI-30 and KSE-30 are based on free-float capitalisation. The performance of the Pakistan stock market indices has witnessed a significant and steady improvement in the past five years, reaching historic highs in 2015. This solid performance is attributed to a number of factors, principally a stabilising political environment, cheap oil, the strengthening exchange rate of the Pakistan Rupee against the dollar, strong foreign interest in Pakistani stocks, and more confidence and support from multinational agencies such as the World Bank and IMF.

The KSE-100 index posted another great year, despite taking a deep dive in March 2015. The index closed 2015 at 32,811.89, slightly higher than 2014 at 32,131.28. The KSE-100 comprises the top company from each of the 34 sectors on the Pakistan stock exchange in terms of market capitalisation, with the 66 remaining companies having the highest market capitalisation regardless of sector. The KSE-100's current performance indicates stability in the market, which is driven by strong economic fundamentals in the country.

KMI-30 is one of the two Shariah-compliant indices and consists of the 30 largest companies that meet Shariah compliance criteria. The index was launched in September 2008, with the base period starting in June 2008. The KMI-30 has outperformed other indices in Pakistan by a large margin, posting a sturdy growth with a compound annual growth rate (CAGR) of 25% from 2011 to 2015. Overall economic conditions in Pakistan have been stable, with interest rates reaching 42-year lows at 6%, making borrowing cheaper for companies to expand their businesses. This performance also indicates investors' confidence in the equity markets.

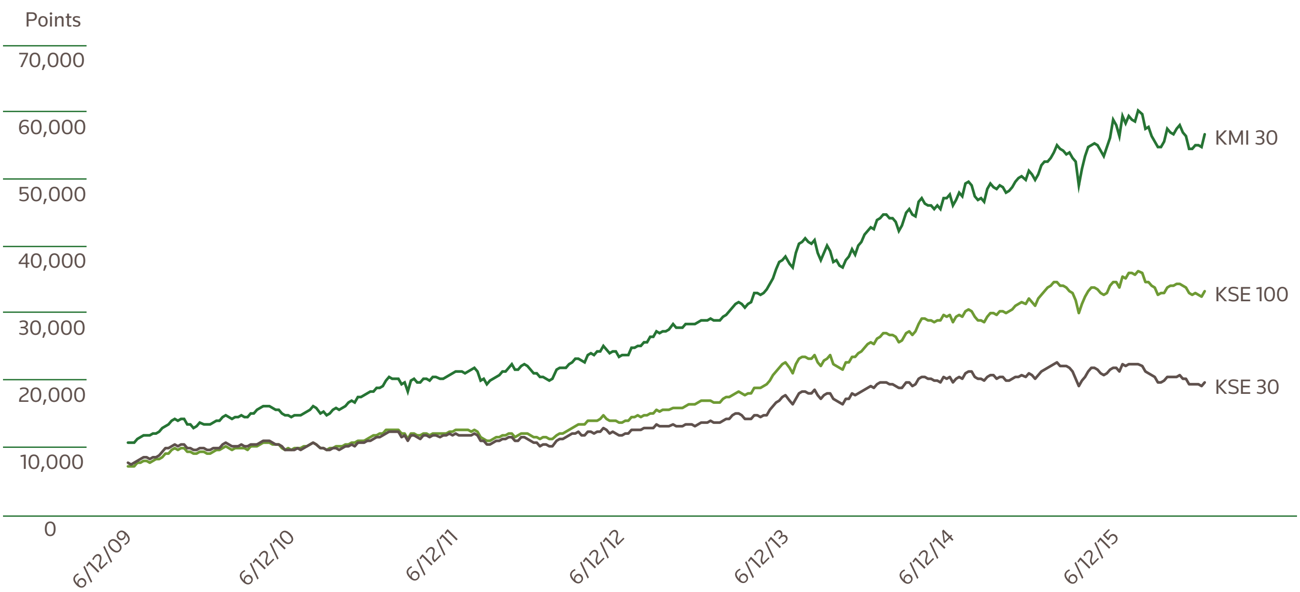
The All-Shares Islamic Index of Pakistan was launched in November 2015 and contains all Shariah-compliant stocks, covering a list of 225 stocks. The index was introduced to address the growing demand for investing in interest-free companies in Pakistan. The index aims to support investor interest in the sector and the development of Islamic capital markets in the country overall.

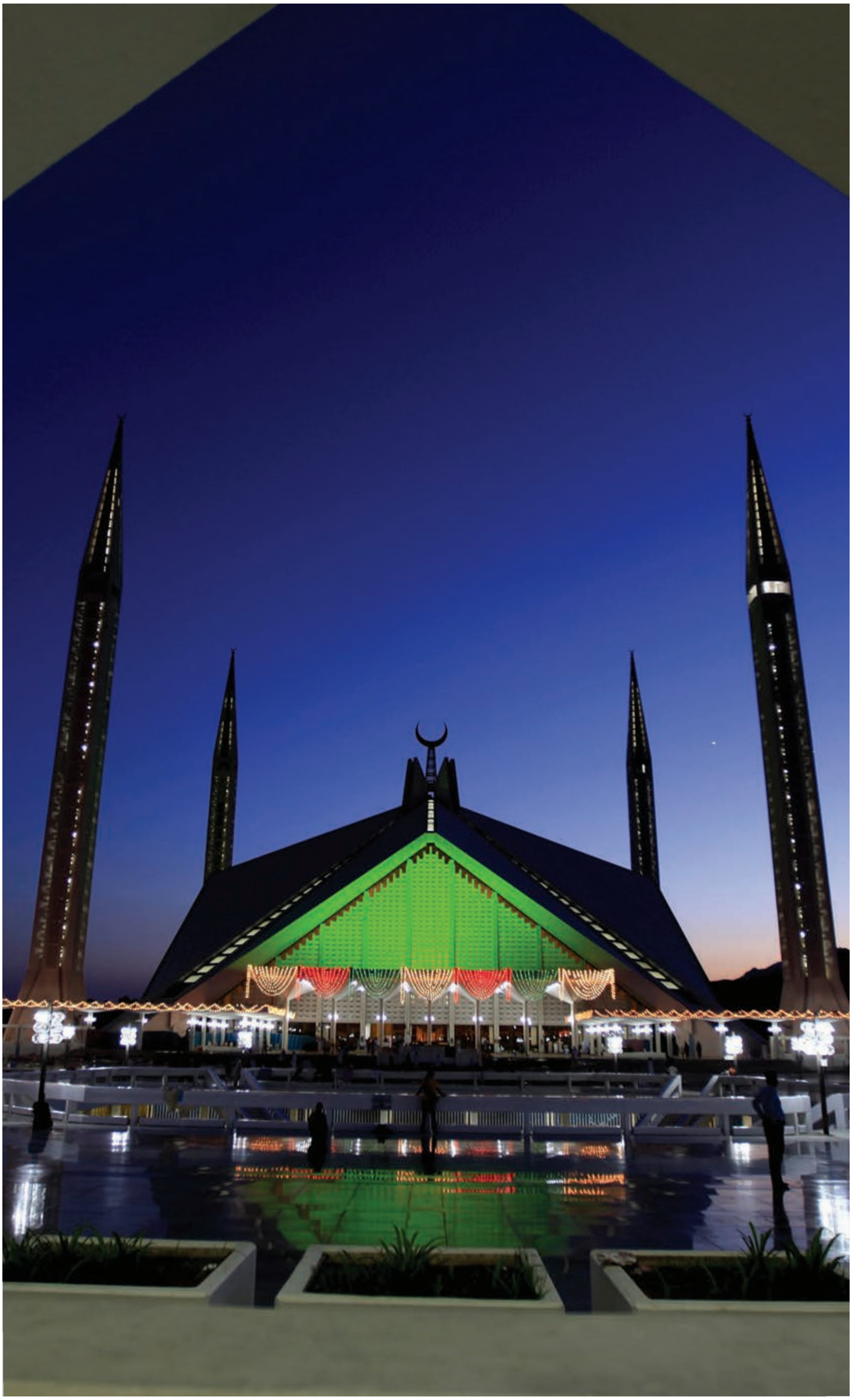
NEW LISTINGS OF COMPANIES AND DEBTS



Source: Pakistan Stock Exchange

PERFORMANCE OF INDICES IN PAKISTAN





Faisal mosque is seen illuminated during the holy fasting month of Ramadan in Islamabad, Pakistan. REUTERS/ Faisal Mahmood

Islamic asset management at a glance

A NEW INDUSTRY CATCHING UP

The conventional asset management industry in Pakistan is about 50 years old; National Investment Trust launched the first mutual fund in 1962. The market remained limited to public sector entities until the early 1990s, whereupon numerous new investment firms tapped into the private sector, offering close-ended mutual funds. In 1995, open-ended funds were first introduced in the private sector.

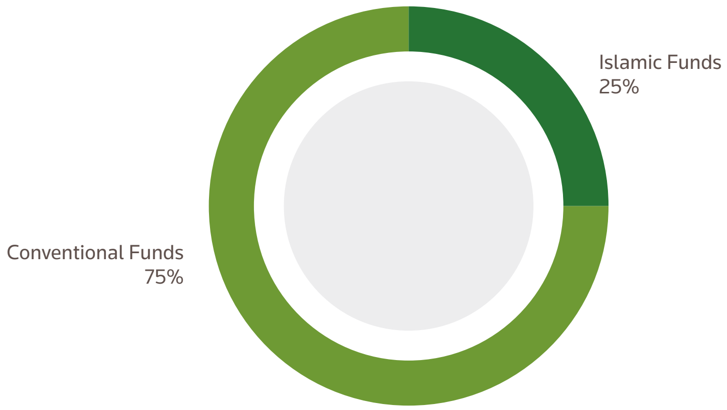
The industry has blossomed since its establishment. By the end of 2015, Pakistan had 22 licensed asset management companies operating in different areas such as advisory, account and asset management, including both discretionary and non-discretionary portfolios.

Islamic asset management first appeared in 2003 when Al Meezan Investment Management Company obtained a licence. Out of the 22 asset management companies, Al Meezan is the only full-fledged Shariah-compliant investment firm. The asset management industry had Rs 415 billion (US$3.96 billion) assets under management as of the end of 2015, up by 3% from the prior year. By the end of fiscal year 2015, the there were 70 distinct Islamic funds, of which 11 had been launched in the prior year in different categories.

Of the Rs 415 billion under management in the total industry, the share of Shariah-compliant funds share was Rs 105.3 billion (US$1 billion), representing a market share of 25.3% in June 2015. The industry has been growing at a fast pace. In just 5 years, the this market share has more than doubled from 12% to 25%, as total assets under management grew at a CAGR of close to 30%, compared to an unexciting CAGR of 12% of conventional funds.

Islamic equity funds have reported a solid performance, registering a five-year CAGR of 31%. The performance of the KSE Meezan Index (KMI-30), the Shariah-compliant equity index is a benchmark for the industry. In contrast, the conventional funds performance measured through index KSE-100 has generated a yearly CAGR of 28.8%. Other categories have also performed well. The Islamic fixed income funds posted a well-rounded CAGR return of 10.2%, and money market funds posted 11.3%.

ISLAMIC FUNDS MARKET SHARE BY END OF JUNE 2015



Source: Al Meezan Investment Research

GLOBAL MAJOR INDICES PERFORMANCE (2014 -2015)

Market	Index	Dec-14	Dec-15	Change
Pakistan	KMI-30	50735	55604	↑ 9.60%
Germany	DAX	9806	10743	↑ 9.56%
China	SSEC	3235	3539	↑ 9.40%
Japan	N225	17451	19034	↑ 9.07%
France	CAC 40	4273	4637	↑ 8.52%
US-NASDAQ	Nasqaq	4736	5007	↑ 5.72%
Pakistan	KSE	32131	32816	↑ 2.13%
US-S&P 500	S&P 500	2059	2044	↓ -0.73%
US-DJI	DJI	17823	17425	↓ -2.23%
Russia	RTSI	791	757	↓ -4.30%
UK	FTSE	6566	6242	↓ -4.93%
India	BSE 30	27499	26118	↓ -5.02%
Sri Lanka	ASPI	7299	6895	↓ -5.54%
Hong Kong	HIS	23605	21914	↓ -7.16%
Indonesia	JSX	5227	4593	↓ -12.13%
Brazil	Bovespa	50007	43350	↓ -13.31%
Kuwait	KSE	6536	5615	↓ -14.09%
Turkey	XU100	85721	71727	↓ -16.33%
Dubai	DFM	3774	3151	↓ -16.51%
Saudi Arabia	TASI	8333	6912	↓ -17.05%
Egypt	EXG	8927	7006	↓ -21.52%

KMI-30 SHINING IN GLOBAL MARKETS

Globally, the KMI-30 outperformed all major indices, posting a strong growth of 9.6% by December 2015. This occurred despite some volatility in global stock markets, especially in the second half of the year with the departure of some foreign investment from the KSE. The crash of the Chinese markets raised concerns about a worldwide economic slowdown, and it put international investors on a more conservative and defensive footing.

The outflow of investments from Pakistan peaked following the increase in interest rates by 0.25% by the US Federal Reserve. Generally, emerging markets witness an outflow of investments to more developed countries when interest rates increase. However, both indices in Pakistan posted positive growths, indicating confidence, resilience and stability of the domestic market.

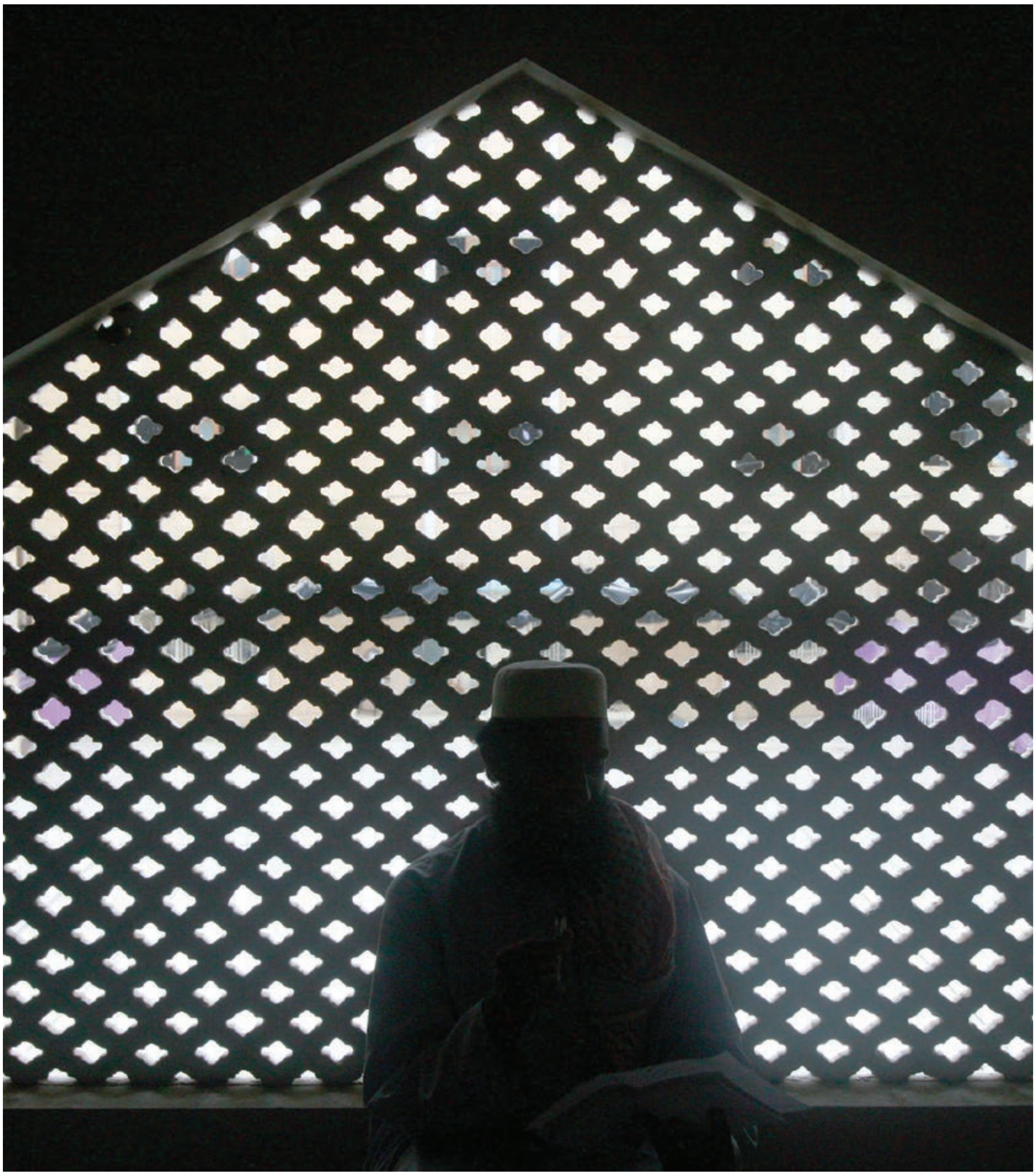
Amongst domestic investors, one of the fundamental reasons for the strong performance of the KSE is the increased awareness of institutions about different financial savings options available in the market. However, the need for greater awareness about the benefits of investing on the part the general public remains a key challenge to grow the industry beyond these institutions.

The market is seeing increasing interest from investors in mutual funds, as opposed to traditional savings vehicle of bank deposits. Islamic funds are also becoming more attractive that conventional funds to such investors, thanks to their consistently strong and less volatile returns. As a result, more conventional institutional investors are tapping into the Islamic asset management industry to get a piece of this growing pie.

THE BIGGEST EQUITY FUND IS MANAGED BY AN ISLAMIC FUND MANAGER

In terms of players, Al Meezan stands out with a substantial market share of 57% in the Islamic asset management industry, and a 14% market share in the whole industry. Interestingly, although it is an Islamic fund manager, Al Meezan manages the largest equity fund of both conventional and Islamic funds, which has AUM of Rs 27.4 billion (US$261.6 million).

The majority of investors on the KSE are Pakistani, with institutions representing as much as 80% of the investor base. This is a contrast from many other global markets, where the majority of investors are mainly ultra high- and high net worth individuals. In Pakistan, there has been some progress in increasing the number of retail investors, which have been estimated to have to grown from 10% to 20% by December 2015. One way to increase the market share in individual investors further is by marketing Sukuk funds to a retail market interested in fixed-income instruments.



< A man stands, identifying he has completed an exam to become a religious scholar, at the Jamia Binoria Al-Alamia Seminary Islamic Study School in Karachi. REUTERS/ Athar Hussain

SHARIAH COMPLIANT INVESTMENTS IN PAKISTAN'S CAPITAL MARKET: AN UNDENIABLE WINNING OPTION

Muhammad Farhan ul Haq Usmani | SVP and Head of Shariah Audit and Advisory, Meezan Bank Limited
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FARHAN USMANI holds a Bachelor in Business Administration, Commerce, and Masters and M. Phil. in Economics from University of Karachi, Pakistan. He is also a Certified Islamic Banker from Centre for Islamic Economics (CIE), a division of Jamia Dar-ul-Uloom Karachi, chaired by Justice Muhammad Taqi Usmani. His areas of research include Islamic Capital Markets, Shariah Compliant Funds and Asset Management and Shariah Audit and Compliance. Mr. Usmani joined Meezan Bank Limited in 2005. His main areas of responsibility include product development and implementation, policymaking, Islamic finance training, Shariah compliance and auditing, and Islamic financial and Shariah advisory. Mr. Usmani is also a founder member of Karachi Stock Exchange's Index Committee for the KMI 30 Index, Pakistan's first-ever Shariah-compliant index and the KMI All Share Index. He is a senior member of the Federation of Pakistan Chambers of Commerce and Industry's (FPCCI) committees on Islamic Banking and Takaful, and on NBFIs and Modaraba. Mr. Usmani is also a member of Academic committee of Centre for Islamic Economics (CIE).

IRUM SABA is Assistant Professor at Centre for Excellence in Islamic Finance (CEIF)-IBA. Ms. Saba has more than 12 years of progressive regulatory, research, training and teaching experience with organizations of international repute. Previously, she worked as Deputy Director in the Islamic Banking Department of the State Bank of Pakistan. She is also honorary secretary of the Chartered Institute of Islamic Finance Professionals (CIIF), Malaysia. Before joining the State Bank of Pakistan, she worked with the Securities and Exchange Commission of Pakistan (SECP) and The Islamia University, Pakistan. She has written several articles and chapters in books on the topics of corporate governance, Islamic finance and Islamic microfinance. She is a Shariah-registered financial planner (Shariah RFP). She holds the Chartered Islamic Finance Professional (CIFP) credential from INCEIF with distinction and currently working on a PhD in Islamic Finance from INCEIF. She holds a Master in Commerce (M.Com) with distinction and PGD in Islamic Banking and Insurance from Institute of Islamic Banking and Insurance (IIBI), London. Her areas of interest are Shariah, Islamic microfinance, corporate governance and Islamic finance.

Pakistan's stock market, previously composed of the Karachi Stock Exchange (KSE), Lahore Stock Exchange (LSE) and Islamabad Stock Exchange (LSE), has been merged into a single institution, Pakistan Stock Exchange (PSX), inaugurated on January 11, 2016 by Finance Minister Mr. Ishaq Dar. Currently, PSX is one of the best-performing stock exchanges in the world especially in terms of year-on-year returns. Pakistan ranked third in 2014 among the top ten best performing markets in the world in the estimation of Bloomberg, and it has been in the top ten for the past four consecutive years.

The strong performance of Pakistan's equities market is principally the result of the recent crash in global oil prices, resulting in a reduction in the country's fiscal deficit, and of improved corporate results. Further adding to the attractiveness of this market, the State Bank of Pakistan (SBP) has been cutting rates aggressively since November 2014, resulting in a net positive flow of investor funds from banking deposits to the capital markets. This has also lowered financing costs for industries, resulting in improved financial results for listed companies.

In this bull market in Pakistan, Shariah-compliant investment options are a natural choice for any investor, as they can provide better returns in many cases.

The key drivers for the growth of Islamic Investments in Pakistan can be classified as follows:

- First and foremost, the demographics of Pakistan, with a 95 to 98 % Muslim population, provide a strong untapped demand for Shariah-compliant products by investors who want

> A KEY COMPONENT OF ISLAMIC CAPITAL MARKETS IN PAKISTAN IS THE ISLAMIC MUTUAL FUNDS INDUSTRY, AND THIS INDUSTRY IS MAINLY POPULAR AMONG LARGE INSTITUTIONS AND HIGH-NETWORTH CLIENTS. THIS PRESENTS A GREAT OPPORTUNITY FOR ISLAMIC MUTUAL FUNDS TO MARKET THIS INVESTMENT OPTION TO THE RETAIL SEGMENT OF MASS CONSUMERS.

to invest and earn solid returns in a fashion harmonious with their beliefs.

- The next important driver is the trust of investors in the Shariah compliance of the products and options available because of the strong Shariah controls systems embedded in institutions' Shariah supervisory boards, Shariah advisors and internal and external Shariah audits.

- Lastly, the presence of a large untapped retail investor segment is an important factor for the growth of Islamic investments in Pakistan.

A key component of Islamic capital markets in Pakistan is the Islamic mutual funds industry, and this industry is mainly popular among large institutions and high-net-worth clients. This presents a great opportunity for Islamic mutual funds to market this investment option to the retail segment of mass consumers. This is gaining immense popularity, not just because of the some good investment returns, but also because of some great tax incentives by the government.

Another major reason for the growth and popularity of Shariah-compliant equity investments is the new product innovation in Pakistan's Islamic capital markets. The launch of Shariah-compliant commodity funds, gold funds and capital preservation funds are great steps in expanding the horizon and options for Shariah conscious investors. Academic researchers, industry players and regulators are working on great initiatives for the expansion of Islamic investment options, like introduction of a dedicated Islamic counter at the local stock exchange, the introduction of exchange-traded funds, and Islamic private equity funds.

With the introduction of new products and an increase in the volume of issues, Shariah-compliant investment is gaining popularity among other Shariah-compliant players in the market such as Islamic banks and takaful companies, which are achieving double-digit growth.

Pakistan's surging Shariah-compliant equity market opened a new chapter in the year 2008, with the introduction of Pakistan's first Shariah-compliant stock market index, the KMI 30 index (Karachi Stock Exchange Meezan Islamic 30 Index). It was a collaboration of the Karachi Stock Exchange (KSE) and Meezan Group (Meezan Bank Limited and Al Meezan Investment Management Limited). The index was formed to track the 30 most liquid Shariah compliant stocks listed on the Karachi Stock Exchange, based on a free-float market capitalisation methodology. KMI weights 30 companies that qualify the Shariah-screening criteria and by float-adjusted market capitalisation with a 12 % cap on weight of individual security. The index is re-composed twice a year.

The index uses the Shariah screening criteria for stocks developed and approved by the Shariah Supervisory board of Meezan Bank Limited, chaired by Justice (Retd.) Mufti Muhammad Taqi Usmani with other prominent scholars like Sheikh Esam Ishaq and Dr. Imran Usmani.

For any stock to be eligible for evaluation, it must pass all the six screening filters prescribed by the Shariah screening criteria, which are:

1. The core business of the investee company should be "halal" (permissible as per Shariah).

2. The interest-bearing debt of the investee company should be less than 37 % of the total assets of that company.

3. The investee company's non-compliant investments should be less than 33 % of its total assets.

4. The investee company's ratio of non-compliant income to total revenue should be less than 5%. The investors or investment agents on behalf of investors must ensure that any non-compliant income, less than 5 % earned, must be eliminated from the earnings so that the income is purified.

5. The investee company should have at least 25 % or more illiquid assets as compared to its total assets.

6. The net liquid assets per share of the investee company should be less than the market value of the share.

The companies, once screened on the basis of Shariah stock screening criteria, must pass through the technical screening criteria for the KMI 30 Index, which is:

A. The company which is on the Defaulters' Counter and/or its trading is suspended, declared Non-Tradable (i.e. NT) in preceding six months from the date of re-composition shall NOT be considered for inclusion in KMI-30 Index.

B. The company will be eligible for KMI-30 Index if its securities are available in the Central Depository System.

C. The company should have a formal listing history of at least two months on KSE.

D. The company must have an operational track record of at least one financial year.

E. The company should have minimum free-float shares of 5% of total outstanding shares.

F. The company will be eligible for KMI-30 Index if its securities are traded for 75% of the total trading days.

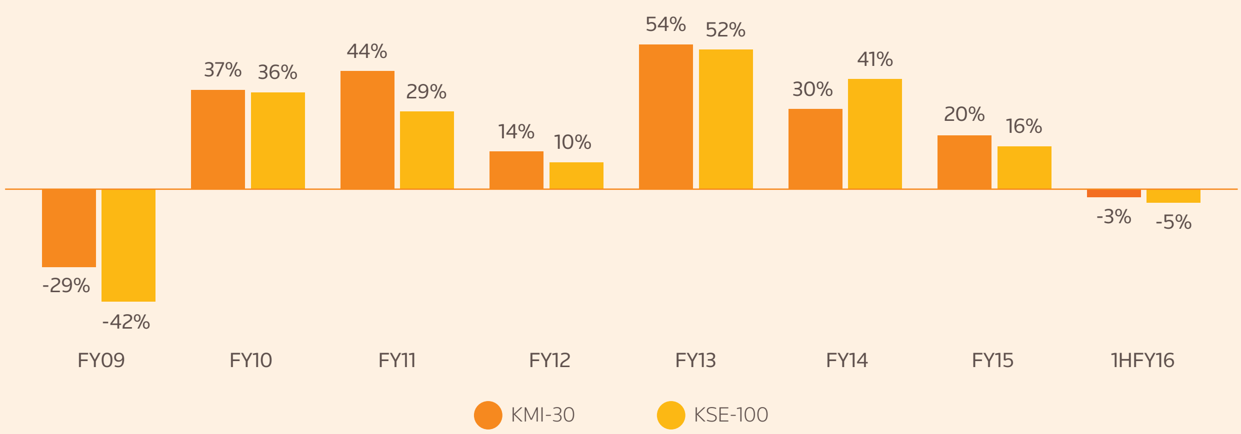
G. Mutual Funds (both Open-Ended and Closed-Ended) are ineligible for inclusion in the KMI-30 Index.

Once the companies are screened on the basis of this criterion, they are assigned the weightings on the basis of their free-float market capitalisation and impact costs. The top thirty companies make it to the index list until the next re-balancing. Since its inception in 2008, the KMI 30 has outperformed the KSE 100 index by a healthy margin, showing a gain of 270.45% against cumulative returns of 164.64 % by KSE 100 index.

Based on the tremendous success and performance of the KMI 30 Index, public demand increased for the development and launch of an All Islamic shares index.

The Steering Committee of the Government of Pakistan for the development of Islamic banking and finance has recently formed a sub-committee for the promotion of Islamic Capital Markets. At the first meeting of the sub-committee on March 6, 2014, it was decided to initiate the development of an All Share Islamic Index of Pakistan, comprising of all Shariah-compliant

COMPARISON OF INDICES



Courtesy: Al Meezan Research

companies listed on the Karachi Stock Exchange (KSE). The sub-committee decided to recommend to the Securities and Exchange Commission of Pakistan (SECP) to constitute a Technical Committee for the development of All Share Islamic Index of Pakistan which would include members from SECP, State Bank of Pakistan (SBP), KSE (now PSX), Meezan Bank Limited (MEBL) and Mutual Funds Association of Pakistan (MUFAP).

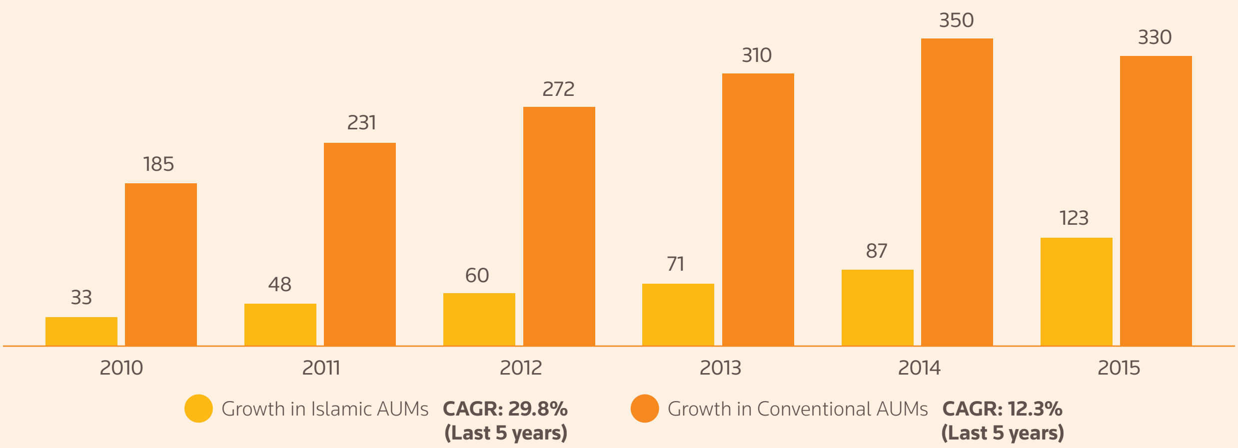
The principal objective of the All Share Islamic Index is to gauge the total performance of the Shariah-compliant segment of the equity market. Accordingly, it is important that all shares that meet the Shariah screening criteria should be included in the All Share Islamic Index in order to ensure completeness of the index, and its adherence to the core objective of the proposed All Share Islamic Index. However, it is also worth noting that many of the listed companies in Pakistan are closely held by sponsors, resulting in very small free floats. Such shares can be illiquid and carry a high risk of price distortion. In order to achieve the objective of the index, companies that do not meet the requirements of a minimum free float of 5% and at least 75% days with trading, should be disclosed as a separate category to inform the investors about the illiquid nature of these shares.

The technical committee for the development of All Share Islamic Index submitted its detailed recommendations, and on the basis of these recommendations, KSE and Meezan jointly launched the All Islamic Shares index in November 2015. As of April 2016, the index consists of 238 Shariah-compliant companies, which provides a great indicator for Shariah-conscious investors to choose from a wide range of investment options in one of the best performing stock exchanges in the world.

Another important segment in Pakistan's capital market, growing in the double-digits, is Islamic mutual funds. Pakistan's largest private sector mutual fund is an Islamic equity fund, and the huge demand of Islamic mutual funds has compelled all asset management companies in Pakistan to add a range of Shariah-compliant mutual funds in their range of product offerings.

The general acceptance of Shariah-compliant mutual funds in Pakistan is evident by comparing the growth trends of Islamic funds with their conventional counterparts. During the last five years, Islamic mutual funds' assets under management has shown a CAGR of 29.8%, compared to conventional mutual funds assets under management CAGR of 12.3%. The public acceptance of the Shariah compliance controls adopted and approved by religious scholars in Pakistan is a key factor in the Islamic financial sector's success. The industry enjoys a great mix of vastly diversified Islamic financial products, besides adopting a conservative yet practical approach to Shariah compliance in developing and launching these products. Shariah acceptance with some highly competitive returns makes Pakistan's capital market a great option for any Shariah Conscious investor.

GROWTH TREND (ISLAMIC VS CONVENTIONAL; PKR BN)



Courtesy: Al Meezan Research

Sukuk regulation at a glance

The Sukuk market in Pakistan is regulated by the Securities and Exchange Commission (SECP). The first draft of Sukuk regulations was introduced in 2012, although Sukuk issuances started in 2005. However, as the Sukuk market started gaining ground in the country, the need for updated regulation emerged in 2015. Under the new regulation, Sukuk must be structured in compliance with Accounting and Auditing Organisation of the Islamic Financial Institutions (AAOIFI) standards. In the new regulation, the SECP has mandated that investment agents issuing and selling Sukuk must safeguard the interest of the Sukuk buyers in addition to their clients.

Furthermore, for Sukuk issuance eligibility, the issuer must have a rating of at least BBB- and the instrument should not rate lower than BBB, as determined by a credit rating company registered with the SCEP. The issuer must also arrange the appropriate security, where and when required, in a form that is acceptable by the investment agent. One of the challenges facing the Pakistan Sukuk industry is the reform of tax rules. Currently, wholly-owned special purpose vehicles (SPVs) backing Sukuk issues are still subject to stamp duty tax and the capital value tax, which make Sukuk more costly.

Children play on a boat-shaped swing at sunset in Islamabad. REUTERS/Zohra Bensemra

SUKUK MARKET OVERVIEW AND PERFORMANCE

Where is the Sukuk Market Heading in Pakistan?

The volume of Sukuk issuance in Pakistan has been volatile in the past five years. The industry witnessed a high net value of Sukuk issued in 2011, at US$1.9 billion, before declining to the lowest value ever in 2015 with only a single issuance worth US$216 million. Despite the volatility in the issuance, Sukuk has been instrumental for funding large-scale public and private projects and for investor liquidity management. The government made its debut through an international Sukuk issuance worth of US$600 million in 2005.

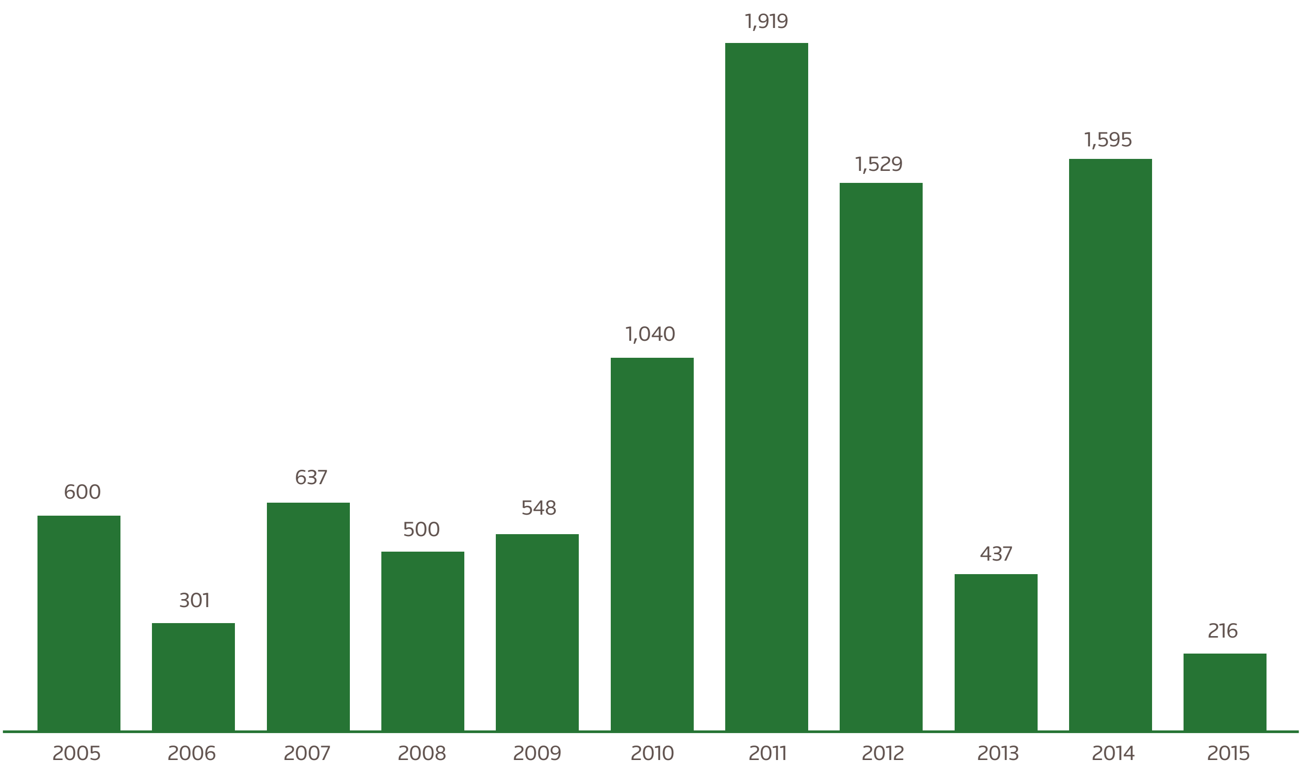
The Introduction of OMOs

One of the main challenges facing Islamic financial institutions, which invest regularly in Sukuk for liquidity management, is the short terms of sovereign issuances, which usually do not exceed three years. An innovative solution emerged in October 2014 when the SBP began making Shariah-compliant open market operations with ijarah Sukuk.

The SBP began auctioning ijarah Sukuk six years earlier, in 2008. This was a novel instrument in the Sukuk market, offering Islamic financial institutions for the first time an opportunity to deploy their excess Pakistan Rupee funds in zero-risk, government Sukuk.

With the launch of open market operations, the SBP now sells ijarah Sukuk to absorb excess liquidity in the market and purchases these Sukuk from Islamic financial institutions to inject short-term liquidity as the market demands. These Sukuk operations provide a number of benefits

PAKISTAN SUKUK ISSUANCE (2005–2015; US$ MN)



Source: Thomson Reuters Zawya

to the financial markets apart from liquidity management. They will also improve the transmission of monetary policy indicators from Islamic financial institutions to the capital markets, which will be essential to improving macroeconomic management as the Islamic finance sector grows.

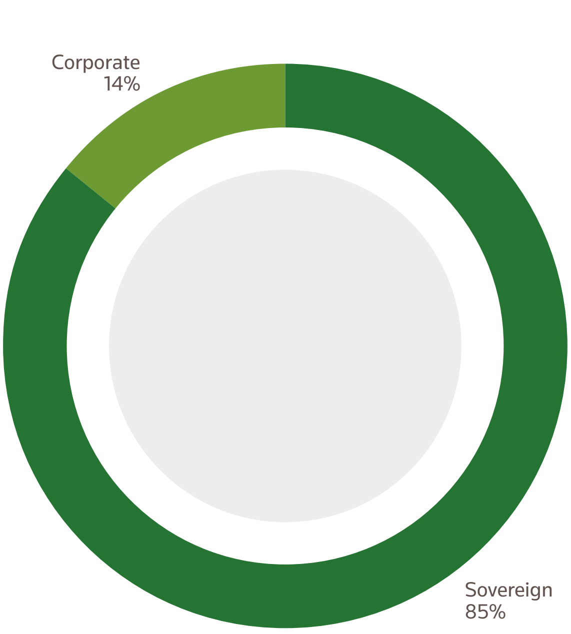
A Small Yet Active Corporate Market

The Pakistani Sukuk market is no different than other countries in terms of the involvement of the government and private issuers. By the end of 2015, 86% of all Sukuk had been issued by the government and just 14% by the private sector. In most countries, investors and issuers have relied on governments to activate the Sukuk industry, creating investment and liquidity management opportunities, particularly given the limited Shariah-compliant investments available to Islamic banks. The latest international government Sukuk, issued in 2014, raised a notable US$1 billion from international investors. The Shariah-compliant issue also helped raise Pakistan's foreign currency reserves from US$8.5 billion at the time of the issue to US$13 billion by June 2015, a goal set by the International Monetary Fund (IMF). Foreign currency reserves by the end of 2015 stood at US$15.4 billion.

There is no doubt that this international Sukuk issue occurred at an opportune time to restore international investors' confidence in Pakistan, which was shaken following an unsuccessful attempt by the government to sell 10% of its share in the Oil and Gas Development Company. The sale attempt was part of government's ambitious to boost privatisation, in addition to its commitment of reforms to the IMF, however due to lack of interest by investors, the deal was not completed.

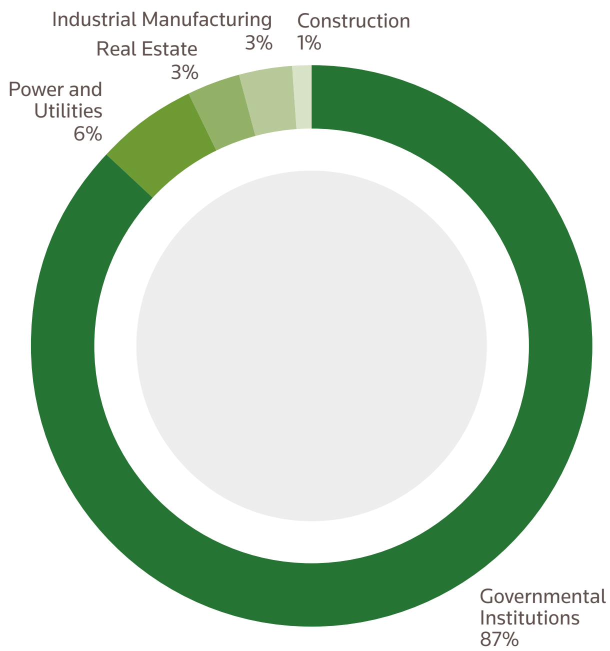
The details of the 2014 international Sukuk issue show that the government was able attract a better price compared to the US$2 billion international bond that was issued in October 2014. Because of the existence of an underlying asset, certain Sukuk are better secured and as a result, issuers may obtain a lower profit rate. The 2014 international Sukuk was issued with a five-year tenor at a profit rate of 6.75%, compared to 7.25% profit rate for the conventional bond. While the

SUKUK BREAKDOWN BY ISSUER TYPE (2005–2016)



Source: Thomson Reuters Zawya

TOP 5 SUKUK ISSUANCE SECTORS



Source: Thomson Reuters Zawya

profit rate of 6.75% is significantly below the profit rate offered in the local market of 11%, it should be noted that in the event of currency depreciation, the transaction could become more expensive.

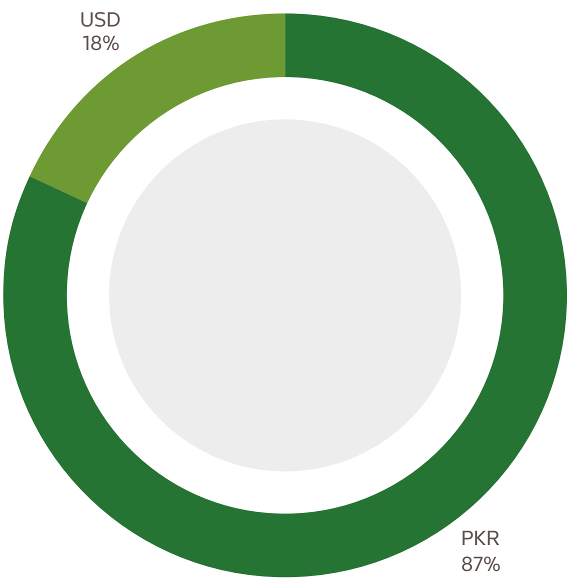
While the number of Sukuk issues by corporations outpaces the government only 45 to 20, according to Thomson Reuters Zawya data, the Sukuk market share for corporate issues remains very low by value, although it is slowly expanding. As a matter of fact, the sole Sukuk issuance in 2015 was by a corporation, K-Wlectric, a name that has been appearing more frequently in the Pakistani Sukuk market. The power and utilities sector is quite active in the Sukuk market and issued approximately US$500 million in total in the past decade. In fact, the power and utilities companies can capitalise well on Sukuk given their matching characteristics, these include: 1) power companies are large and they engage in large-scale construction projects; 2) power plants and transmission equipment are real fixed assets to back their Sukuk, and 3) the long-term nature of power infrastructure is suitable for longer maturities, which investors looking for liquidity management instruments demand.

However, increasing the market share of corporate Sukuk issuance remains a challenge faced in most countries as generally corporations are not be big enough to tap into the Sukuk market. Moreover, they struggle to identify the appropriate security to back their Sukuk.

82% of Pakistan Sukuk Issued in PKR

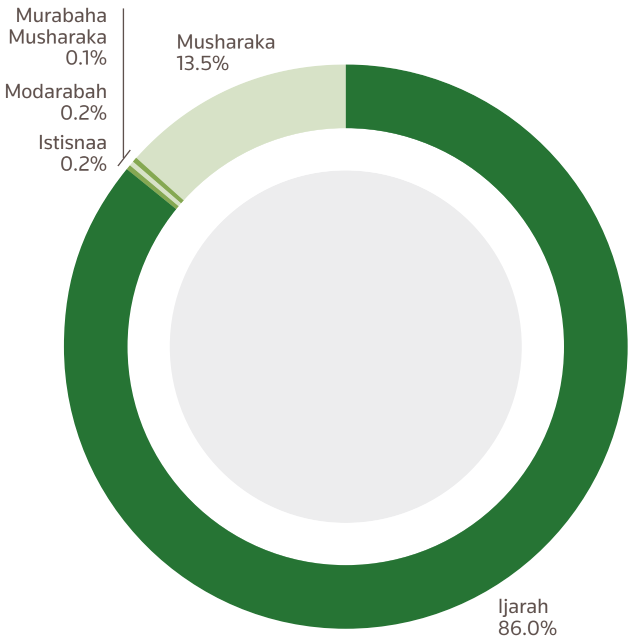
Sukuk in Pakistan is principally issued for the local market, with 82% of the Sukuk issued in rupees. There have only been three international Sukuk issues, of which two were made by the government of Pakistan in 2005 and 2014, and the other by Lahore SunCity Holding Ltd. However, the value of these three dollar-denominated Sukuk issues stood at 18% of all historic issues. It is very likely that the international Sukuk will expand further due to the strengthening PKR against the dollar is recent years, in addition to the objectives of the government to maintain its foreign currency reserve at US$13 billion. Apart from PKR and USD, no Sukuk was issued in other currencies.

SUKUK CURRENCY OF ISSUE (PKR VS USD)



Source: Thomson Reuters Zawya

SUKUK ISSUANCE STRUCTURE



Source: Thomson Reuters Zawya

Innovation through Ijarah Sukuk

An 86% share by value of total Sukuk issued have been structured as ijarah, a structure Islamic finance experts prefer around the world, and especially in the MENA region. The use of ijarah has been a growing trend in Sukuk for nearly a decade, especially for countries that follow AAOIFI standards. While AAOIFI standards permit the issue of Sukuk with debt-based structures such as murabahah, they prohibit the trade of such Sukuk. It is likely that ijarah Sukuk will continue growing, given their easy tradability.

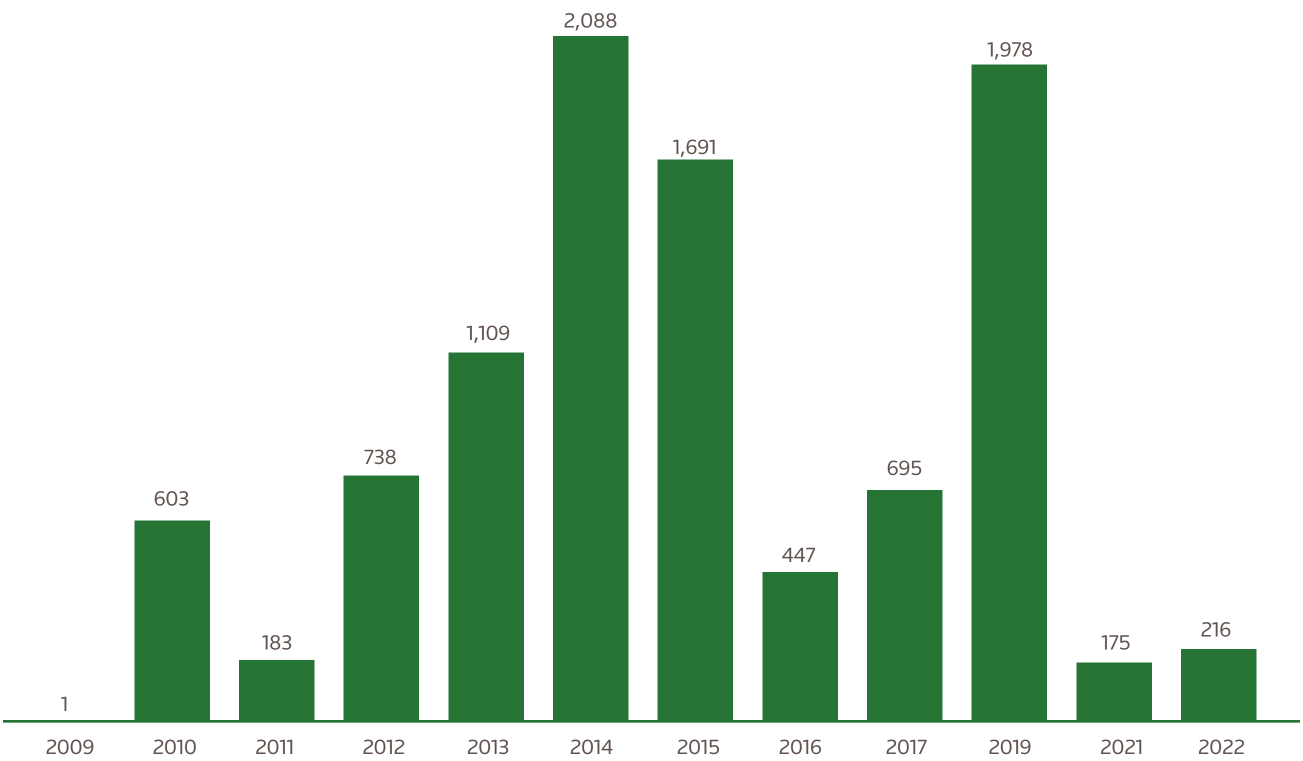
Pakistan has seen the innovative structuring of Sukuk issues compared to other markets, especially in the GCC. One of the innovative structures that have redefined the Pakistani landscape is the airtime Sukuk arranged by Meezan bank for Pakistan mobile communication in 2014, raising as much as Rs 6.9 billion (US$65 million). This issue was based on ijarah and sub-ijarah of services, with minutes being the underlying assets representing prepaid calling cards and indentified by the serial number of each card. The airtime Sukuk is not completely new to the global sukuk markets; Malaysian mobile phone operator Axiata Group issued such a Sukuk in 2012.

Another innovative structure was the introduction of the short-term Sukuk based on Shirkatul Aqd (a partnership based on profit and loss sharing) for power and utilities companies. Initially, the structure was developed for Kot Addu Power Company (KAPCO) by Meezan Bank Limited in 2011. The structure has gained ground among companies in the power and utilities sector, as it is suitable to meet their short-term working capital requirements for purchasing fuel for power generation.

Sukuk Issues Expected to Revive and Cover Market Shortages

One of the challenges facing today's Islamic capital market players is the decline in Sukuk issuance and the looming maturity of outstanding

SUKUK MATURITY PROFILE (US$ MN)



Source: Thomson Reuters Zawya

Sukuk. Simply put, there are not enough Sukuk in the market for Shariah-compliant investors to fill their books. By the end of 2019, US$3.1 billion will mature, which represents 88.9% of the total outstanding Sukuk in the market.

The concern over the availability of Sukuk has increased after US$2.1 billion and US$1.6 billion in Sukuk were redeemed in 2014 and 2015 respectively. With the growth of Shariah-compliant institutions, new Sukuk issues are crucial for placing their excess funds and for generating income. The government is well aware of the situation. In early 2016, the SBP auctioned US$955 million, and it plans to expand PKR Sukuk sales by auctioning another US$955 million later in the year. The first Sukuk issued in 2016 had a fixed rental rate, which will be paid on semi-annual basis, compared to the variable rental rate it has used since it began Sukuk sales in 2008. The introduction of the fixed rental rate could hedge against further increase in global interest rates as was performed by the Federal Reserve. Should the second Sukuk take place, the two Sukuk issues would exceed the total value of Sukuk issued by the central bank in the previous three years.

RETAIL SUKUK PERFORMANCE

Retail Sukuk: An Effective Way to Increase Financial Inclusion

The retail Sukuk sector remains untapped globally. The development of this sector has the potential to further promote both the primary and secondary capital markets in any country. Pakistan is relatively ahead of other countries in terms of issuing retail Sukuk, following some successful corporate retail issuances. Retail Sukuk would generally benefit both issuers and investors. The issuers are able to obtain slightly cheaper rates, as the interest rates offered to the retail can be lower than what is offered to institutional investors. Given the limited investments available to retail investors in Islamic finance apart from fixed deposits, they should be eager to move to instruments with rates higher than these deposits.

Capitalising on its huge Muslim population, Indonesia was first issue Sukuk argeted specifically at retail investors in 2009 with an IDR 5.5 billion issue from the government. Since then, the government has issued one retail Sukuk issue every year, with the latest in February 2016. Retail Sukuk have also been issued in Malaysia and Bahrain. They provide an investment avenue for the low- and middle-classes seeking better returns from other than savings accounts and fixed-return deposits.

Without a doubt, adding retail investors to the financial will increase financial inclusion and spread awareness among the people. Diversification of the investor base is another motivation that governments have cited for issuing retail Sukuk.

In one downside, however, retail Sukuk divert available funds from bank deposits, which could restrict the growth of Islamic banks or increase their financing-to-deposit ratio. Historically, this effect has been limited based on the experience of some the countries that have issued retail Sukuk, since the subscription volume for retail investors is typically small and affordable. Sukuk rather permit retail investors to diversify their savings.

Retail Sukuk is often considered a more secure investment opportunity for retail consumers when compared to traditional Islamic bank deposits. An Islamic bank deposit is an unsecured obligation of a bank. If a restricted Mudarabah structure is applied, the deposit would be even further unsecured, given the restrictions involved. In this case, an investor, as the rab-ul-mal, would depend on the performance of the borrowers who receive financing from the bank, while remaining at risk to loss of principal. A government retail Sukuk removes, or at worst limits, the risk of loss of the principal amount. However, the only downside to retail Sukuk is the possibility of a loss in value received at maturity because of currency devaluation.

INFRASTRUCTURE SUKUK PERFORMANCE

Infrastructure Sukuk between concept and reality

Pakistan is at the cutting edge in developing Sukuk as vehicles for financing infrastructure projects. A number of projects have been successfully financed using sukuk by both the government agencies, such as the Pakistan Water and Power Development Authority (WAPDA), and by corporations like K-Electric.

Conceptually, Sukuk is the ideal method of financing infrastructure projects, as it is closely tied to the 'real assets' in their structure and it embeds the risk sharing features at the heart of Islamic finance. However, in reality, there are some factors that limit the applicability of Sukuk, especially in projects involving public-private partnerships. Many heavily leveraged projects also violate limits and guidelines against this risk in Islamic finance.

Some limitations:

- The biggest limitation is that some of the large infrastructure projects like stadiums or railways needing finance require five to ten years for completion. Under AAOIFI standards, Sukuk do not become tradeable until after the asset or project under construction is more than 50 % completed. This presents potential investors with less portfolio flexibility and higher risk than in shorter-term issues. In the past years, infrastructure projects were partially or fully undertaken by sovereign states, so this issue was irrelevant.
- Unlike conventional heavily leveraged projects, conceptually, Islamic finance is supposed to avoid leveraged projects. A hypothetical example of US$2 billion infrastructure project could have US$945 million in equity contribution, plus land worth of US$300 million set aside for a sale-and-lease back transaction combined with a US$300 million through sukuk, then raise US$455 million in Islamic syndication bank loan. While these vehicles are all technically Shariah-compliant, the end result is a project where the equity is drastically leveraged.
- Project risk is also inequitably shared within project transactions as finance structures give priority to sukuk holders and Islamic syndicated loans that is not proportionate to the outcome of the project.

Modarabas and the non-bank financial sector

OVERVIEW

An association bridging non-banking financial institutions (NBFI) and Modaraba companies was originally formed in July 2010 after the merger of Modaraba Association of Pakistan (MAP) and Leasing Association of Pakistan (LAP). The sector is regulated by the SECP, which has also been supporting the industry in terms of sustainability and development. These three types of companies are currently united under the umbrella of the NBFI and Modaraba Association. The number of such companies by the end 2014 was 35, which includes 22 Modarabas, 10 leasing companies and 3 investment banks.

In order to re-establish the Modarabas as one the key channels of Islamic financing, it is necessary to increase the number of Modaraba companies. The association, as declared in its founding memorandum is constantly striving to widen its scope. It has laid out the possible inclusion of other types of companies such as housing finance, investment advisory services, discounting services, private equity/venture capital, REITs and other businesses as permitted activities for the members of the association.

These companies, despite of their small number, play a major role in the country's Islamic capital markets. The companies combined provide over Rs 41.8 billion (approximately US$400 million) in financing to different sectors, compared to the financing of billions of dollars by commercial banks. The NBFI and Modarabas have focused disproportionately on sectors that are not the primary focus of the commercial banks such as small and medium enterprises (SMEs).

HISTORY OF MODARABA COMPANIES AND PERFORMANCE

The Modaraba companies represent one of the main branches of the Islamic finance industry in Pakistan because of their historical importance, as they have been in operation for more than 30 years. The first Modaraba company was founded in July 1980. The industry grew slowly while the finance and banking industries underwent extensive restructuring towards interest-free operations. By 1990, there were only five Modaraba companies. In the next five years alone, however, the number of Modaraba companies increased substantially from 5 to 56, the peak in their history. This fast growing period for Modarabas represented fresh interest in an Islamic mode of financing, as commercial banks stumbled during the regulatory situation before interest-based financial operations became active once more in the 2000s. The Modaraba companies played an important role in building the confidence amongst the public about the practice of Islamic financing.

The product development for Modaraba companies went from three basic structures— ijarah, murabahah and musharakah—to 12 structures by 2008 to assist the investors in financing different projects as some of them required more structured instruments. The new structures were introduced with the joint efforts of the NBFI and Modaraba Association and the SECP, which were approved by its Shariah supervisory board in the same year.

The Modaraba sector has unfortunately become associated with the unethical practices of some Modaraba managers, who fled the country with millions of dollars of investors' funds. These practices shook the confidence of investors and damaged the industry's reputation, although the remaining players have improved the sector's image of late.

ROLES OF THE MUDARIB

1. Ameen

The money and the assets belong to the Rab-ul-Mal and the Mudarib holds them as trustee.

2. Wakeel

The Mudarib acts as agent while purchasing goods for trade in the business of Modaraba.

3. Shareek

In case the Modaraba earns profit, the Mudarib takes his share as partner and assumes the role of Shareek.

4. Zamin (liable)

The Mudarib is also a Zamin to the Modaraba and if the Modaraba business suffers a loss due to negligence of the Mudarib, he is liable to compensate the loss to the business.

5. Ajeer (employee)

When he acts against the charter of the Modaraba business and the Rab-ul-Mal terminates the Modaraba, the role of Mudarib changes into employee and till the date he works for disposal of assets of the business he is entitled to salary for his work as Ajeer.

Steady performance in the past five years

In the past five years, the Modaraba sector has been posting positive returns, despite a drop in number of total companies. The sector witnessed a compound annual growth rate (CAGR) in profits of 14.6% from 2010 to 2014, but this was still below the CAGR of commercial banks, 21.1% over the same period. The commercial banks posted a massive growth from Rs 63 billion in 2011 to Rs 163 billion in 2014. The only year the Modaraba sector posted a loss of US$1.51 million was in 2009, during the global financial crisis.

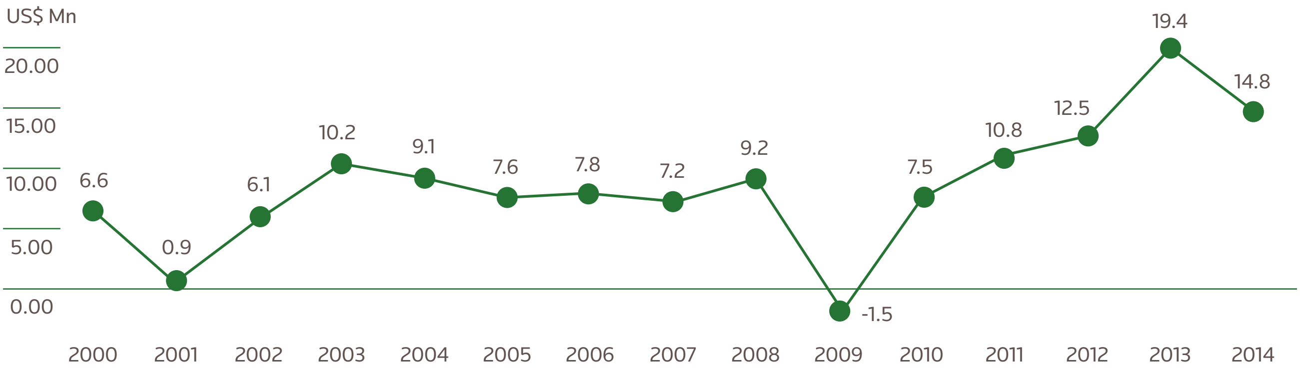
The industry's best recent year was 2013, a positive sign that the sector is gradually shedding the unethical image from which it previously suffered. For the fiscal year ending June 30, 2013, the Modaraba sector announced profits of Rs 2.04 billion (US$19.44 million) signifying a muscular growth of 55% from the year before of Rs 1.31 billion (US$12.53 million). Of 22 Modarabas currently in business, 20 announced a profit, 14 declared cash dividends in the range of 1.5% to 50% and one company declared bonus issues for its investors.

A Quasi-Monopoly Market

One of the challenges facing the industry is the concentration of market share by a few larger financial corporations, which is becoming a barrier to entry for new players. Interestingly, the top three companies—Standard Chartered Modaraba, First Habib Modaraba, and Allied Rental Modaraba—that manage 56% of total industry assets. The concentration by these companies put the industry in a quasi-monopoly environment that has in return reduced the number of Modaraba companies over the years. The top three companies have large corporate affiliates, and smaller companies have difficulty competing on that scale.

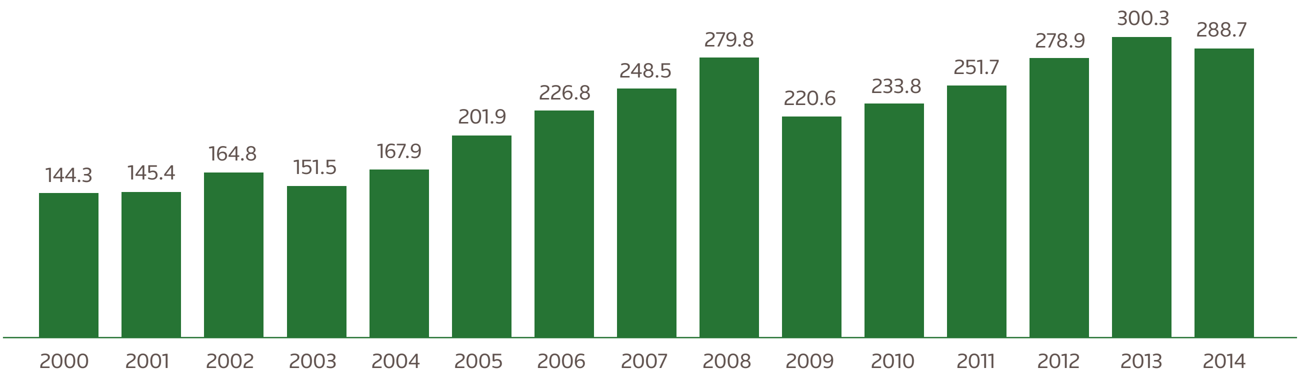
The three top companies outperform the rest of industry in all three categories. Out of the US$14.8 million, US$10.7 million came straight from the top three companies, which means, apart from these three companies, the industry is fairly small and barely profitable. Similarly, total assets and total equities of the top three companies outstrip the industry.

MODARABA SECTOR PROFIT AND LOSS (2000–2014)



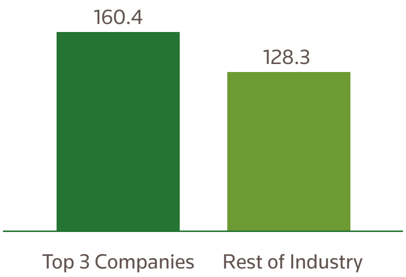
Source: NBFI & Modaraba Association of Pakistan

MODARABA SECTOR TOTAL ASSETS (2000–2014; US$ MN)

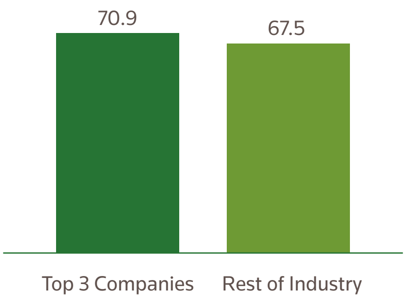


Source: NBFI & Modaraba Association of Pakistan

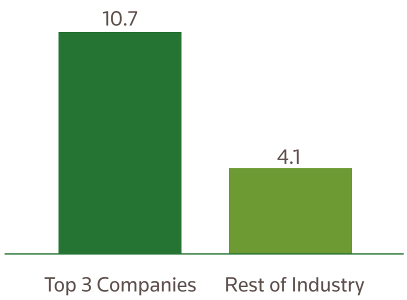
TOTAL ASSETS COMPARISON TOP 3 COMPANIES VS. THE INDUSTRY (US$ MN)



TOTAL EQUITY COMPARISON TOP 3 COMPANIES VS. THE INDUSTRY (US$ MN)



PROFIT AND LOSS COMPARISON TOP 3 COMPANIES VS. THE INDUSTRY (US$ MN)



Source: NBFI & Modaraba Association of Pakistan

NBFI SECTOR OF PAKISTAN

Muhammad Shoaib Ibrahim | Managing Director & CEO, First Habib Modaraba

MR. SHOAIB is the CEO and Managing Director of First Habib Modaraba (FHM). At present. Mr. Shoaib holds a Master of Business Administration (MBA) in banking and finance from the Institute of Business Administration (IBA). He has also completed a Post Graduate Diploma (PGD) in Islamic Banking from the Centre of Islamic Economics (Darul Ulum), Karachi Pakistan. He has presented research papers on the Modaraba model and other Islamic financial products at different international forums in Malaysia, Singapore, Hong Kong and South Africa. On number of occasions he served as Executive Member of the NBFI & Modaraba Association of Pakistan. Last year, he was Chairman of the association.

Non-banking financial institutions (NBFIs) play a vital role in broadening access to financial services, and they extend support around the globe to the banking system. They enhance the efficiency of investments and savings and also give support to broaden the base of the financial markets. A strong NBFI sector not only offers diversified range of asset classes to investors, but it also provides alternative fundraising opportunities to the participants of the financial system and assists in growing the capital and debt markets. Globally, NBFIs have gained a prominent position within the financial market as a very vibrant segment of the economy.

Normally NBFIs run in parallel to traditional deposit taking commercial banks, and they supplement banks in providing financial services to individuals and firms. They complement the role of commercial banks by filling gaps in their range of services. Simultaneously, this segment also competes with commercial banks and forces them to be more efficient and responsive to the needs of their customers. Most NBFIs are also actively involved in the securities markets and in the mobilization and allocation of long-term financial resources, which greatly supports the development of debt and capital market of the country. The state of development of NBFIs is usually a good indicator of development of financial system of the country.

The regulatory framework of the NBFI sector is also a critical factor for the sound performance of this segment on a long term and sustainable basis. In the recent global financial turmoil, a few segments of NBFIs were not properly monitored, and they were the main cause of the financial crisis. The world financial industry learned that weaknesses in NBFI regulation can fuel a credit bubble and asset overpricing, which was not sustainable. It was followed by collapse in prices and widespread credit defaults.

In Pakistan, the NBFIs sector does not hold a very large share within the financial sector compared to the size of commercial banks. Dependence on the banking sector makes our financial system vulnerable to risks through lack of diversification, and it also restricts the scope of product innovation. Keeping in view the recent change in global financial conditions, it is now imperative that Pakistan further strengthen the risk management capacities of the sector and provide a complete range of products and services to cater to the need of prospective customers with product diversification and innovation.

The NBFI Sector of Pakistan includes non-banking finance companies (NBFCs) and Modaraba companies managing Modarabas. The NBFCs include investment finance companies, leasing companies, housing finance companies, asset management companies (managing mutual funds, pension funds and also providing investment advisory services), fund management companies providing private equity and venture capital fund management services, REIT management companies managing REIT funds.

The NBFCs can be broadly divided into two categories, i.e., lending NBFCs (engaged in the business of deposit taking and financing) and fund management NBFCs.

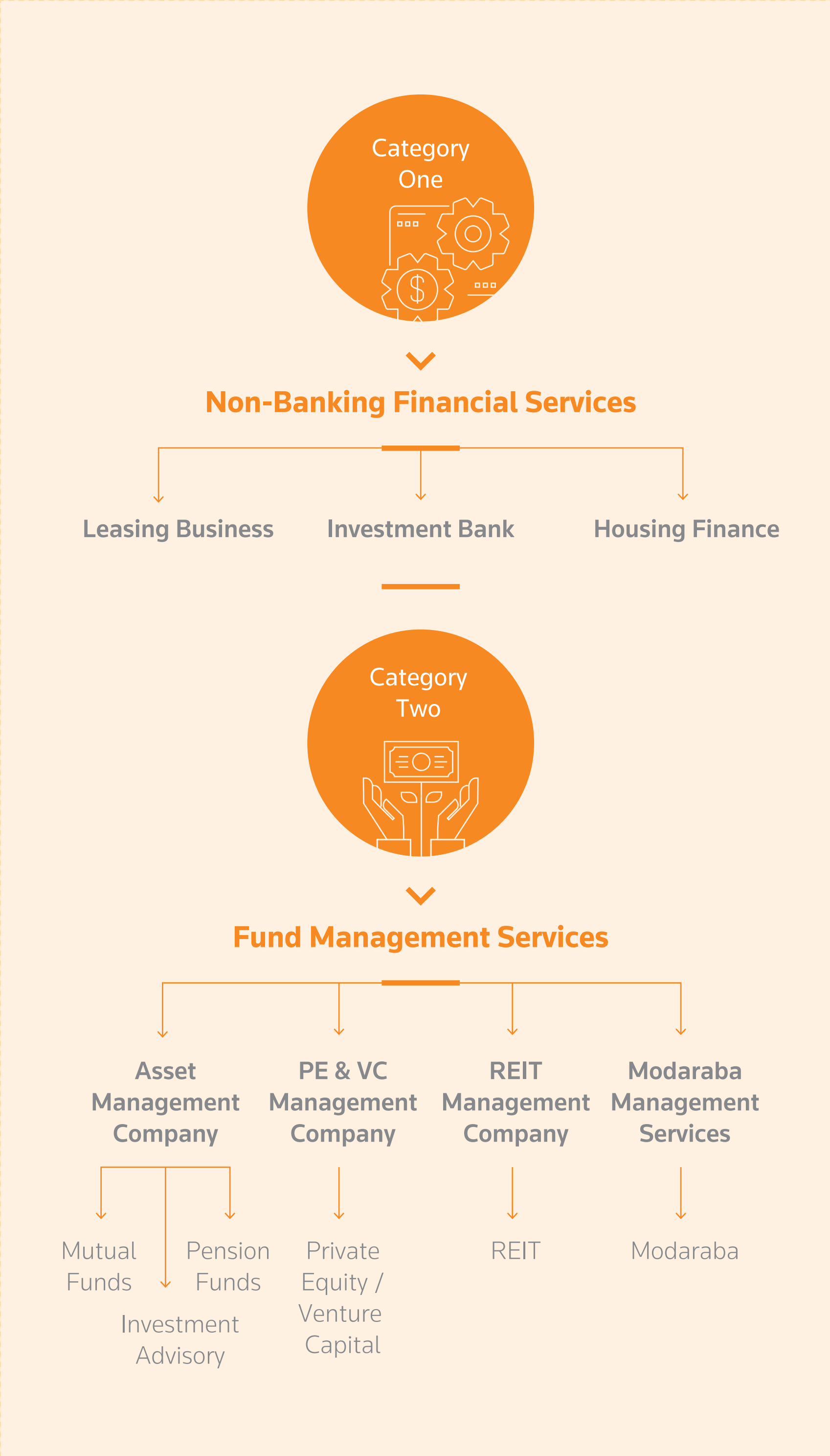
According to annual report of SECP, the total asset size of NBF sector as of June 30, 2015 was Rs. 797 billion. Details of which are as follows:

Financial Services or Lending NBFCs

According to the SECP, the net asset value held by lending NBFCs continued their upward trend for a second year in a row. Numbers of lending NBFCs such as leasing companies, investment banks, housing finance and Modarabas also increased. This jump is attributable to an increase in the asset size of leasing companies which increased by around Rs 4 billion from Rs 36 billion as of June 30, 2014 to Rs 40 billion as of June 30, 2015.

A New Entrant: The Real Estate Investment Trust (REIT)

Pakistan's first Shariah-compliant REIT was successfully launched in Pakistan last year, when Dolmen City REIT completed its initial public offering of Rs 4.16 billion to fund the Dolmen Mall Clifton on the Karachi



NON-BANKING FINANCIAL SECTOR (IN BILLION RUPEES)

Sector	No. of entities	Total assets	As % of total assets
Asset management companies (23) and investment advisors	26	31	4%
Mutual Funds	172	492	62%
Discretionary/non-discretionary portfolio under management	–	96	12%
Pension funds	17	14	2%
REIT management companies	3	–	0%
REIT funds	1	22	3%
Investment finance companies	8	71	9%
Leasing Companies	9	40	5%
Modarabas	25	31	4%
Total	**261**	**797**	**100%**

Source: SECP Annual Report 2015

seafront, which was well received and oversubscribed. Through this issue, Pakistan has now become the first country in South Asia to launch an Islamic REIT scheme. The public offering included units marketed to retail investors as well as to institutional investors. The high success of said REIT model has set a strong precedent for the future growth of REIT funds in Pakistan's market. This will not only encourage savings and broader investment prospects for small investors, but also improve the quality of real estate in Pakistan.

According to SECP, three REIT management companies (RMCs) have been licensed to carry out REIT management services in Pakistan.

The Modaraba Sector

Modarabas are playing a significant role for the promotion of Islamic finance in Pakistan. The concept of Modaraba as a separate incorporated fund was introduced in early 1980s as the first Islamic Shariah-compliant financial model with a statutory framework and regulations. The Modaraba business model remains extremely versatile and dynamic. Under this concept, any business venture complying with the principles of Islamic Shariah can be floated, which can be for one specific purpose or many purposes. The Modaraba concept is derived from the Islamic traditions of trade and finance. Pakistan is the first among Muslim countries that converted the concept of Modaraba as a financing mode into a stand-alone entity.

Over the years, Modarabas have emerged as major sector within the segment of non-banking financial institutions. It is a viable

LEGAL STRUCTURE IN PAKISTAN

Modaraba Management Company

A company incorporated under the companies Ordinance, 1984

MODARABA

A legal entity - a unique model all over the world - two tier system

Listing Mandatory

Business to be undertaken is to be cleared by Religious Board

- Multi-Purpose
- Specific Purpose
- Fixed Period
- Indefinite Period

and dependable source of medium-term financing which also offer opportunity to investors to earn riba-free income. At present, the Modaraba sector is performing well, and it is now poised for faster growth with an improved regulatory and monitoring framework.

During the year 2014-15, the Modaraba sector booked a profit of Rs 1.4 billion. Its net assets held were Rs 30.7 billion and its total equity was Rs 15.9 billion. Modarabas' declared cash dividend to its certificate holders ranged between 0.9% and 90% and the payout was Rs 1.05 billion.

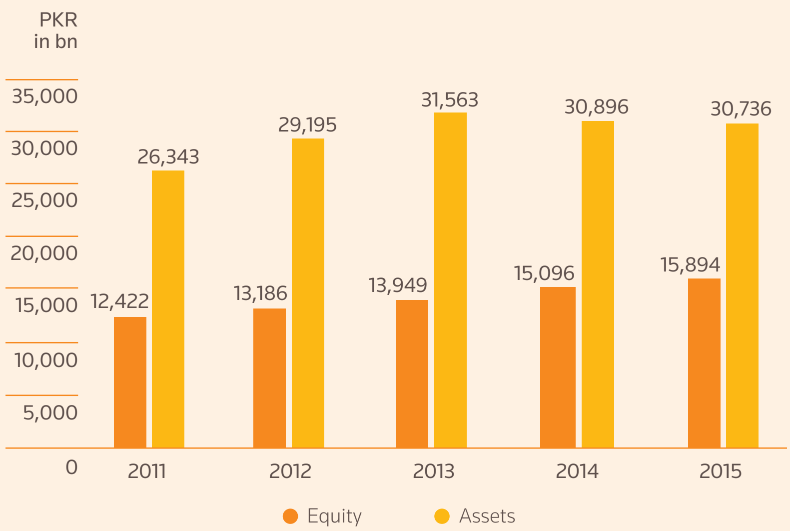
The market perception and investors' opinions of Modarabas have also improved. The market capitalization of Modarabas has increased from Rs 4.6 billion in 2010 to Rs 14.4 billion in January 2016.

Besides financial success, a few institutions in the modaraba sector have received awards and recognitions from different prestigious association and forums, such as:

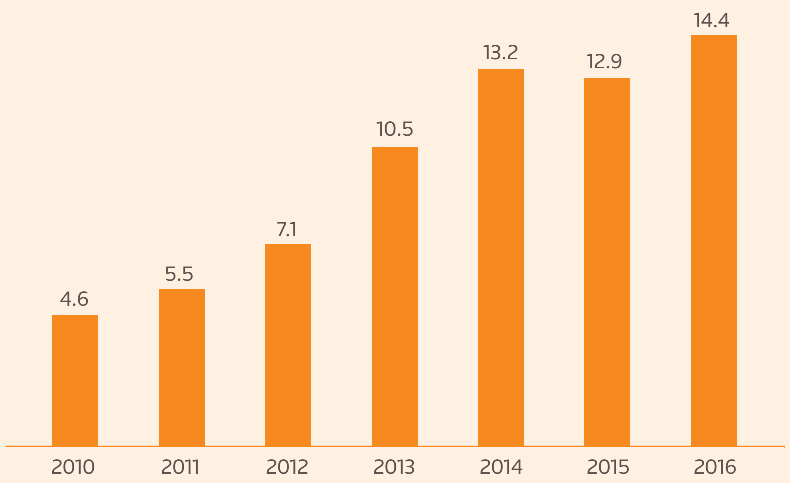
By First Habib Modaraba:

- The best report award from ICAP
- The Corporate Excellence Award from
- The best presented account award from SAFA an apex body of SAARC
- The FPCCI project achievement award
- The best performance award from NBFI and Modaraba Association of Pakistan

MODARABA SECTOR – EQUITY AND ASSETS GROWTH (PKR IN BILLION)



MODARABA SECTOR – MARKET CAPITALIZATION (PKR IN BILLION)



By Standard Chartered:

- The Corporate Excellence Award from Modaraba
- The best performance award from NBFI and Modaraba Association of Pakistan

By Allied Rental Modaraba:

- The Corporate Excellence Award from
- The FPCCI project achievement award
- The best performance award from NBFI and Modaraba Association of Pakistan.

Within the sector, First Habib Modaraba and Standard Chartered Modaraba enjoy credit ratings of AA+ and A1+ for long-term and short-term respectively, which demonstrates the strong financial and soundness of the sector.

Issues and Challenges in the Modaraba sector

- Undercapitalization and unavailability of low-cost funds
- Shortage of Islamic finance professionals
- Concentration in large cities
- A low Modaraba company management fee (10% of the

profit of Modarabas is the maximum by law)

- A shortage of new Islamic financial products, particularly resource mobilization
- Lack of product development and innovation
- A reluctance to spend on marketing of products, research and development
- Modaraba laws does not permit private or unlisted Modaraba

Future Prospects of the Modaraba Sector

Islamic banking and finance in Pakistan has witnessed significant growth during the last decade and now constitutes around 12% of the country's banking system. However, a huge potential market for Islamic finance is still untapped in Pakistan. Along with other Islamic finance institutions, the Modaraba sector has immense potential for future growth.

The corporate Modaraba model in Pakistan is a unique form business in the world. It provides an opportunity of Halal business operation and investment to the general public and with skilled managers. It can carry out a universe of Shariah-compliant businesses encompassing financial products and services, local and international trading, manufacturing, distribution and various corporate functions under one umbrella and one license. Recently, two new Modaraba companies started their operations, and we foresee a significant number of new entrants in the sector.

The SECP, under new leadership, has become very active in the promotion of Islamic finance in the non-bank financial markets. Recently, the SECP has established the Islamic Finance Department, which is also a great move by the regulator and this will further boost the promotion of Islamic finance ventures under its supervision. It is expected that with the dynamic approach of the regulator to address issues in the competitive environment. There is no doubt that Modarabas will definitely set new milestones in coming years.

Recently, the SECP has introduced major amendments to the regulatory framework to encourage small and mid-sized lending NBFCs. The new regulation will allow non-deposit taking entities to start businesses with a minimum equity of Rs 50 million.

The SECP is constantly striving to further strengthen and promote NBFI and Modaraba sector of Pakistan. The existing companies other than NBFCs have been allowed to apply for licenses to carry out lending activities subject to prescribed eligibility criteria. Further, a new class of NBFC, non-bank microfinance companies, has been introduced, which will enable the commission to regulate non-bank micro finance institutions.

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DURING THE YEAR 2014-15, THE MODARABA SECTOR BOOKED A PROFIT OF RS 1.4 BILLION. ITS NET ASSETS HELD WERE RS 30.7 BILLION AND ITS TOTAL EQUITY WAS RS 15.9 BILLION.

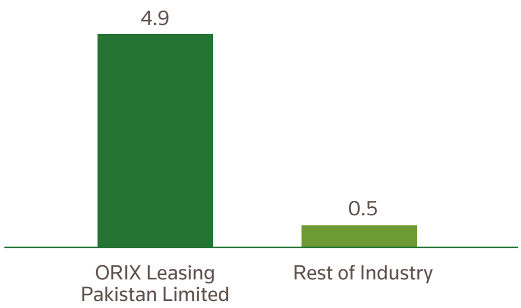
LEASING COMPANIES PERFORMANCE

A One-Man Show

Like Modarabas, Shariah-compliant leasing companies are another type of non-bank secondary lender in the market. Despite their past and potential growth, the companies remain inadequate in terms of earnings and leverage when compared to commercial banks.

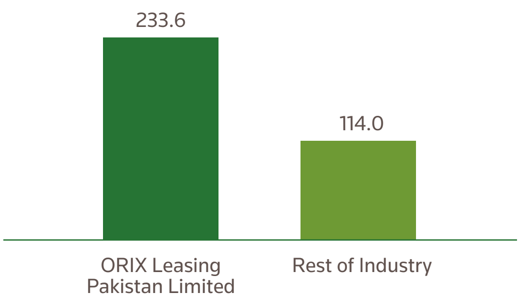
The year-end results of the leasing industry shows that performance of majority of the companies is deteriorating. At a glance, the industry's net profit has increased from US$4.6 million in 2013 to US$5.5 million in 2014. However, US$4.9 million came from a single company, ORIX Leasing Pakistan Limited, leaving the industry with a profit of just US$0.5 million (2013: US$1.4 million). The weak performance of majority of the other nine companies put the industry in a critical position and possibly in decline. The industry is faced by liquidity constraints, a monopolistic market creating a high barrier to entry, and a lack of innovative products. New entrants also confront the capital requirement, which initially was Rs 50 million, then was revised to Rs 100 million in 1992. The capital base was further increased to Rs 200 million in 2001, which made it challenging for some companies to increase their capital at the time. While on the positive side, the investment climate in the country has improved recently, which could potentially help the leasing companies bring these specialised services to appropriate industries and clients.

PROFIT AND LOSS COMPARISON ORIX LEASING VS. THE INDUSTRY AS OF 2014 (US$ MN)



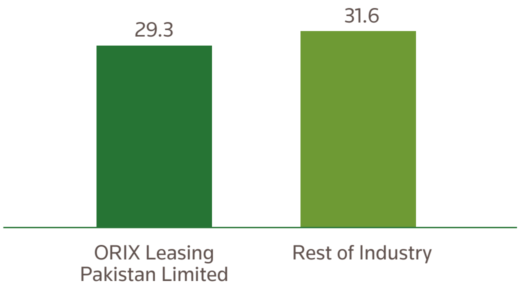
Source: NBFI & Modaraba Association of Pakistan

TOTAL ASSETS COMPARISON ORIX LEASING VS. THE INDUSTRY AS OF 2014 (US$ MN)

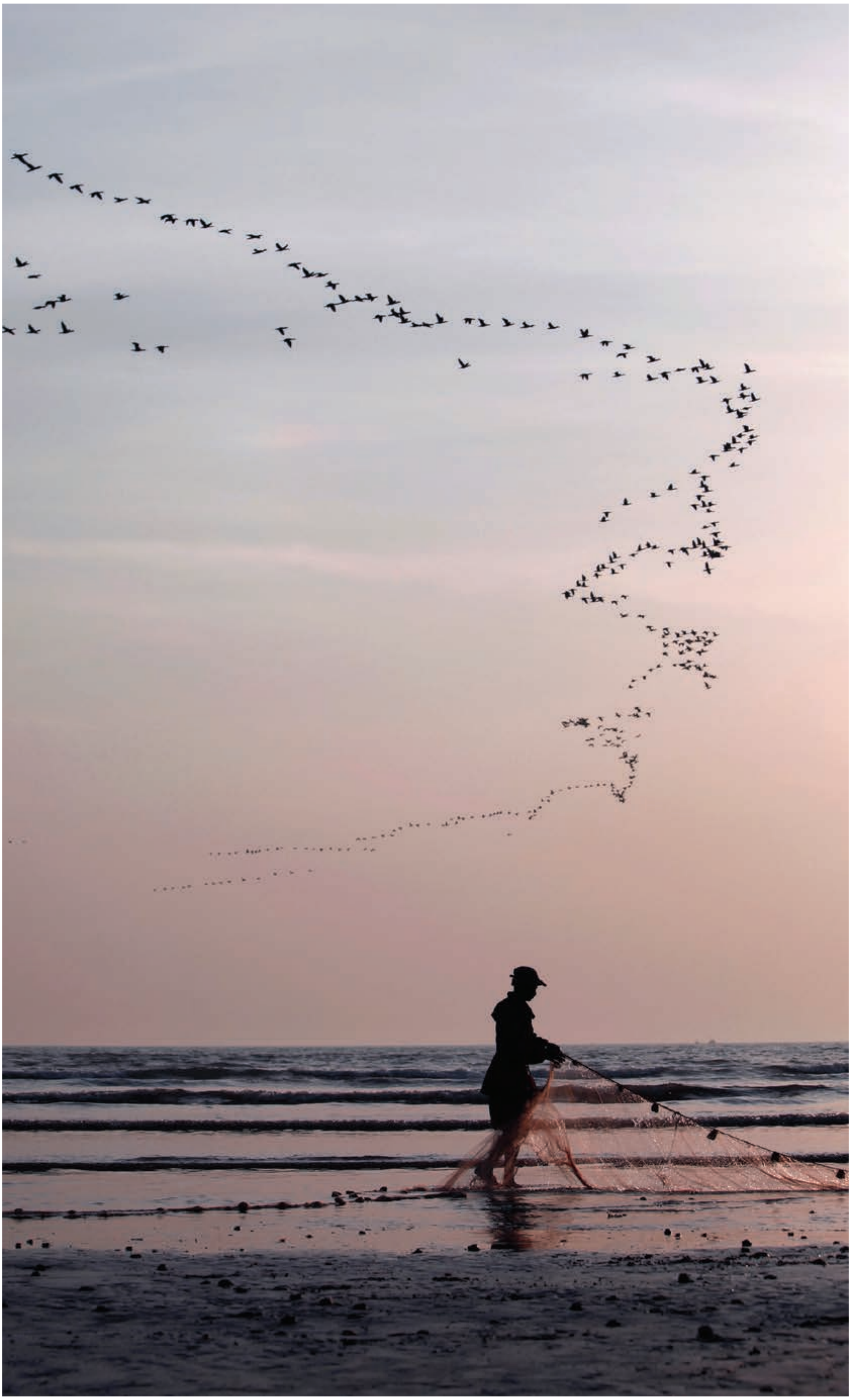


Source: NBFI & Modaraba Association of Pakistan

TOTAL EQUITY COMPARISON ORIX LEASING VS. THE INDUSTRY AS OF 2014 (US$ MN)



Source: NBFI & Modaraba Association of Pakistan



A flock of birds flies overhead as a fisherman cleans his net along Karachi's Clifton Beach at sunset REUTERS/ Akhtar Soomro

7 Insurance sector landscape

An umbrella salesman sets up umbrellas display at his spot on a highway outside Peshawar, Pakistan. REUTERS/ Khuram Parve

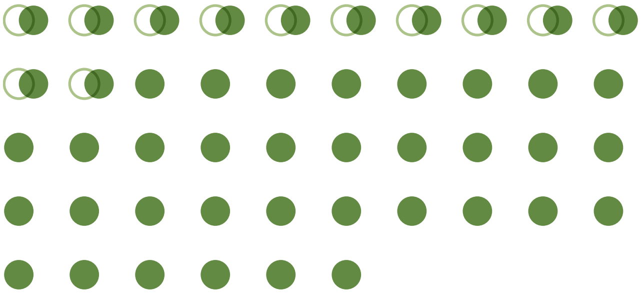
INSIDE THIS CHAPTER

Insurance sector overview

INSURANCE FOOTPRINT IN PAKISTAN

Insurance in Pakistan: Ecosystem and Evolution toward Takaful

Number of insurers in Pakistan



46 Insurers

Total No. of Insurers in Pakistan

Insurers	Life	Non-Life
Public Sector	6	37
Private Sector	1	1
Reinsurance	0	1
Takaful	2	3
Windows	3	4
Total	**12**	**46**

Surveyors & Brokers

664 Surveyors

Total No. of Insurance Surveyors in Pakistan

251 Licensed insurance surveyors

413 Registered authorized surveying officers

12 Brokers

Total No. of Insurance Brokers in Pakistan

5 Local Brokers of Public Sector

7 Foreign Brokers of Public Sector

Regulators and Supporting Institutions:
The Lahore Chamber of Commerce and Industry
Securities and Exchange Commission of Pakistan (SECP)
State Bank of Pakistan (SBP)
Federal Board of Revenue (FBR)
Insurance Association of Pakistan (IAP)

Source: Securities Exchange Commission Pakistan Annual Report

REGULATIONS DRIVING THE INDUSTRY'S PROSPERITY

The SECP has been the leading regulator in Pakistan since January 2001, and it is committed to strengthening and maintaining an effective regulatory environment for the prosperity of the insurance and takaful industries in the country.

The SECP strives to strengthen the soundness of the insurance and takaful industry and to improve the industry's penetration, with objectives including:

- Providing protection to policyholders with life and non-life products.
- Enhancing the regulatory framework for takaful companies and takaful window operations.
- Spreading awareness with educational campaigns about insurance and takaful.

In Pakistan, third-party liability auto insurance is one segment of compulsory coverage. The Workmen's Compensation Act also requires group life insurance for employees of industrial and commercial establishments. The ongoing war in Afghanistan, internal instability, and poverty mean Pakistan suffers from relatively high rates of death and disease. Therefore, the regulation of universal health insurance as a compulsory benefit partially compensated by the government could in turn improve insurance penetration.

The primary insurance and takaful products in Pakistan with individual and group plans:

- Auto (compulsory)
- Fire
- Marine
- Health
- Life
- Property
- Miscellaneous
- Savings Plans

^
Pakistani Air Force pilots leave colour trails in the sky during a full dress rehearsal for the Pakistan Day parade in Islamabad. REUTERS/Mian Khursheed

SAIFUDDIN N. ZOOMKAWALA

Director, EFU Life Assurance Limited

MR. SAIFUDDIN N. ZOOMKAWALA is Chairman of Allianz EFU Health Insurance Limited and Director of EFU Life Assurance Limited, and EFU Services (Pvt.) Limited, all being EFU Group Companies. He was also the Chairman of EFU Life Assurance Limited from February 1999 to July 2011. He has been associated with EFU Group since 1964. He also worked as general manager for Credit and Commerce Insurance Company at UAE, an insurance company of EFU group. He served as managing director of EFU General Insurance Limited from July 10, 1990 until July 2011. He is also associated with the following social institutions: Shaukat Khanum Memorial Trust and Research Centre, Member; Board of Governors, Burhani Hospital, Karachi, member trustee; Cupola Cares Foundation, member; Sindh Institute of Urology and Transplantation, Karachi, board member; and Fakhr-e-Imdad Foundation, director.

1. How do you see the impact of the global economic slowdown and the drop in oil prices on the Islamic financial markets, particularly in the takaful and insurance sectors? Given the close relationship of EFU General Insurance Company with China on infrastructure projects, how have unstable economic conditions in China affected the insurance risks of such projects? What are the measures to mitigate these risks?

The impact of the economic slowdown in Pakistan has been minimal. The Pakistan economy is most influenced by its own sphere and region. Neither the slowdown nor the global booms will drastically affect the economy of Pakistan. Pakistan will continue moving at its own pace.

Pakistan is a beneficiary of high oil prices in terms of financial assistance from Middle Eastern countries. A drop in oil prices that affects the Middle East therefore may have a negative impact on Pakistan. Furthermore, Pakistan receives a large amount of remittances from its citizens working in the Middle East, and a drop in oil prices could severely affect the flow of such remittances, which is a major part of the government of Pakistan's revenue.

As far as the insurance industry is concerned in Pakistan, the global slowdown will have no impact, especially on the general side.

The impact of the China-Pakistan Economic Corridor on the insurance industry would be positive. However, takaful business generally would not benefit from this because most Chinese companies prefer to insure their assets using conventional insurance.

2. EFU was the first company to commence takaful window operations, offering general and family services in July 2014 and February 2015 respectively. How would you evaluate the performance of the takaful window compared to the conventional business? What is your outlook for the company in five years,

as well as for the takaful sector regionally and globally?

The appeal of takaful is the participative nature of operations, while conventional insurance transfers risk for the premium. The conventional policyholder is not concerned with the business of the insurance, while takaful participants directly benefit from the operational performance of the operator.

Takaful window operations benefit conventional insurance companies because they can use their existing infrastructure and sales force to spread the message of takaful. Companies only operating in takaful are small in size and have very limited capability in terms of reach and the ability to provide cover. Until recently, only takaful operators were allowed to offer takaful products, therefore awareness about takaful business was very limited. However, with the legalization and regulation of window operations, the ten biggest insurance companies are carrying the message of takaful now.

Our takaful window has had a tremendous impact on the overall business of EFU. The impact maybe is more on the life of our customers. Many clients were insuring only the compulsory items such as marine insurance for letter of credit transactions. Now, because of the availability of takaful, they are more willing to insure almost all their assets. During the last six months of 2015 gross premiums from the takaful operation of EFU reached Rs 300 million, while in the first quarter of 2016 it crossed Rs 500 million. This clearly exhibits the greater acceptance of takaful products in the market because of their religious value. Furthermore, the increase in business is not the result of cannibalization. Rather, this is absolutely caused by the innovation and attraction of takaful in the market. Major contributions are coming from new customers who were not previously buying conventional insurance for religious reasons.

3. How will EFU takaful windows compete with the fully-fledged takaful operators to win market share over the growing base of affluent and middle-class mass market? And how would you assess the impact of the increased competition, distribution channels and technologies to your company?

Full-fledged takaful operators are very small, and bigger businesses are more comfortable working with bigger insurance companies like EFU. Furthermore, the financial performance of takaful operators is weak. There are examples of takaful operators closing down due to financial difficulties. Most of the Takaful Family operators have foreign ownership, which may give the impression that these operators may not stay in Pakistan in the case of financial difficulties. While on the other hand, most of the big insurance companies have a majority local shareholdings.

4. How is EFU innovating with products like microtakaful and Bancatakaful, and in technology, to boost the financial capacity of the rural and poor populations? In general, how would you describe the position of takaful sector in terms of innovation, inclusion and human resources compared to conventional insurance? How is Pakistan positioned in this regard?

Takaful has just started operations in Pakistan. There are still many

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UNTIL RECENTLY, ONLY TAKAFUL OPERATORS WERE ALLOWED TO OFFER TAKAFUL PRODUCTS, THEREFORE AWARENESS ABOUT TAKAFUL BUSINESS WAS VERY LIMITED. HOWEVER, WITH THE LEGALIZATION AND REGULATION OF WINDOW OPERATIONS, THE TEN BIGGEST INSURANCE COMPANIES ARE CARRYING THE MESSAGE OF TAKAFUL NOW.

> THE GROWTH OF TAKAFUL IN PAKISTAN WILL BE DIRECTLY PROPORTIONAL TO THE GROWTH OF ISLAMIC BANKING. THERE IS A NEED TO ENHANCE THE AWARENESS OF TAKAFUL. HOWEVER, THE BEST WAY TO ENHANCE THE AWARENESS IS BY WORD OF MOUTH, ESPECIALLY FROM SALES AGENTS IF THEY CARRY THE RIGHT MESSAGE TO THEIR CUSTOMERS.

people who are not aware of the availability of takaful arrangements. The disposable income of the middle class is increasing in Pakistan. Small- and medium-size businesses are growing as well. Microtakaful and Bancatakaful are the products of the future. By allowing microfinance companies to offer and manage microtakaful at their end will boost the takaful business overall. Small branchless operations will be a solution for small-scale entrepreneurs. The cost of branchless takaful operations is much lower because of the absence of agents' commissions. The lower premium paid by micro-entrepreneurs will help to increase the volume of policies sold and the profitability of operators. Although there may be some cannibalization at the beginning, big volumes from smaller takaful participants will raise their profitability. There will be a great need for trained staff, but the industry has the capability to raise human resources with their own training.

5. Does your company see any other areas and issues that would need to be addressed in order to boost takaful penetration? From a global perspective and in Pakistan, what are the growth opportunities for individual and corporate general and life takaful?

The growth of takaful in Pakistan will be directly proportional to the growth of Islamic banking. There is a need to enhance the awareness of takaful. However, the best way to enhance the awareness is by word of mouth, especially from sales agents if they carry the right message to their customers.

Risk management is another important area where takaful operators need improvement. Fortunately, re-takaful is already available, which will be very helpful for the growth of the takaful industry. Takaful operators can also benefit from coinsurance for risk management purposes.

In terms of regulations, the SECP has been very helpful. However, window takaful has started their operations only recently, and it will take some time for operators and the SECP to develop regulations for this business.

6. How do you train your staff on the management and marketing of takaful products?

EFU has an independent training institute that provides takaful training courses conducted by Shariah advisors and the CEO of EFU Takaful operation that is absolutely separate from the insurance side. It is very important for EFU that our sales force carries the right message to customers without complications and misinterpretations of takaful. EFU is very conscious that the sales force should not misinterpret our products or convey the wrong message. We conduct regular courses on the benefit of takaful products and the technical details for all the products that we offer, including marine, vehicle, personal, and accident insurance policies.

A bus passes a money changer displaying various currencies at his roadside stall in Karachi's business district. REUTERS/ Akhtar Soomro

A MATURE MARKET, YET UNDERPENETRATED

The insurance industry plays a crucial role in economic development, both by providing financial risk management and by stimulating capital markets through insurers' investment policies. Pakistan's insurance industry is a mature market in terms of its historical presence and development, but it remains relatively small compared to its regional peers in terms of penetration. Insurance penetration in Pakistan was 0.9% (a ratio of total premiums and contributions to GDP) at the end of 2014. By comparison, India stood at 3.3% in 2015, which was also below the world average of 6.2%.

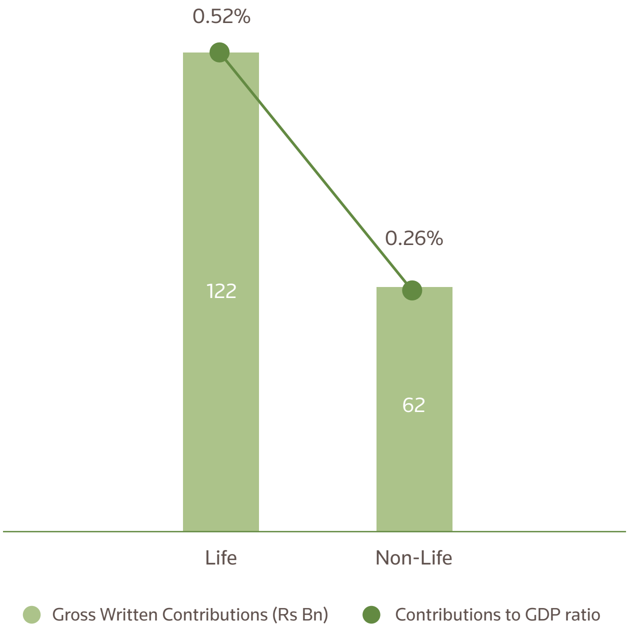
Currently, the Securities and Exchange Commission (SECP) regulates the insurance industry under Insurance Ordinance 2000. The sector had been under the supervision of Ministry of Commerce since 1948, following Insurance Act 1938. With the shift in Pakistan's focus to growing the capital markets and ensuring a high level of governance, the SECP took over the role from the Ministry of Commerce in 2001.

Forty-five Insurance companies operate in Pakistan—seven life insurers and 38 non-life. Apart from conventional providers, there are five full-fledged takaful operators and six takaful windows, of which four are family takaful operators and seven general. There is only one local re-insurance company, the Pakistan Reinsurance Company.

The reform of the insurance sector in 2001 allowed several new private insurance companies, including takaful operators, to start business. Prior to this, the insurance industry had remained stagnant under a single public insurance conglomerate, State Life Insurance. As of December 2014, the industry's premiums and income contributions amounted to Rs 201 billion (US$1.9 billion), worth 0.9% of GDP. The contribution of the conventional insurance sector to the industry stood at Rs 184 billion (US$1.8 billion) gross written premiums (0.78% of GDP). Re-insurance gross premiums reached Rs 9 billion (US$86 million), and the takaful sector's contributions stood at a meagre Rs 8 billion (US$76 million), a ratio of only 0.04% of GDP.

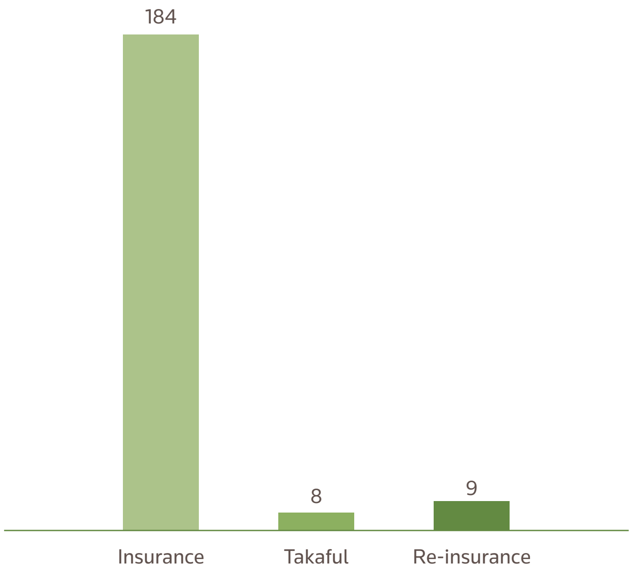
City of Karachi, Pakistan

INSURANCE PREMIUMS EXCLUDING RE-INSURANCE (YEAR TO DECEMBER 2014)



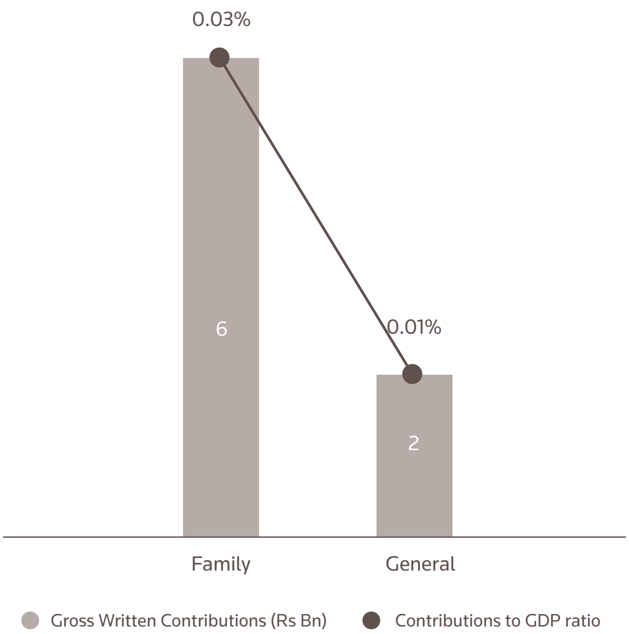
Source: The Insurance Association of Pakistan - Yearbook , December 2014 -15

GROSS WRITTEN PREMIUMS/CONTRIBUTIONS (YEAR TO DECEMBER 2014)



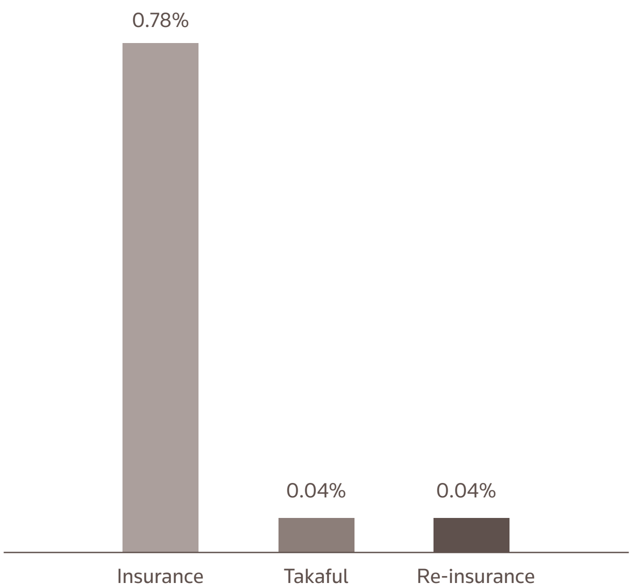
Source: The Insurance Association of Pakistan - Year Book , December 2014 -15

TAKAFUL CONTRIBUTION INCOME EXCLUDING WINDOWS (YEAR TO DECEMBER 2014)



Source: The Insurance Association of Pakistan - Yearbook , December 2014 -15

OVERALL INSURANCE SECTOR PENETRATION (PREMIUMS TO GDP)



Source: The Insurance Association of Pakistan - Yearbook , December 2014 -15

GROWTH TRENDS: LIFE INSURANCE SHOWED GROWTH, ENHANCING PENETRATION

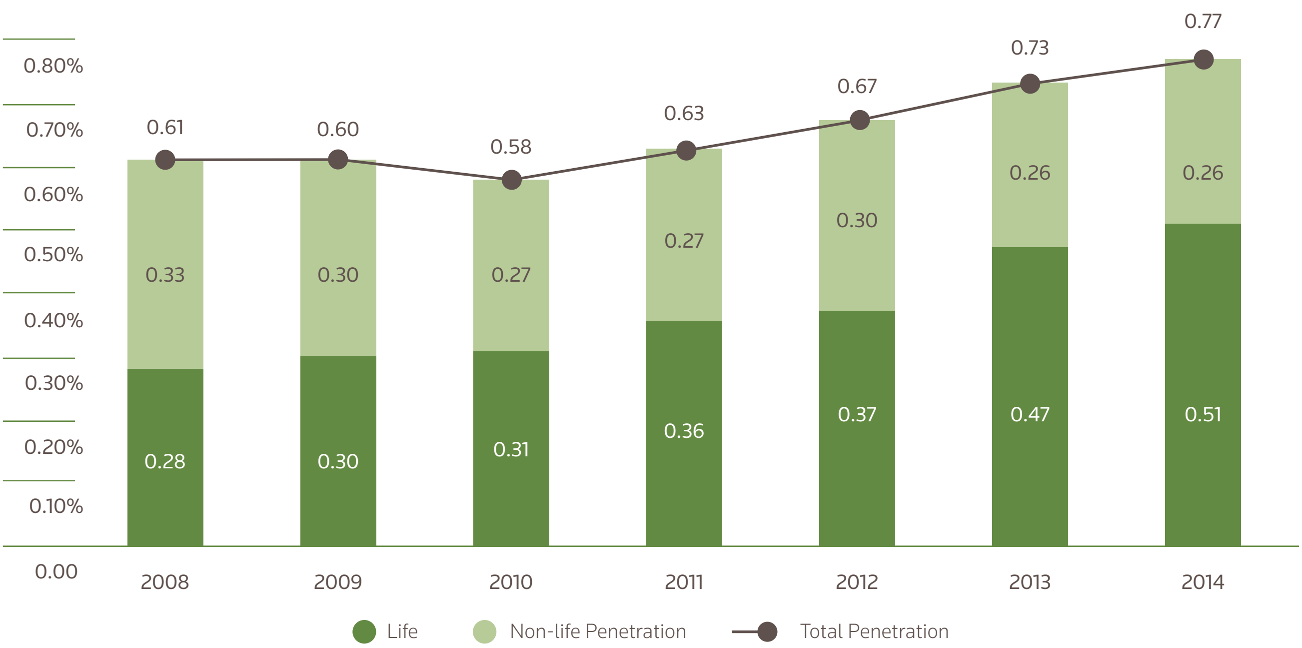
Overall, insurance penetration in Pakistan remains relatively limited. It was stagnant for several years because of the state monopoly and the public perception that insurance products did not comply with Shariah. Non-life insurance services dominated the market until 2009. Since this time, life insurance has outpaced them, and its growth has accelerated in recent years. Life insurance penetration reached 0.51% in 2014, an almost 66% market share out of all products. It has grown at a 9% compound annual rate (CAGR) since 2009.

Pakistan's seven life insurance operators earned 61% of net premium revenue, whereas the non-life insurers held 39% in 2014. Life net premiums in 2014 increased to Rs 46 billion (US$439 million), up from Rs 39 billion (US$373 million) in 2013. Life insurance followed international markets by evolving into a new avenue for long-term saving products besides covering only traditional death benefits, and illness and health damages. The investment-linked policies in Pakistan show the potential for ample growth, as they meet the need of the market.

By contrast, the non-life insurance segment showed decreasing growth in net premiums between 2011 and 2014, when it represented only 39% of the conventional insurance sector earnings. Although there are 38 companies providing general insurance benefits including motor, fire, marine and other benefits, the growth of this segment remained slow as represented by premiums revenue. However, the segment showed positive trends in profitability as measured by return on assets (ROA). In 2014, net profits after tax were approximately Rs 9 billion (US$86 million) in the life insurance segment compared to Rs 2 billion (US$ 19 million) in non-life insurance, with ROAs of 7% and 2% respectively.

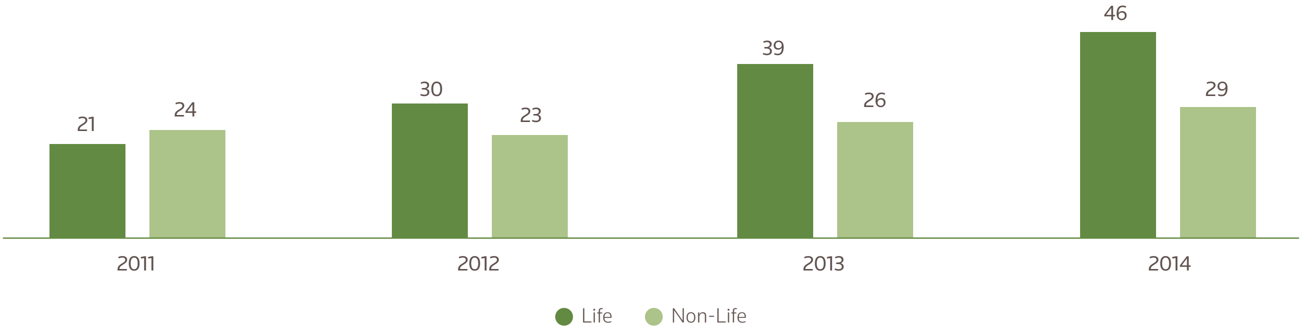
By the end of 2014, conventional insurers hold 96% of the total assets of the insurance industry, while takaful captures only 4%. Life and non-life takaful insurers each hold equal 50% shares of total assets.

INSURANCE PENETRATION 2008 - 2014 (PREMIUM TO GDP RATIO)



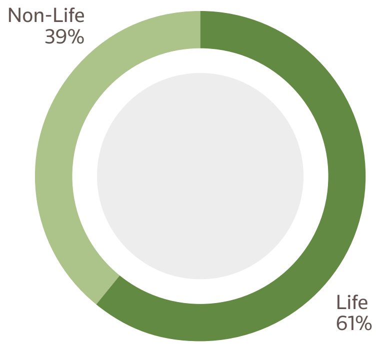
Source: Securities Exchange Commission Pakistan Annual Report - December 2014

LIFE AND NON-LIFE INSURANCE PROFITABILITY (NET PREMIUMS REVENUE — YEAR TO DECEMBER 2014; IN RS BN)

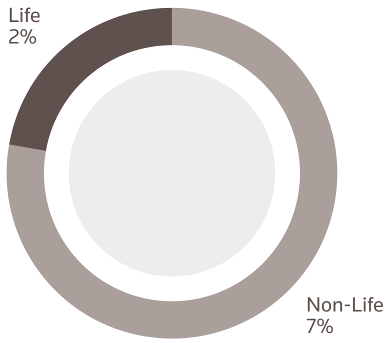


Source: The Insurance Association of Pakistan - Yearbook , December 2014 -15

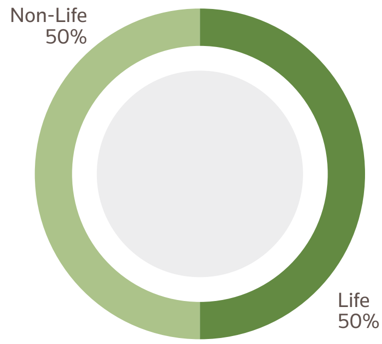
PROFITABILITY (YEAR TO DECEMBER 2014; NET PREMIUMS BY SEGMENT)



PROFITABILITY (YEAR TO DECEMBER 2014; ROA BY SEGMENT)

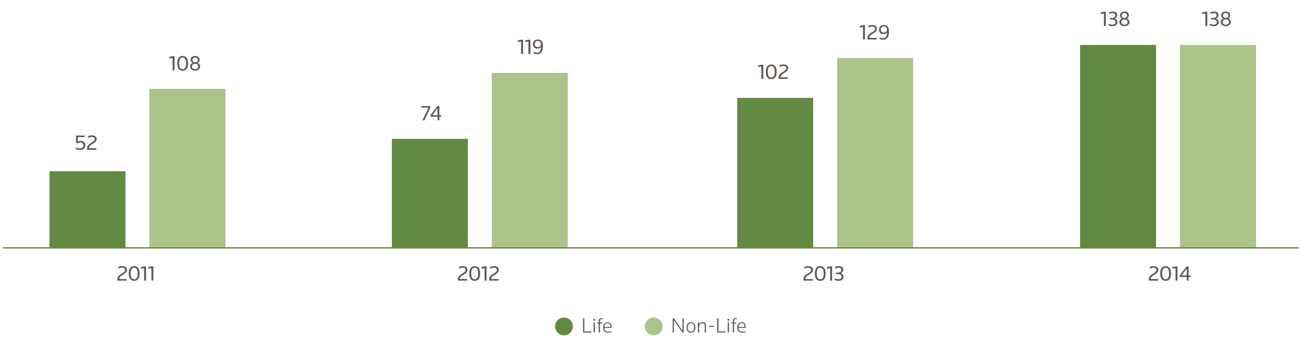


FINANCIAL POSITION (AS OF DECEMBER 2014; TOTAL ASSETS BY SEGMENT)



Source: Insurance Association Pakistan (IAP) - Year Book, December 2014 - 15

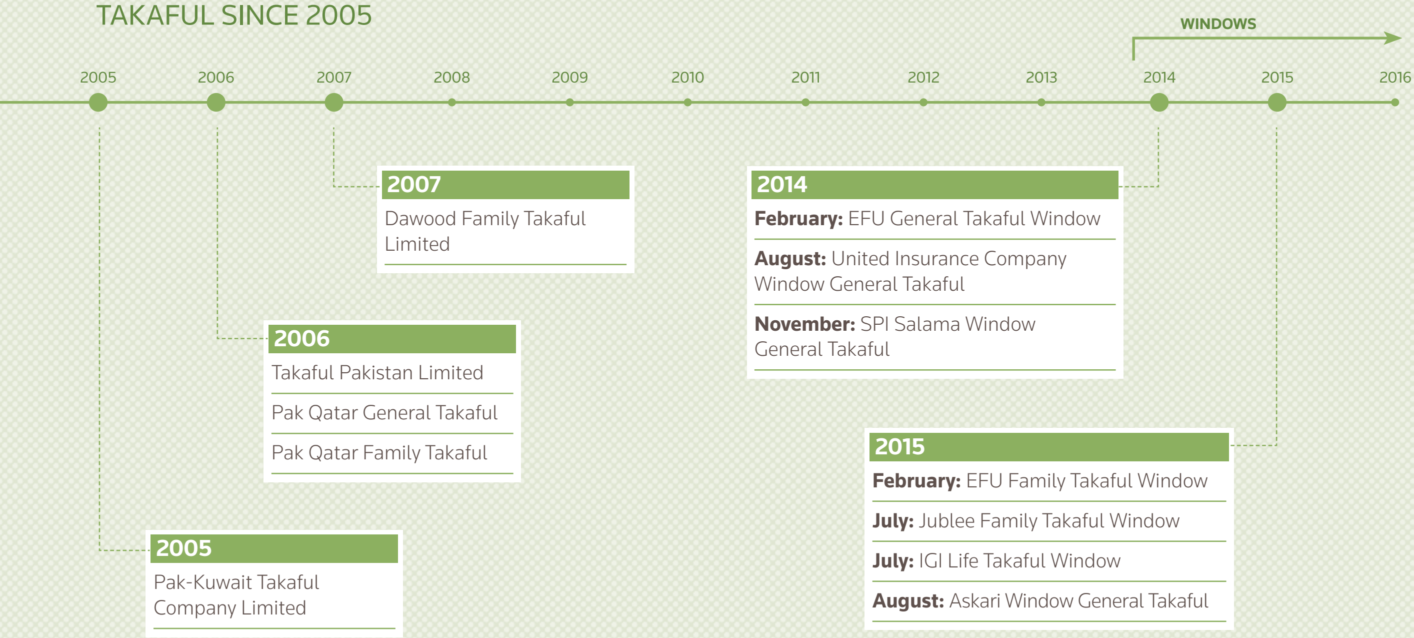
LIFE AND NON-LIFE INSURANCE ASSETS (AS OF DECEMBER 2014; IN RS BN)



Source: Insurance Association Pakistan (IAP) - Year Book, December 2014 -15

FOCUS: TAKAFUL FOOTPRINT IN PAKISTAN

THE MOVE TOWARD TAKAFUL SINCE 2005



The SECP permitted the formation of takaful companies and windows after the passage of the Takaful Law in 2005. Pak-Kuwait Takaful Company Limited was the first Islamic insurance company in Pakistan. Takaful Pakistan Limited and Pak Qatar followed in 2006, and finally, Dawood Family Takaful started operation in 2007. No new takaful companies have been founded since 2007.

The takaful sector remains small and underpenetrated, representing only 0.04% of GDP and contributing only 4% to the industry's gross written premiums, Rs 8 billion (US$76.2 billion) in 2014. Nevertheless, the sector is showing prospects since the revision of takaful law in 2012. This law allows the SECP to create a central Shariah board that regulates the takaful market's risk management and rating procedures.

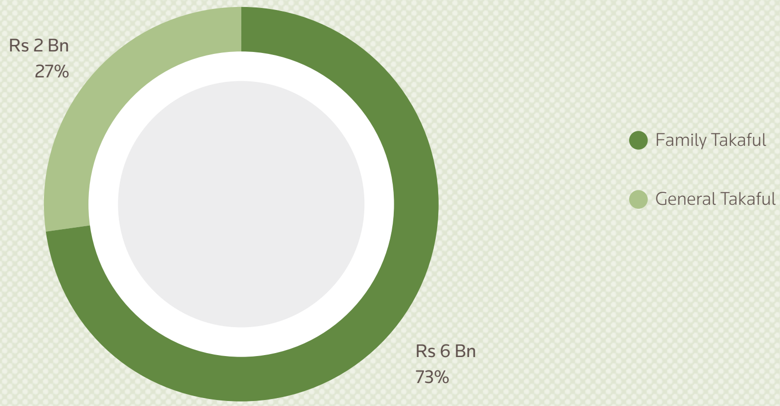
Moreover, an amendment to the law now allows takaful windows at conventional insurers. Aiming to increase market penetration, after reaching an out-of-court settlement between operators and then government, the SECP announced officially in April 2014 the approval of takaful windows in Pakistan. As a result, many conventional insurers have prepared to expand their volume through by offering Shariah-compliant service. EFU General Takaful Window and United Insurance Company Window General Takaful opened the first Islamic divisions in 2014.

People walk outside the Pakistan Stock Exchange building in Karachi, Pakistan. REUTERS/ Akhtar Soomro

FAMILY AND GENERAL TAKAFUL OPERATORS' PERFORMANCE

Similar to conventional life insurance, family takaful is leading the sector in Islamic insurance space. It contributed almost Rs 6 billion (US$57 million) in gross contributions income in 2014. Family takaful drives 73% of gross contributions income, while general takaful accounts for only 27%.

GROSS CONTRIBUTIONS INCOME, 2014



Source: Data are collected from operators' annual report — December 2014

Family Takaful: More Recent Foundations Dominant

Pakistan's two family takaful operators have performed well since opening in 2006. Total assets as of 2014 reached Rs 10 billion (US$96 million), with gross contributions income of Rs 5.9 billion (US$56 million) and net income of Rs 5 million (US$47,800). The individual family segment represents 86.9% of the gross contributions income, while 4% is attributable to group family insurance, and 9.1% by group health insurance, offered only by Pak Qatar Family Takaful.

This sector maintained slim profits in 2014, but avoided the negative performances of the general takaful operators because of high claims and less disposable income. The segment enjoyed a lower claims-to-premiums ratio of 26% and a 0.05% return on assets.

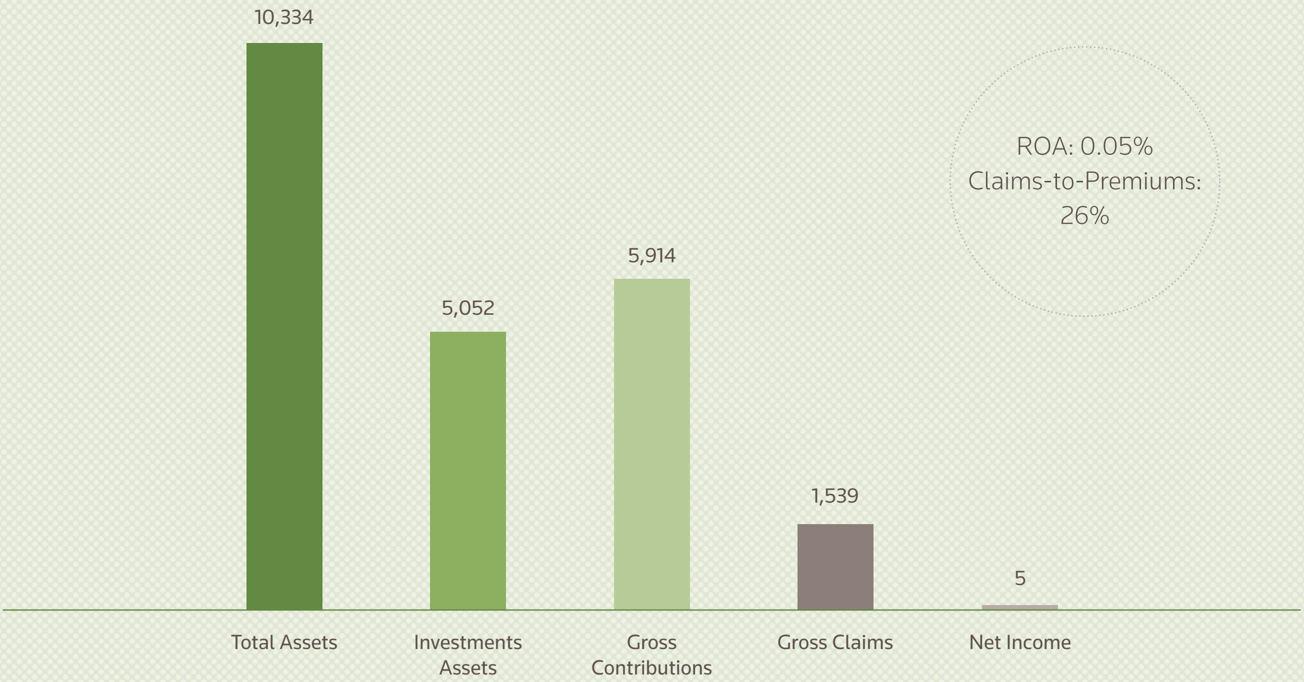
The investment portfolios of life takaful companies generally contain into three different categories of assets. Sukuk assets dominate the investment funds of takaful operators, constituting 54% of total investment income, which poses a serious challenge for takaful firms as Sukuk issuance has been slowing down in recent year. Investment in Shariah-compliant equities represents a further 26%, and the remaining 20% is in other investments. In 2014, the investment income of family takaful companies was Rs 5 billion (US$48 million).

General Takaful: Negative Performance Due To High Claims

The financial health of Pakistan's three general takaful companies is more precarious than the family takaful sector. They generated gross contributions income of approximately Rs 2.1 billion (US$20 million) in 2014 and held total assets of Rs 2.5 billion (US$24 million). Motor takaful policies contribute 46% of gross contributions income, followed by fire (23%), health (16%), and marine and miscellaneous segments, with 8% each.

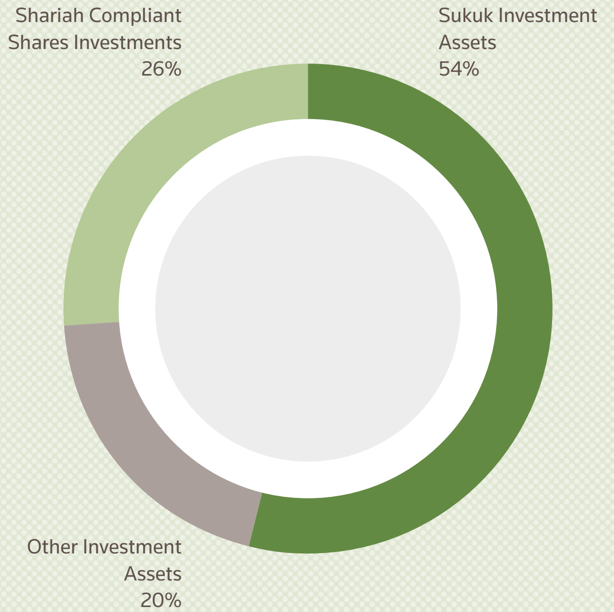
However, the profitability of the sector dropped in 2014 and showed negative net income of Rs 96 million (US$918,000), a return on assets of negative 4% in 2014 and a high claims-to-premiums ratio of 57%.

FAMILY TAKAFUL OPERATORS PERFORMANCE (DECEMBER 2014; RS MN)



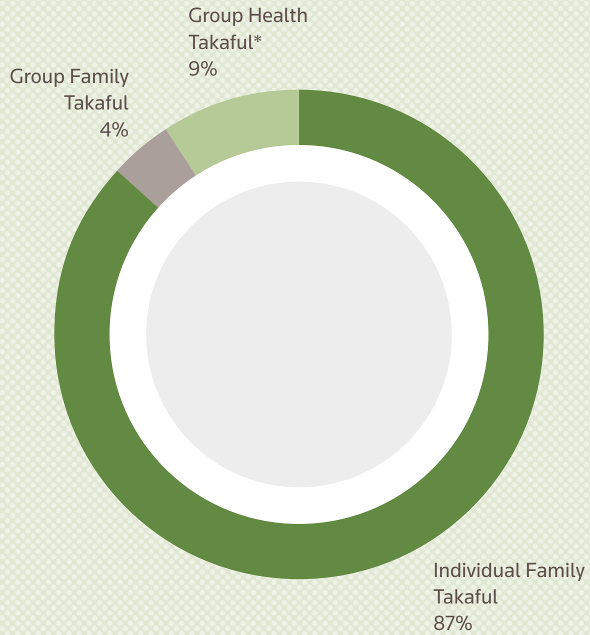
Source: Data are collected from operators' annual report — December 2014

INVESTMENT ASSETS BY FAMILY TAKAFUL OPERATORS (DECEMBER 2014)



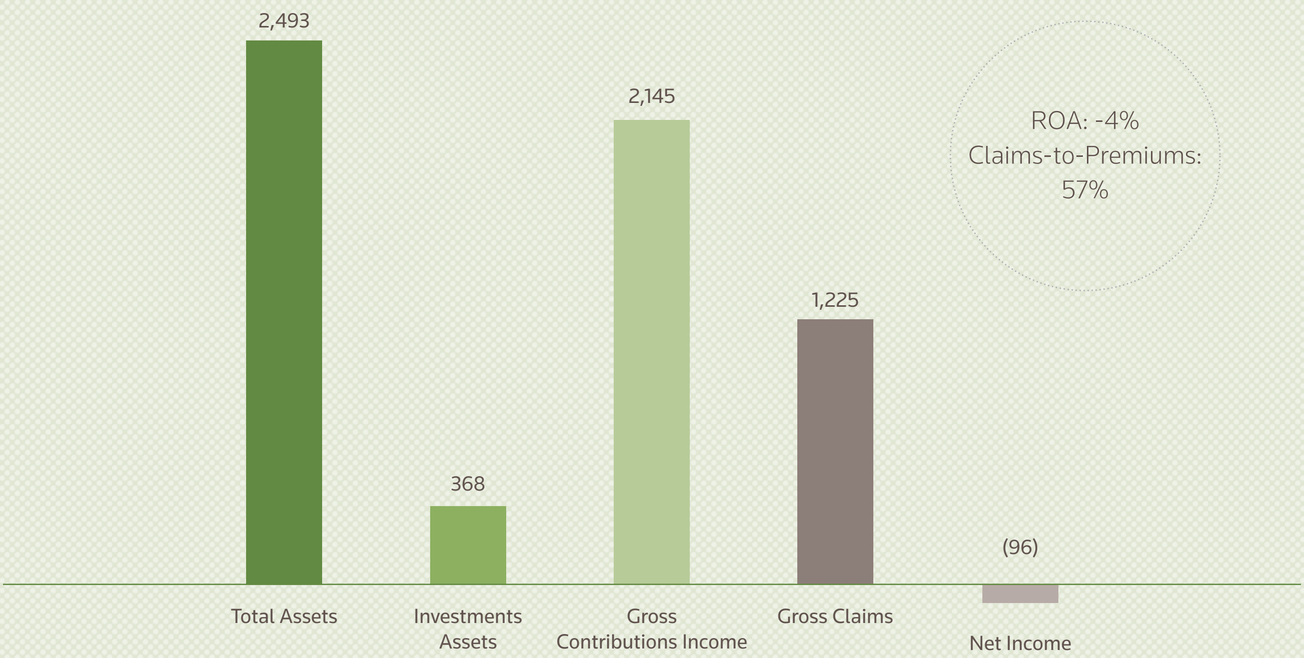
Source: Data are collected from operators' annual report — December 2014

GROSS CONTRIBUTIONS INCOME OF FAMILY TAKAFUL



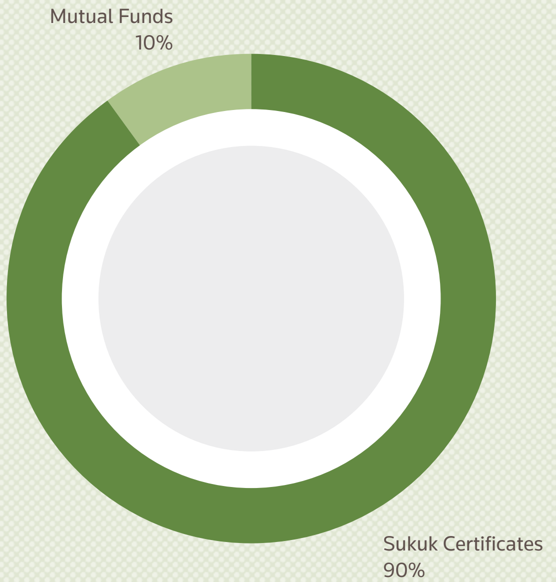
Source: Data are collected from operators' annual report — December 2014
* Group health takaful fund is mainly from Pak Qatar Family Takaful

GENERAL TAKAFUL OPERATORS PERFORMANCE (DECEMBER 2014; RS MN)

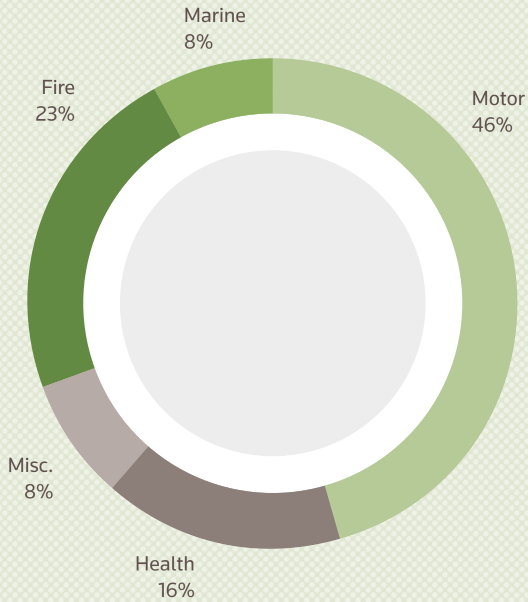


Source: Data are collected from operators' annual report — December 2014

INVESTMENT ASSETS BY GENERAL TAKAFUL OPERATORS (DECEMBER 2014)



GROSS CONTRIBUTIONS INCOME OF GENERAL TAKAFUL



Source: Data are collected from operators' annual report — December 2014

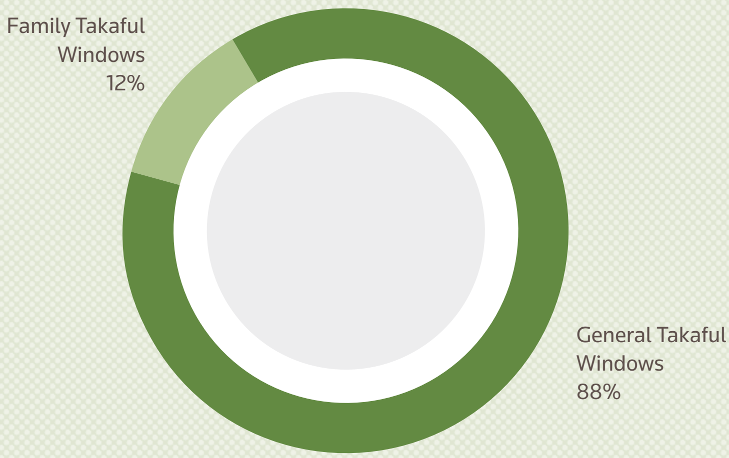
THE NEW GENERATIONS' PERFORMANCE: WINDOWS' SHOWING AN IMPETUS FOR GROWTH

Takaful window operations—the Shariah-compliant divisions of conventional insurers—commenced during 2014. With only one year of operations, this industry is still in its infancy, but it is showing the capacity for growth. In 2014, the first year the SECP allowed the windows, the three top conventional general insurers entered the sector. By early 2016, there are seven takaful windows, of which three sell insurance and four sell general products.

Takaful windows performed very well in their first year of operations, generating a gross contributions income of Rs 116 million (US$1.1 million). General takaful windows contributed 88% of this value, or Rs 103 million (US$985,000).

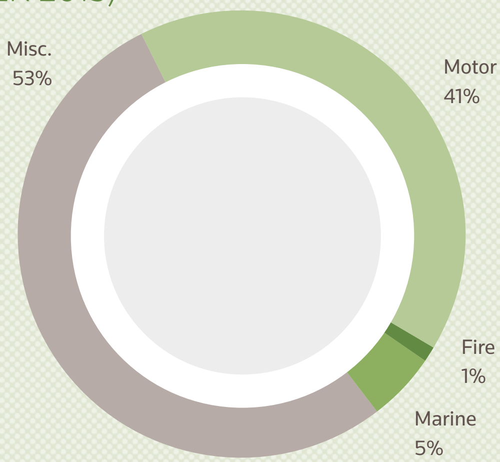
In terms of profitability, however, general takaful windows lag behind family takaful. Like full-fledged takaful general insurers, takaful windows selling general insurance face a high claims ratio.

GROSS CONTRIBUTIONS INCOME — TAKAFUL WINDOWS SECTOR (SEPTEMBER 2015)



Source: Data are collected from operators' Quarterly Report — September 2015

GROSS CONTRIBUTIONS INCOME AT GENERAL TAKAFUL WINDOWS (SEPTEMBER 2015)



Source: Data are collected from operators' Quarterly Report — September 2015

Challenges and policy response

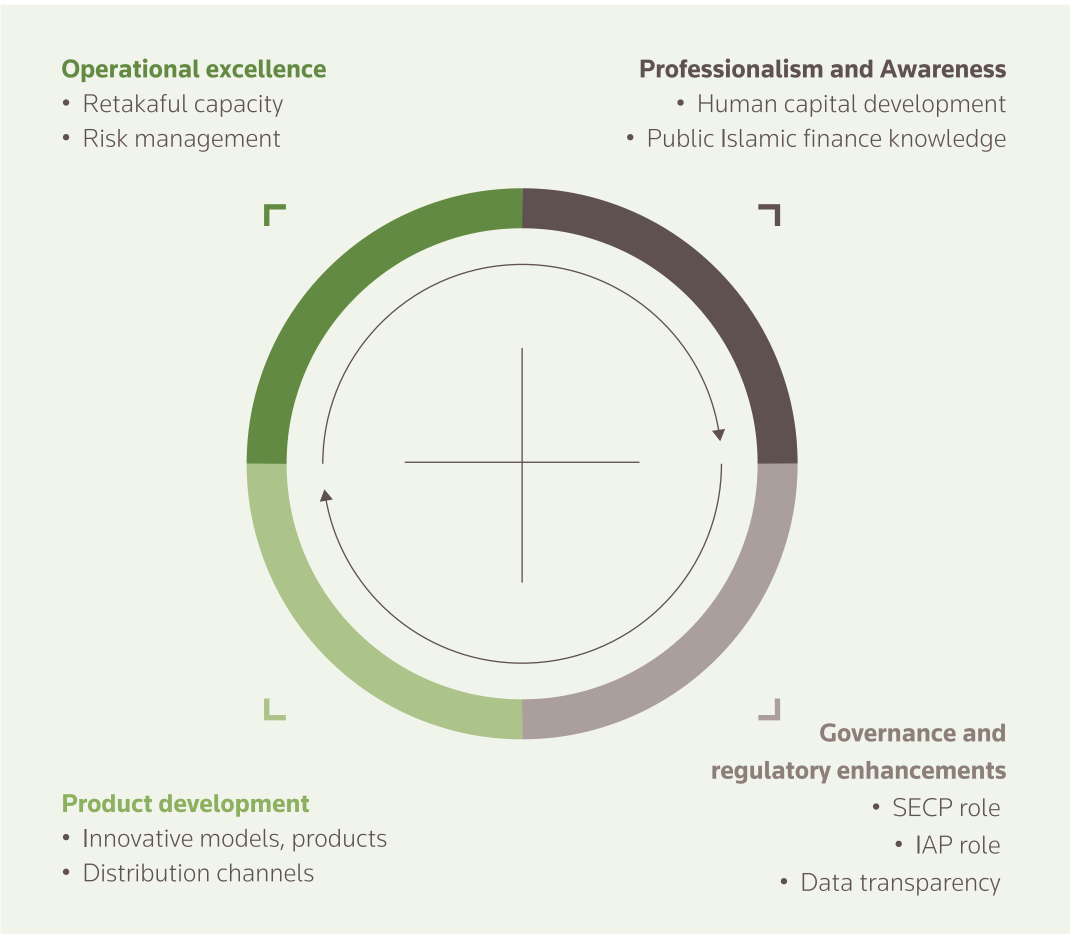
FACING THE INDUSTRY'S CHALLENGES

The insurance industry in Pakistan had been dormant until the 2000s. With the introduction of the takaful law in 2005, the market has witnessed remarkable growth. Pakistan is the world's second most populous Muslim country after Indonesia, which makes it a very fertile market for takaful. Further, takaful window operations are a recent entry for the industry, which should help boost insurance penetration to GDP. However, many challenges remain that the industry needs to address to establish a stable base for growth.

Professionalism and Awareness

Training professional insurance company employees remains a significant roadblock to the development of the insurance industry in Pakistan. There is a shortage of skilled qualified personnel, particularly in specialised areas such as product development, risk management and underwriting, as well as in developing customer-oriented marketing techniques to educate the mass market.

Low insurance industry penetration has traditionally been excused by the absence of products that are more appealing to Muslim-majority country demand, such as takaful. However, the market is still underpenetrated after 10 years of takaful operations. Therefore, the industry needs a significant reassessment of marketing techniques to reach the large majority of Pakistanis not using



insurance products in order to increase takaful and insurance density. Between 2008 and 2014, insurance density increased to 10.4% in 2014 from 6.8% in 2008, showing a growth of 53%.[40]

To overcome these challenges, all key stakeholders need to devote efforts toward raising awareness about the unique aspects of takaful with both customers and professionals.

A strong talent-building environment requires:

1. A strategic focus on talent development under a dedicated division within the current insurance association to shift the industry toward professionalism.

2. Defined skill-set and assessments to measure the industry's training level and required knowledge and skills.

3. Partnerships with educational and training providers for Islamic finance such as ISRA, INCIEF, AAIOFI and others.

4. Improving agency and brokerage management skills.

Operational Excellence

To follow the growth trends of other financial sectors, the insurance industry requires holistic solutions that improve operational excellence. These include achieving efficiency with cost effective solutions that are customer-centric and employ innovative technology and financial structuring.

The introduction of takaful in Pakistan has opened the opportunity to greatly expand the market's size. Customers are the engine of any market development. Therefore, identifying important customer behaviours and potential roadblocks to expansion are critical. Although religious individuals using takaful have impacted insurance density and expanded insurance penetration in 2014 to 0.04%, the public's reluctance to use insurance remains a challenge to the insurance industry.

Prevailing high claims ratios have a harmful effect on the bottom line for both conventional and Islamic insurance in Pakistan. Improving communication with customers and applying stricter risk management is therefore vital to improving the market.

One of the most important changes to increase cost-efficiency and innovation, would be an effort from the SECP to enhance the industry's capacity by inviting multinational operators, especially to work in re-insurance and re-takaful. Currently, Pakistan Reinsurance Company is the only local conventional re-insurance company serving the market. The capacity of this company has shrunk because of the growth of the insurance sector overall, and so re-insurance costs have risen. Moreover, there is still no local re-takaful company.

Therefore, the SECP should create regulations enabling the foundation of local re-insurance operations and encouraging foreign investment in such operations to avoid the flow of premiums abroad.

Product Development

Operators also need to continue researching new niche and uncovered markets to develop speciality products.

Pakistan's insurance industry has fallen behind in serving rural areas with agricultural insurance and other socially oriented products. Such products and segments show growth potential in takaful, considering its objective of fostering social solidarity similar to mutual insurance companies. Micro-takaful is another emerging segment in the developed Islamic financial market that needs to be tapped. With the effort of the SECP to introduce micro-insurance report in 2012, this should be considered as well in terms of micro-takaful to provide a thorough assessment of the market in terms of demand, supply, market reach and regulations.

Governments and regulators have played a key role in boosting the takaful industry in many leading Islamic financial markets such as Malaysia, Indonesia and the GCC countries with Public Private Partnership (PPP) programmes. Such partnerships would not only improve the industry's penetration in Pakistan, but also would help in providing basic insurance to low-income consumers. Pakistan's lifestyle and environment may lead the government to introduce compulsory health insurance in more districts as an extension of their previous initiative of micro-health insurance, initiated in 2012 under the Benazir Income Support Programme (BISP) as a flagship national safety net system.

Banks in Pakistan are the key drivers of the financial services sector; hence their extended support to takaful with bancatakaful (takaful windows in bank branches) would push the industry's prosperity. Some banks have already established such programmes. If replicated by conventional banks with Islamic windows, this will widen takaful's reach to a much larger client base.

Meezan Bank, as the premier Islamic bank in Pakistan, started offering free takaful coverage for depositors in a form of accidental death and permanent disability policy and ATM cash withdrawal takaful of up to Rs 1 million (US$9,520) to all account holders maintaining an average monthly balance of Rs 10,000 (US$95.2) or more.[41] Likewise, Bank Islami—Takaful has initiated a detailed takaful plan with marriage, retirement and education plans. Other bancatakaful products include Bank Al Falah' Uroos Marriage Plan, Tadbeer' multi-purpose saving plan and Danish education plan, and the Sarparast Family Takaful Plan by Al Baraka Bank Pakistan.

Governance and regulatory enhancements

Although insurance regulation has made remarkable strides in recent years since the SECP took over the role of regulator, with the support of the Insurance Association of Pakistan (IAP), the insurance industry still requires the more effective involvement of the regulatory body to improve its performance and address its challenges.

With the SECP more focused on capital markets, the insurance industry has been left behind. The recent entrance of takaful and takaful windows to the industry brings further complications and technical challenges to the industry. It's recommended the government establish a regulatory authority dedicated to insurance, as a one-stop solution for assessing market performance, demand, and compliance issues and to provide thorough guidelines, information, profiling and statistics of the industry. The government should also consider merging IAP into this institution.

TAKAFUL ENVIRONMENT GROWTH STRATEGY: KEY ENABLERS AND PLANS

Key Enablers

Education and awareness support

Regulatory support through dedicated insurance/takaful regulatory authority

Key Enablers

Collaborative effort from boards and executives of takaful operators

Government support and directions

Key Plans

Country-focused

a. Build multinational market expertise through outreach to regional markets, such as target invitations and roadshows to attract blue chip investments.

b. Visible involvement and participation in events and seminars in takaful.

Institutional-focused

a. Product development and harmonisation: takaful operators are urged to develop an attractive portfolio of products to meet mass market needs, and to shift their focus from traditional family takaful benefits to those covering education, health and other life protection. And therefore, the investment portfolio of Takaful companies could capitalize on the surge in Sukuk to boost the investment position of the industry.

b. Diversified distribution channels through bancassurance, websites and new means of reaching customers to reduce the cost of high brokerage fees.

Company-focused

a. Improve customer awareness with better branding and marketing and partnerships with educational bodies.

b. Strengthen underwriting skills and actuarial analysis, skills in assets allocation and access to retakaful capacity.

A PATH TOWARDS INSURANCE AND TAKAFUL GROWTH IN PAKISTAN

Syed Arif Hussain | CEO, Takaful Pakistan Limited

DR. SYED ARIF HUSSAIN is CEO of Takaful Pakistan Limited. He has had more than 20 years of professional experience at senior positions in underwriting, reinsurance, claims management and marketing with the State Life Insurance Corporation of Pakistan. He also established the operations of Dawood Family Takaful Company. His areas of expertise include life, health and project-related insurance and Takaful schemes. He has extensive experience in restructuring, insurance operations and automation. He holds M.B.B.S. and Masters of Business Administration degrees. He has also attended a number of Insurance and Takaful and management related workshops and conferences conducted locally and internationally.

In the light of my 20 years' experience in the field of insurance and takaful (both life and non-life), I would like to share some ideas about why insurance and microinsurance have not been successful in Pakistan and to suggest ways of improving insurance penetration in the country.

Why Insurance Struggles:

1. In our country, insurance is sold, not purchased.

2. The insurance industry mostly depends on agents as a distribution channel. Their remuneration is largely based on commission, so they make their efforts to sell policies with large sums insured. In this way, they earn more commission and related benefits, so they focus on wealthy clients. The premiums of low-sum insurance policies are also little, which is why this segment has no charm for the agents.

3. Insurance companies are also interested in large-sum insurance policies to save the time and labour. In this way, they also achieve their given targets easily. Their interest is in volume, not in the numbers.

4. Insurance companies also set their minimum premium benchmark; below this benchmark a policy is not accepted.

5. There is a lack of awareness about the importance of insurance in the general public.

6. There are religious objections towards conventional insurance, which Takaful seeks to counter.

7. Insurers are inflexible in addressing specific needs of clients.

8. Since insurance is not compulsory, businessmen take advantage of this leniency.

The following are my suggestions for improving operational conditions for macro- and micro insurance and takaful:

1. The SECP should license composite and comprehensive insurance companie for dedicated microinsurance providers

Presently, the SECP issues licenses separately for life and non-life insurance and takaful companies. For the promotion of microinsurance, I suggest that the SECP issue licenses for life, general and health insurance under one umbrella. Incorporation requirements should include a detailed microinsurance five-year business plan and a paid up capital of Rs 500 million. To attract new incorporations, the SECP should reduce fees on premiums, waive or reduce taxes on non-life general insurance practice, and allow such companies to transform to higher value "macro" insurance after five years.

2. The SECP should motivate existing insurers

The SECP charges a 0.2% fee on gross written premiums and contributions, a steep levy. The SECP should reduce this fee to encourage the insurer or operator. Instead of requiring the registration and approval of new microinsurance policies, the SECP should allow operators to alter existing schemes by reducing the benchmark for minimum premiums to attract smaller policyholders to conventional insurers. It should allow life insurance companies to sell term policies (without investment or cash value) and personal accidental policies.

The SECP could instruct non-life insurance companies to provide coverage to small shops and also prepare guidelines to underwrite the business. Finally, it should reduce the percentage of agency commissions on first year premiums of life insurance and the agency commission of fire and marine classes of non-llfe insurance.

3. Government should reduce taxes and fees

The provincial and federal governments should reduce current sales taxes of 14 to 16% and an additional 1% federal insurance fee on gross written premium/contributions of non-life insurance, which represents an extra burden for these companies. It could further reduce the rate of income tax on agency commissions from insurance premiums. Most agents operate on a commission-only basis, on which a 12% income tax. To encourage the agents, I suggest that the government reduce the income tax from 12% to 5%.

Moreover, the government should pass laws requiring compulsory group insurance for industrial and commercial employers rather than simple compensation. Under section 10-B the Industrial and Commercial Employment (Standing Orders) Ordinance, 1968, employers in such establishments with more than 20 employees are liable to pay compensation to workers for accidents arising out of and during the course of employment. This compensation is compulsory for industries and commercial enterprises to have their permanent workmen insured against death and disability. Typically, however, employers compensate workers from their own pocket instead of getting group insurance policies for their employees. The government should legislate and enforce compulsory group life Insurance for every industrial or commercial establishment where 10 or more workers are employed.

4. The SECP Shariah Advisory Board should better regulate and promote Takaful

I recommend the board prepare and implement a uniform Shariah-compliant policy guideline. Presently, takaful operators follow guidelines provided by their personal Shariah Advisors. Different opinions may lead to confusion between takaful operators, as well as in the market. Like Islamic banking, a central Shariah advisory board could resolve this confusion or disputes.

The regulator should allow takaful companies to transact business with conventional banks. At present, the takuful industry depends on the business of Islamic banking and finance institutions. The size of Islamic banking industry is very small as compare to the conventional sector, so the takaful industry struggles to grow as fast as it can. That’s why it is imperative to allow the takaful industry to do business with conventional banks.

Finally, the regulator should permit takaful coverage with conventional re-insurance companies. As per Takaful Rule 2005, takaful operators had been allowed to get retakaful arrangements with reinsurance companies. Takaful Rule 2012, which was implemented in March 2014, currently does not allow takaful operators to make retakaful arrangements with conventional reinsurance companies. Therefore, in Pakistan the arrangement of a 100% retakaful treaty is very difficult. Most of the retakaful operators are not interested in doing business in Pakistan, and the few that are do so with very strict terms and conditions. As a result, competing with the conventional insurance companies has become very difficult for takaful operators.

8 The role of Islamic finance in social development

A girl waits for customers as she sells balloons after Eid al-Fitr prayers in Karachi. REUTERS/Athar Hussain

INSIDE THIS CHAPTER

Poverty in Pakistan

Poverty is a complex and multidimensional phenomenon that extends beyond the notion of income and encompasses social, economic, and political exclusion. Therefore, it takes well-coordinated measures to reduce the incidence of poverty. Countries like Pakistan have been struggling for many years to alleviate poverty. In the past, the public sector was the key driver for poverty reduction initiatives. More recently, civil society institutions and NGOs have joined efforts to reduce poverty.

Pakistan is a lower-middle-income country, with about one-third of its population being extremely poor and under-privileged. Pakistan is spending a significant amount on safety nets and social protection programmes. In the fiscal year ending June 30, 2014, the safety net and social protection related expenditures amounted to Rs 1.9 trillion (US$18 billion, 14.2% of GDP). Under these programmes, the government provides food subsidies, social security, the peoples' work programme and the natural calamities and disaster management programme. Some programmes, such as Zakat, Pakistan Bait-ul-Mal, and the Benazir Income Support programmes provide direct cash grants to the poor and other indirect support through various institutions, while microfinance institutions provide financial services such as micro-credit, micro-savings and micro-insurance to their beneficiaries.

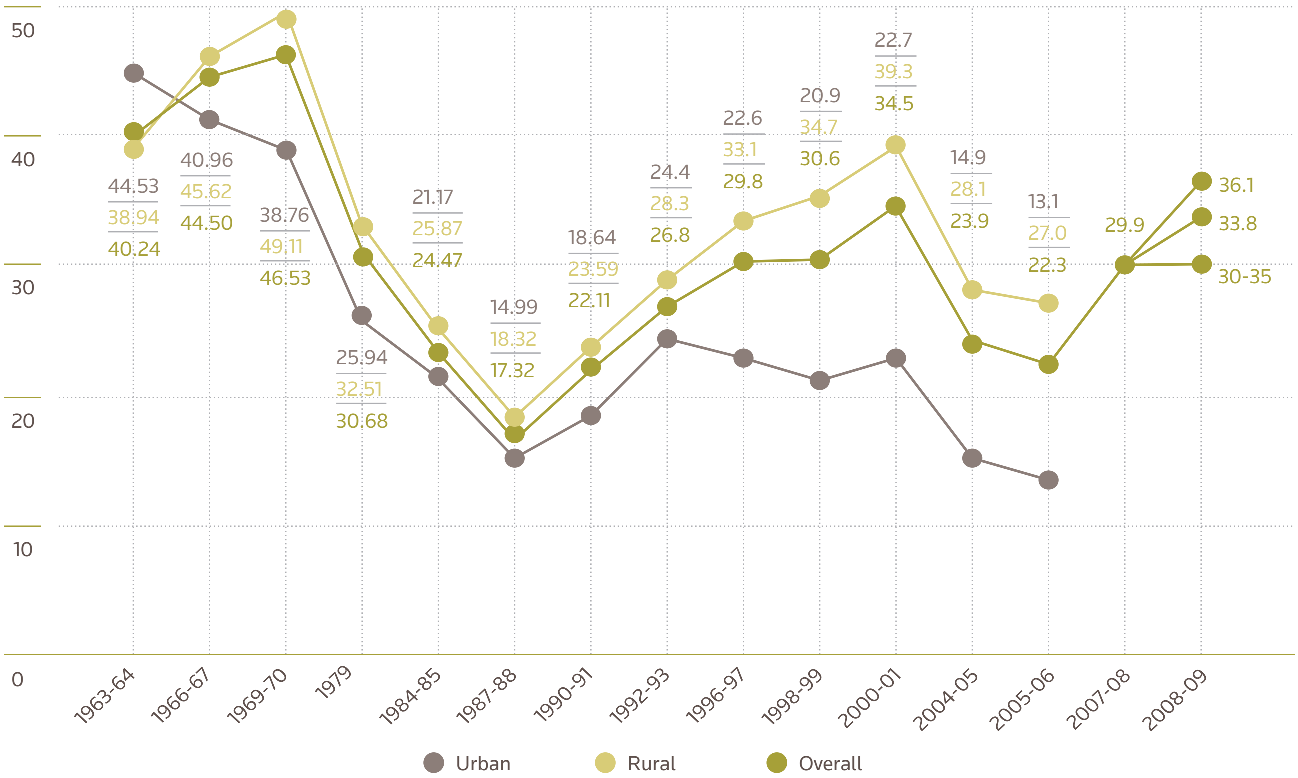
The government of Pakistan has fully fostered an environment for the successful operation of the microfinance industry. The microfinance industry is flourishing, and it has been increasing its outreach. However, despite all efforts, according to estimates, it hardly covered 10% of the potential microfinance demand in 2013 Shirazi et al. (2015).[42]

INCOME POVERTY

Determining the poverty threshold is the first step to identifying the poor and targeting services to them. Due to the differences in measuring poverty lines, poverty estimates are not comparable across regions and time periods. Estimates of incidence of poverty do not show unidirectional trends. After broad improvements from the 1960s to the 1980s, Pakistan witnessed increasing poverty during the 1990s, rising from 26.8% in 1992-93 to 34.5% in 2000-2001. Rural poverty significantly contributed to overall poverty levels of the country during the 1990s. A number of factors, including a decrease in economic growth, political uncertainty, economic instability, and large fiscal and current account deficits, were responsible for the increase in poverty during the 1990s. Poverty levels then dropped, reaching 22.3% in 2005-06. During the same period, the drop in rural poverty was faster (12.3 percentage points) than the drop (9.6 percentage points) in urban poverty. The possible contributing factors for the decline in poverty could be high economic growth, combined with increasing public sector spending on education, health and infrastructure.

However, the country could not sustain the decline in poverty and the level of poverty started rising again after the 2007-08 global financial crisis. Since the mid-2000s, Pakistan's economy has been facing number of problems including declining economic growth, high food and oil prices and thus high inflation, power shortages, weak governance and, above all, terrorism. Among others, these have been the main factors, which shattered the declining trend in poverty that the country observed during 2000 to 2006.

PAKISTAN: TRENDS IN POVERTY (HEAD-COUNT RATIOS)



Source: Poverty estimates from 1963 to 1991 are reported from Amjad, Rashid and A. R. KEMAL (1997), Macroeconomic Policies and their Impact on Poverty Alleviation in Pakistan, The Pakistan Development Review, 36: 1, pp. 39—68, and poverty estimates from 1992 onward are reported from Arif, G.M and Shujaat Farooq (2011), Background Study for the MCPs Document for Pakistan on Poverty, inequality and Unemployment

SOCIAL POVERTY

The Human development index (HDI) is a broader measure of development compared to development measured in terms of GNP per capita only. HDI is a composite measure developed by the UNDP that takes into account health, education and income indices. Alternatively, it shows the improvement in social progress or social poverty. The United Nations ranks Pakistan low in terms of human development at 146 of 187 countries in 2012. Pakistan's HDI figure increased from 0.337 in 1980 to 0.515 in 2012. This moderate increase over 32 years slowed further over the period 2005 to 2012. Because of the slow progress in health, education and nutrition, Pakistan has been unable to achieve its targets set in the Millennium Development Goals.

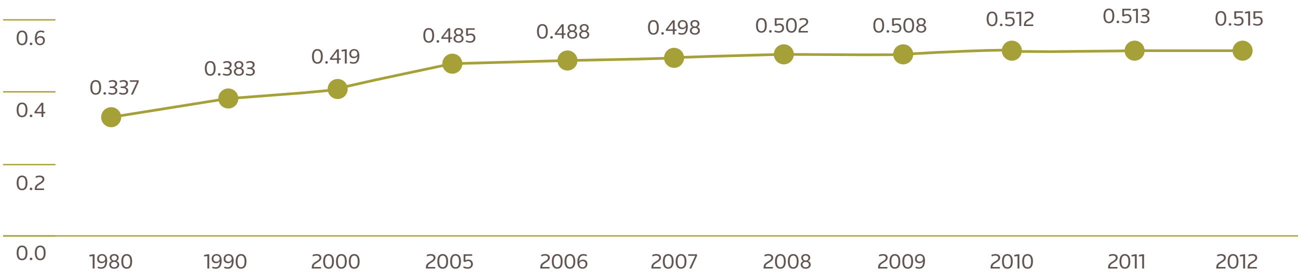
INCOME INEQUALITY

In the 1990s, income inequality increased in Pakistan in both urban and the rural areas. However, independent estimates, such as the Anwar (2005) study[43] showed higher income inequality than the official ones (e.g. FBS and the World Bank). In the early 2000s, overall income distribution improved marginally, but reversed its trend from 2005-2006 until 2010.

During 2007-2008, the Gini coefficient decreased in urban areas and at the country level, but increased in rural areas of the country. On the other hand, it may be noted that the official estimates of poverty showed a declining trend during 2001-02 to 2005-06, which was the result to respectable economic growth during the same time period. Comparing estimates of poverty with Gini coefficients reveals that there is a negative correlation between poverty reduction and income distribution in Pakistan. Economic growth reduced poverty but increased income disparity, thus implying that the benefits of growth have reached the rich more than the poor.

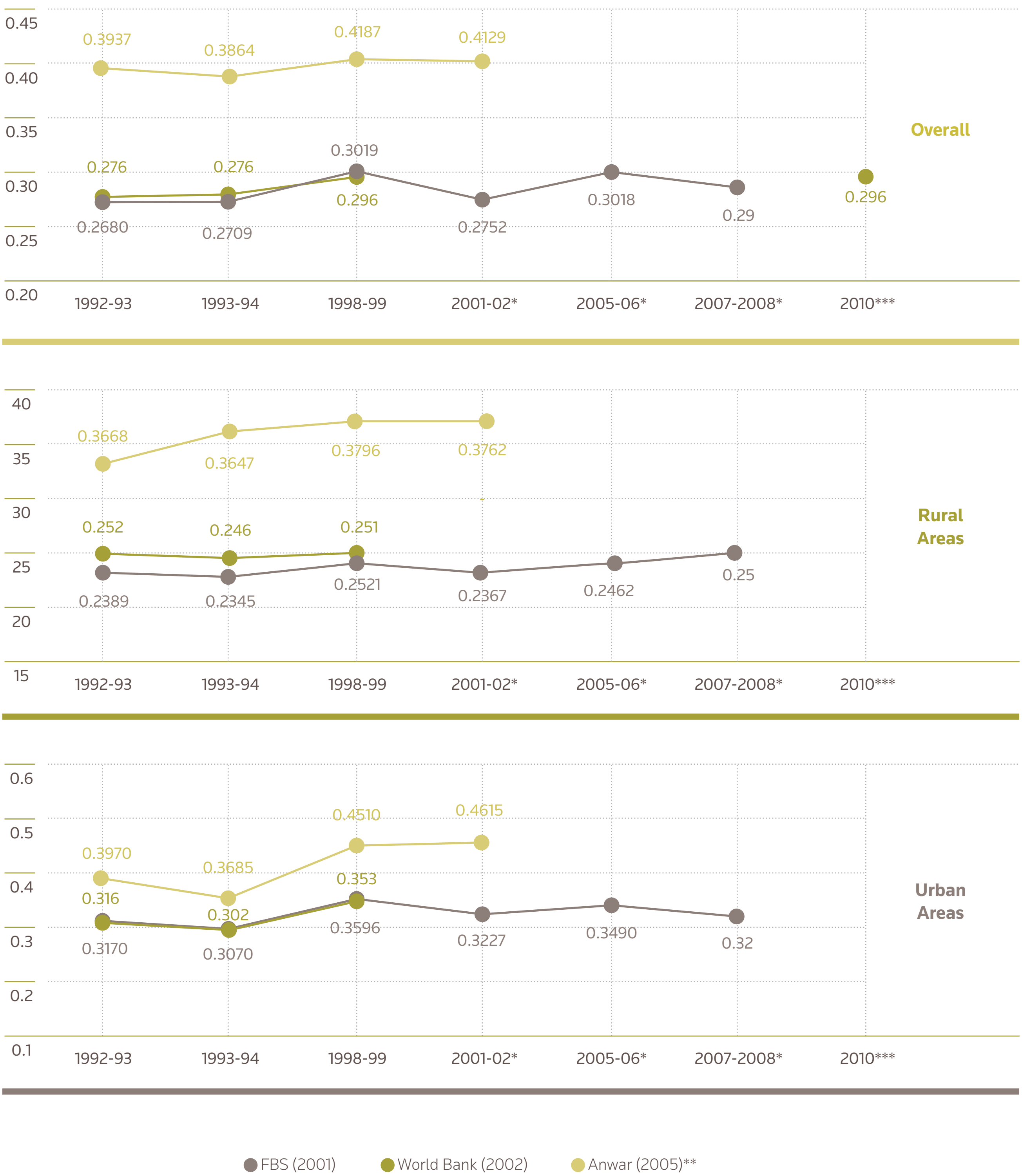
Economic growth is a necessary but not a sufficient condition for the reduction of poverty. Whether growth is pro-poor essentially depends on how the benefits of growth are distributed amongst the different income groups. The often-cited Haq and Zia (2009)[44] study provided analysis of linkages between governance and pro-poor growth in Pakistan for the period 1996 to 2005. On the aspect of pro-poor growth, they demonstrated that the poor do not benefit proportionately from economic growth. The income and expenditure share of the rich increased more than the income and expenditure share of the poor. Over time, the share in income and expenditure of the bottom 20% of the population decreased, although absolute levels increased. Inflation for this lowest income group, concentrated in basic goods and necessities, impacted their budget far more than the highest-income group.

HUMAN DEVELOPMENT INDEX



Source: HDI, UNDP (2013)

PAKISTAN: GINI-COEFFICIENT BY REGIONS AND OVERALL (1992/93 – 2007/08)



*Based on Economic Survey of Pakistan

** Anwar, Talat (2005) "Long-Term Changes in Income Distribution in Pakistan: Evidence Based on Consistent Series of Estimates," Centre for Research on Poverty Reduction and Income Distribution. Discussion Paper Series No. 3

*** World Bank, World Development Indicator (2015)

SOCIO-ISLAMIC FINANCE PRACTICES IN THE TRIBAL AREAS OF PAKISTAN

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Khyber-Paktunkhwa (KP) and adjacent tribal areas have a unique socio-religious structure that affects their governance, and social and business matters. KP and tribal areas contain both provincially and federally controlled regimes. The Pakistan federal and provincial governments have retained minimal administrative authority over tribal regions, while permitting the tribes' autonomy. FATA regions in particular have very decentralized governance structures. A political agent directs each agency in FATA, with powers and funds for developmental and non-developmental expenditures. FATA is divided into two administrative categories—protected and non-protected areas. Protected areas include roads and government buildings that are in direct control of the political agents. Non-protected areas are administered indirectly through the unwritten and broad socio-religious code of *Pakhtunwali*. *Pakhtunwali* structures the social finance system of the resident tribes. Its influence, however, is less significant in the settled areas of Khyber-Pakhtunkhwa.

Pakhtunwali demonstrates a unique synthesis of Islamic and tribal norms. *Pakhtunwali* is derived from *Pakhtu* (or Pashto), the dominant language spoken in the region. There are two meanings of *Pakhtunwali*—speaking *Pakhto* and enacting *Pakhto* culture. The later interpretation, *Pakhto* culture, has embedded socially implied agreements cover financial and non-financial commitments to and by residents. *Pakhtunwali* enacts a social and informal financial system through sub-principles such as *Masharwali/Kasharwali, Nanawate, Turah, Baramtha,* and *Namus.*

Masharwali, literally means "eldership," as an elder is called *Mashar*. *Kasharwali* means "youngership," which calls for obedience to elders by the younger members of the tribe called *Kasharan (Singular: Karshar).* These norms establish the elders' superiority, where the sayings of elders work as orders to be followed and even implemented by force by the less senior members across the families and tribes. The wealth distribution in a family is largely controlled by the orders of these elders. In one family, high earners may need to spend more and help those members who earn less. The *Mashar* of the family enacts this process, and non-compliance by the *Kashar* may cause his social exclusion. Similarly, some relatively elder brothers may be free of earning money for the family in return for doing *Gham-Khadi*, or representing the family in the celebrations or mourning rituals of other families in or out of the tribes.

Masharwali also causes *Nanawate* in the socio-Islamic finance system of the tribal areas. In *Nanawate*, elders of a tribe convene as group or *Jirga* to visit a particular person or family and collect some concessions for another member of the tribe experiencing a financial crisis. For instance, if a person defaults in repaying qardh-e-hasana, the *Masharan* (elders) may, on the request of borrower, go to the lender and request to write-off or to reduce the debt. In local ijarah cases where landowners give lands on ijarah to farmers and the produce is not enough to cover the lease, a *Nanawate* can create concessions for the lessee. In *Nanawate*, the lender, due to respect for the elders, will give concessions. *Nanawate* is enacted by the principle of *Masharwali* and disregarding the elders' request can negatively affect the lender's respect within the tribe. In many instances of *Nanawate*, the *Masharan* have successfully requested owners and principals of private schools to help finance the education of children from less privileged families.

Pakthunwali also strengthens finances within the family. *Mlatar*, is a norm derived from *Mla,* meaning "back," and *Tar*, meaning "support." The elders gain social prestige when their sons and grandsons reach earning age, as these men can support the elders financially and socially. In a different context, *Mlatar* is also interpreted when close relatives meet and provide financial support to an individual family member in financial crises. *Mlatar* is an effective social finance stimulus because having close relatives in financial crises makes wealthy members accountable to the tribe at large. The non-response of wealthier members of tribes can hurt their dignity. As part of *Mlatar,* wealthy members of the families often bring animals for the close relatives to perform sacrifice during the Eid. *Mlatar* is a little different from the Islamic principle of cooperation because the incentive is a mixture of both religious and social pressures, and cooperation goes beyond basic needs.

Social finance in tribes sometimes also arises through the norm of *Turah* or *Baturi*, or bravery. This principle, if interpreted and applied positively, can protect local society against financial injustice. For example, if a lender takes control of borrower's security by force against a defaulted loan, the people will tend to support the borrower as part of *Baturi. A Batur*, a person who does *Baturi* to protect the borrower, may go to the extent of warning or fighting the person unjustly taking the security. A relevant principle is *Baramtha,* which is interpreted as a form of tribal justice. For instance, if a person defaults against certain obligations even if he has the capacity to pay these obligations, under the *Masharwali* and *Baramtha* principles, the tribe can forcefully make that person pay an equal value of the obligation. The collection could be either from the person responsible for the particular obligation or from his family at large.

These principles, and many others, have roots both in *Pakhtun* historical social construction and Islam, when it reached the region. For instance, the principle of *Masharwali*, presumably, is inspired by the Islamic ethics of respecting elders, as well as, the Pakhtun historical legacy of respecting elders. Similarly, the principle of *Mlatar* is, more or less, similar to the principle of Islamic brotherhood. However, this principle, alongside the religious motivation of reward in the hereafter, is mainly driven by the need to defend family honor, or *Namus*. Helping a family member in financial need defends family honor within the tribe, which also brings reward from God. Similarly, family members that financing education and marriages of the people within the tribe attributing their decisions to both religious rewards as well as to the maintenance of the tribe integrity. Islam inspires *Baturi,* on the one hand, as an objectively positive value supporting the righteous and powerless. On the other hand, *Baturi* demonstrates the social authority of the person protecting the powerless.

Note: The author has derived thoughts in this article from in-depth narrative cases that the Centre for Excellence in Islamic Finance (CEIF) IMSciences, Peshawar is developing to promote Islamic finance research, education, and best industry practices. For any queries please contact the author at: karim.ullah@imsciences.edu.pk.

Pro-poor expenditure by the government

Over the last decade, Pakistan has embarked on an integrated approach to reducing poverty. Pakistan's strategy for poverty alleviation is based on four pillars: 1) accelerated and broad-based economic growth while maintaining macroeconomic stability; 2) improved governance and consolidated devolution; 3) investment in human capital; 4) and targeted programmes with emphasis on social inclusion. It has identified 17 pro-poor expenditure sectors with the target of spending a minimum of 4.5% of the GDP on them. Pro-poor expenditures have been rising significantly from 3.8% of GDP in 2001-02 to 13.1% of GDP in 2012-13. These expenditures were well above the requirement under the law. During 2013-14, total expenditures for these sectors increased slightly to Rs 1.9 trillion (US$18 billion), which was 14.2% of GDP. During July to December of the fiscal year ending June 30, 2015, Rs 667.47 billion (US$6.4 billion) expenditures have been made in these sectors.[45]

SAFETY NETS IN THE PUBLIC SECTOR

In order to protect the extremely poor and vulnerable, the country has instituted many social protection programmes. These programmes are considered important for creating an environment in which the extremely poor are protected from the social and political costs of economic and structural reforms. Some social protection programmes have been implemented over the last three decades. For example, the Pakistan Poverty Alleviation Fund (PPAF) was initiated in 2000, and the Benazir Income Support Programme (BISP) was launched in 2008-09.

The social protection and safety net programmes of Pakistan can be classified into two categories. The first category applies to the employed labour force or those who have retired from the formal sector. It does not cover the employees in informal sectors or contract employees. The other category is much broader, covering anyone who is outside the labor market, such as the poor and the indigent. The first set of programmes provides benefits in the event of contingencies like sickness, invalidity, maternity, old age and work-related injury. These include the Provincial Employees' Social Security Scheme; the Employees' Old Age Benefits Institution; the Government Servants' Pension Fund; the Public Sector Benevolent Funds and Group Insurance; the Workers' Welfare Fund; and the Workers' Children's Education Ordinance. The second category includes schemes like Pakistan Poverty Alleviation Fund (PPAF), Benazir Income Support Programme (BISP), the *Zakat* Programme and the Pakistan *Bait-ul-Mal* (PBM) programme.

PAKISTAN POVERTY ALLEVIATION FUND (PPAF)

Pakistan Poverty Alleviation Fund (PPAF) was established in 2000 as the coordinating institution for the sector, with the objective of reaching the poor communities through NGOs and Community Based Organizations (CBOs). PPAF is a major financier of the microfinance market, and it supports water and other infrastructure, drought mitigation, education, and health and emergency response interventions. The core operating units of the PPAF deliver a range of development interventions at the grassroots/community level through a network of 129 partner organizations across the country.

From its inception in April 2000 until March 2015, PPAF has disbursed approximately Rs 153 billion

(US$1.46 billion) to its partner organizations in 121 districts across the country. During the same period, 7.8 million individuals received PPAF financing with 60% of loans going to women. It has initiated 34,000 water and infrastructure projects and supported 2,000 health and education facilities. It has helped form 430,000 credit groups and 126,500 community organizations, trained 666,000 staff and community members, and granted 294,000 individuals skills/entrepreneurial training. It has also provided assistance to 75,000 vulnerable and ultra-poor households, and rehabilitated 29,500 people with disabilities. It trained 26,279 individuals, including women and youth, in enterprise development under the Waseela-e-Haq National and Waseela-e-Haq Sindh programme of BISP and facilitated in establishing their successful ventures.

Between July 2014 to March 2015, Pakistan Poverty Alleviation Fund (PPAF) has disbursed Rs 9.8 billion (US$93.3 million) to its partner organizations, about two-thirds of which was on microfinance. About 15% was spent on the Livelihood, Employment and Enterprise Development (LEED) programme. Overall, the projects and interventions benefitted approximately 3.9 million people in the poorest and most marginalized populations in Pakistan, and women were 59% of beneficiaries.

DISBURSEMENT BY OPERATING UNITS/SPECIAL INITIATIVES

BISP's Waseela-e-Haq Programme
0.04 %
Rs 4.36 Mn

Prime Minister's Interest Free Loan
8.12 %
Rs 799.13 Mn

Institutional Development and Social Mobilization
1.89 %
Rs 186.39 Mn

Microfinance Portfolio Management
67.98 %
Rs 6,692.38 Mn

Education, Health and Nutrition
1.41 %
Rs 139.02 Mn

Water, Energy and Climate Change
2.61 %
Rs 256.53 Mn

Community Physical Infrastructure
2.98 %
Rs 293.82 Mn

Disability
0.50 %
Rs 49.11 Mn

Livelihood, Employment and Enterprise Development
14.46 %
Rs 1,423.65 Mn

Total Disbursement
100%
Rs 9,844.40 Mn

Source: Authors own compilation from Pakistan Poverty Alleviation Fund/Economic Survey of Pakistan, FY 2014/15 data.

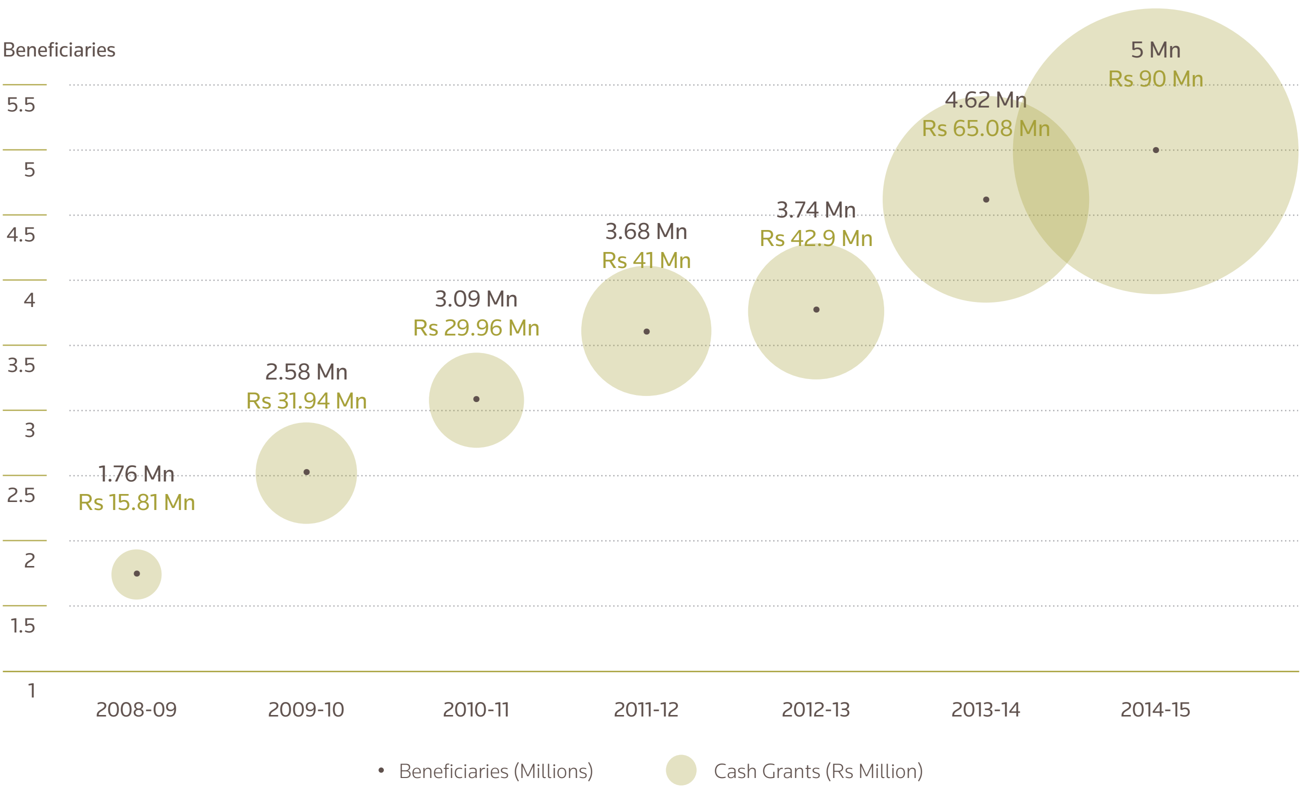
BENAZIR INCOME SUPPORT PROGRAMME (BISP)

Benazir Income Support Programme (BISP) was launched in 2008 to provide direct and urgent relief to poor families that lost their purchasing power because of high inflation. BISP was started with an initial allocation of Rs 34 billion (US$324 million) to cover 3.5 million families in the financial year 2008-2009. The programme was initiated to provide cash grants of Rs 1,000 each month (recently increased to Rs 1,500, US$952-1,427) to families with incomes of less than Rs 6,000 (US$5,700) per month.

The BISP has been supported by multilateral and bilateral institutions and donors including the World Bank, USAID, Asian Development Bank and DFID. BISP has been providing cash grants to an increasing number of families. The numbers of beneficiary families increased from 1.76 million in 2008-09 to approximately 5.0 million by the end of fiscal year 2014-15. The annual disbursement to families increased from Rs 15.8 billion (US$150 million) in 2008-09 to an expected amount of Rs 90 billion (US$857 million) by the end of fiscal year 2015, of a total allocation of Rs 97 Billion.

The cash grants take various forms: *Waseela-e-Taleem* supports beneficiaries' children between 5 and 12 years of age for primary education expenses. Under this scheme, a monthly cash transfer of Rs 200 per child (up to three children) will be provided subject to school attendance. The programme covers 32 districts in Pakistan, and 600,000 children have so far been registered in the programme, out of which 350,000 have already been enrolled in schools.

TRENDS IN BISP SUPPORT



Source: Benazir Income Support Funds

Waseela-e-Rozgar was initiated to provide technical and vocational training to one member per beneficiary family, enabling them to become the family breadwinner. Such training is provided by both public and private sector training institutions. It now covers about 58,000 trainees.

Waseela-e-Haq is designed to promote self-employment among women beneficiaries or their nominees to improve their livelihoods by providing Rs 300,000 (US$2,857) long-term interest-free financial assistance. So far, 41 draws have been held and installments worth Rs 2.6 billion (US$24.8 million) have been disbursed to 16,119 beneficiaries, while 9,193 beneficiaries started their own businesses.

Waseela-e-Sehet covers health care costs of the beneficiary families as well as life insurance coverage of one male breadwinner of each beneficiary family, which receives cash grants. In 2011-12, a pilot project with health care was launched in Faisalabad for 43,000 families. It was extended to around 75,000 beneficiary families in 2014-15. The programme extended life insurance to the breadwinners of 4.1 million beneficiary families.

ZAKAT

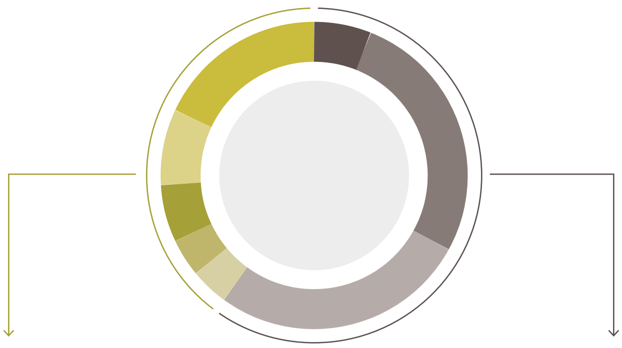
Zakat funds are collected and used by the government of Pakistan for the needy, indigent, poor, orphans, widows, handicapped, and disabled. The deserving people are provided assistance directly through the Local Zakat Committees or indirectly through state and private institutions.

In Pakistan, zakat payment is mandatory according to law. However, in essence, it is only partially so. Zakat of 2.5% of all financial assets is deducted at the source by financial institutions. This is deposited in the central zakat fund. Zakat liability on other assets, such as, agricultural produce and others are voluntarily paid.

Zakat funds have been established at three levels, namely, the central level, the provincial level (in each province) and the local level (in each of the localities). The provincial zakat funds receive six monthly transfers from the central zakat fund, and similarly, the local zakat funds receive six monthly transfers from the provincial zakat funds. Very small amounts of voluntary zakat, atiyat (donations) and other donations are also deposited with these funds.

The central zakat council has laid down guiding principles for the disbursement of zakat funds by the provincial zakat councils and the local zakat committees. At the provincial level, the disbursement of zakat money from provincial zakat funds has been suggested in the following manner:

DISBURSEMENT OF ZAKAT MONEY FROM PROVINCIAL ZAKAT FUNDS



TRANSFER TO INSTITUTIONS FOR ELIGIBLE BENEFICIARIES (MUSTAHIQUEEN)
40%

Breakdown of the transfer to institutions:

Educational institutions
18%

Dini Madaris
8%

Health institutions
6%

Social welfare institutions
4%

Others
4%

TRANSFER TO LOCAL ZAKAT COMITEE
60%

Use of zakat at local zakat committee:

Subsistence grant to eligible beneficiaries (mustahiqueen)
Not more than 45%

Permanent rehabilitation of eligible beneficiaries (mustahiqueen)
At least 45%

Administrative expenses
Not more than 10%

The zakat programme covers a proportionally small number of beneficiaries compared to total need in Pakistan. The total distribution of zakat has been very small, and it remained between 0.04% to 0.06% of GDP during 2004-2008. The total collection was 0.05% of GDP to 0.08% of GDP during the same time, while it was about 0.3% during 1980s. Compared to actual zakat collection by the official sources, its potential is much higher. It is estimated to be between roughly 2% to 4% of the GDP (Shirazi 2014[46]).

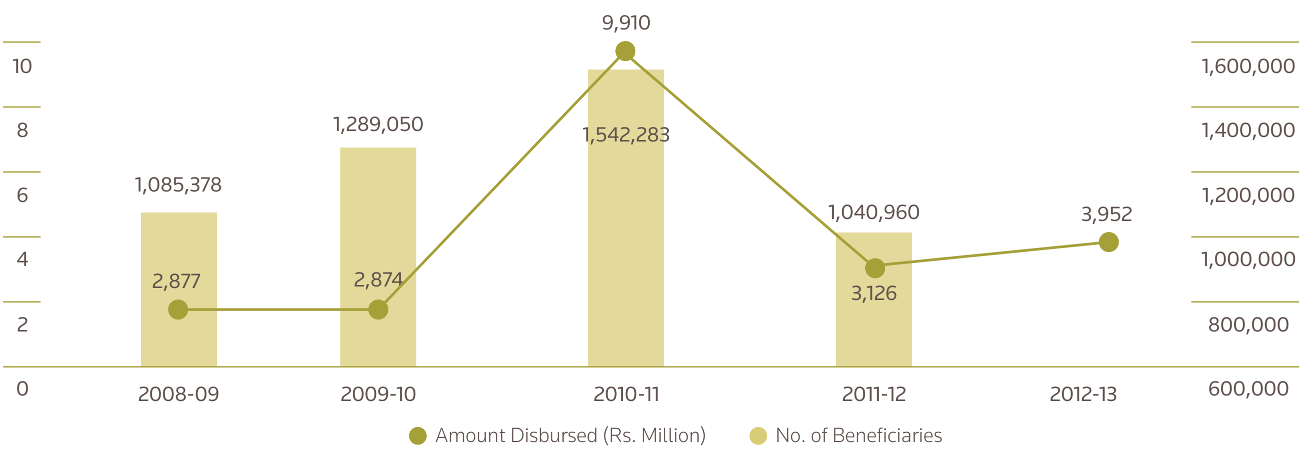
The disbursement of zakat has remained uneven. The number of total beneficiaries barely reached 1.5 million in 2010-11, and it has consistently hovered around 1 million. According to Shirazi (1996)[47], a study revealed about 18% of the total households in the lowest income decile benefited on an overall basis, 16.5% in urban and 18.5% in the rural areas. All households that benefited in all the income deciles were 2.7% on overall basis, 1.4% in the urban areas and 3.2% in rural areas in 1990-91.

Issues and Policies Consultants (2004)[48] reported that 2.7% of poor households received 40% of zakat, while 1.4% of non-poor households received 60% of zakat in 2001-02, which clearly indicates possible misappropriation of zakat funds. The CPRSPD study (2007)[49] reported 27% of non-poor households as zakat recipients. The same study pointed out that 32% of Guzara Allowance and 45% of rehabilitation grant went to non-poor. The contribution of zakat in poverty alleviation was just 0.5% in 1988 and 0.75% in 1990-91 (Shirazi 1996).

As a consequence of 18th Constitutional Amendment, the collection of Zakat devolved to the provinces/federal areas. However, in view of Council of Common Interest (CCI) decision of 8 November 2012 and the subsequent change in Rules of Business, the federal government (Ministry of Religious Affairs and Inter-faith Harmony) has been assigned the job of collection and disbursement of Zakat at federal level until the next NFC under the CCI approved formula. A total amount of Rs 4.8 billion (US$45.7 million) was distributed in bulk amongst the provinces and other administrative areas for fiscal year 2014-15.

As mentioned earlier, zakat deduction at source from specified assets was mandatory until March 1999 and became optional after that. This has negatively affected the collection of zakat by the government. Even before the decision of the Supreme Court of Pakistan, people used to withdraw their money before the date of deduction of the zakat by banks. Overall, it appears that the collection of zakat has not been paid due attention and consequently, a positive social institution that could make a dent on poverty has been neglected.

ZAKAT DISBURSED AND NUMBER OF BENEFICIARIES



Source: PRSP progress Report 2008/09-2010/2011 and PRSP progress Report 2011/2012. Figures for the year 2012/2013 are reported from Economic Survey of Pakistan (2013)

PAKISTAN BAIT-UL-MAL[50]

Pakistan Bait-ul-Mal (PBM) was established in 1991 to provide financial assistance to the destitute, widows, orphans, invalids, infirm and other needy persons irrespective of their gender, caste and religion through its different projects and schemes.

During July 2014 to March 2015, Pakistan Bait-ul-Mal (PBM) disbursed an amount of Rs 2.28 billion (US$21.7 billion) to its core projects that include the following:

- Individual Financial Assistance (IFA) to the poor, widows, destitute women and orphans supported for medical treatment, education, rehabilitation and general assistance
- PBM Thalassemia Center for Thalassemia patients
- Special Friends of PBM (wheelchairs to every disabled person)
- Pakistan Sweet Homes (orphanages)
- PBM Great Homes (retirement homes)
- National Centre(s) for Rehabilitation of Child Labour (NCsRCI)
- Vocational Training Centres (VTCs)
- Employees Old Age Benefits Institution (EOBI)
- Workers Welfare Fund

Women work in a garment factory in Faisalabad, located in Pakistan's Punjab. REUTERS/ Faisal Mahmood

Zakat as instrument of social finance

For Pakistan, data on the actual mobilization of zakat are not easily available and can only be estimated. Data from the Ministry of Religious Affairs on zakat distributed as stated above is perhaps a gross understatement of the actual zakat that is collected and distributed in the country. It is interesting to note that while the Ministry distributed a total amount of Rs 4.8 billion in 2014-15, one private foundation alone, the Shaukat Khanum Hospital collected Rs 2.226 billion of zakat during the same year. Other than this, there are formidable charities, such as, Edhi Foundation, The Citizens Foundation, SOS Village, Fatimid Foundation, which collect and utilize sizable amounts of zakat for the poor.

INSTITUTIONAL STRUCTURE FOR ZAKAT

Pakistan has a dual system of zakat management. For certain types of wealth and income subject to zakat, the muzakki is mandatorily required to pay zakat to the state. For others, zakat may be paid to the state (Department of Zakat under Ministry of Religious Affairs) as well as to the multitude of private zakat bodies at the discretion of the muzakki. The latter include individual and institutional zakat collectors and social organizations that are partially funded through zakat. Matters pertaining to zakat are governed by the Zakat Ordinance, 1980.

REGULATORY FRAMEWORK

Zakat Collection

In addition to countries like Malaysia, Sudan and Saudi Arabia, Pakistan has made zakat payment compulsory as well. In Pakistan, zakat on specific forms of assets is deducted at source. Section 3 (1) of the Zakat and Ushr Ordinance 1980 asserts that "zakat in respect of assets mentioned in the First Schedule shall be charged and collected, on compulsory basis, for each zakat year, at the rates and in the manner specified therein, and as may be prescribed, from every person who is on the valuation date, and for whole of the proceeding zakat year been, sahib-e-nisab, and who owns or possesses such assets on the valuation date." The list of assets includes: savings deposits with banks and similar deposits, mutual fund units, government securities etc. Zakat is to paid voluntarily on self-assessment basis for most other forms of assets, such as, cash, gold, silver, loans receivable, shares and bonds, stock-in-trade, precious metals, agriculture produce, livestock, rental income and the like.

Going by the experience of countries that have made zakat payment compulsory, it appears that there are serious flaws in the implementation of the law. The reasons for weak enforcement are: absence of a muzakki database, unwillingness of zakat officers to list down those who fail to pay zakat, a shortage of staff, and the inadequate authority of zakat officers to investigate failures.

It is interesting to note that while the law in Pakistan seeks to provide definitive methods for the calculation of zakat liability, its rigidity may have resulted in large-scale zakat evasion or avoidance. The law also provides for exclusion of a Muslim from zakat liability if he follows a school of fiqh that stipulates different estimations of zakat liability. It merely requires the person to submit a declaration with the deducting agency that "that his faith and the said fiqh do not oblige him to pay the whole or any part of zakat or ushr in the manner laid down in this ordinance."

Zakat Utilization

An interesting provision in the law in Pakistan deals with the issue of imparting ownership to zakat beneficiaries (*tamleek*). Secton 8 of the law identifies several categories of beneficiaries, such as, the poor, needy, orphans, widows, handicapped and the disabled as eligible to receive zakat under Shariah for their subsistence or rehabilitation, either directly or indirectly through religious seminaries or educational, vocational or social institutions, public hospitals, charitable institutions and other institution providing health care. Zakat may take the form of assistance to the needy persons affected or rendered homeless due to natural calamities like floods and earthquakes and for their rehabilitation.

The law in Pakistan also explicitly addresses operational and administrative expenditures related to zakat collection and distribution. Section 8 stipulates that zakat proceeds may only partially cover expenditure on the collection, disbursement and administration of zakat. The government will meet all expenditures related to administration, while banks will provide all services related to zakat free of charge.

The zakat law is very elaborate in terms of organization and management of central, provincial, district, sub-division and local committees, but it provides very little in terms of penalties and punishments, except the possibility of removing committee members who infringe the law.

Tax Treatment of Zakat

Most countries treat zakat at par with charity contributions made to voluntary organizations and provide tax relief in the form of allowing the same as a deduction to taxable income.

Pakistan also provides for similar tax relief to the muzakki. Section 25 of the act says: "Notwithstanding anything contained in any other law for the time being in force in determining the tax liability of an assessee for an assessment year,"

- Under the Income Tax Ordinance, 1979 (XXXI of 1979), his total income shall be reduced by the amount paid by him to a Zakat Fund, during the income year relevant to that assessment year; and

- Under the Wealth Tax Act, 1963 (XV of 1963), his assets in respect of which zakat or contribution in lieu thereof, has been deducted at source during the year relevant to that assessment year shall be excluded from his taxable wealth; and

- Land revenue and development cess shall not be levied on land on the produce of which ushr or contribution in lieu thereof, has been charged on compulsory basis.

Waqf as instrument of social finance

A*wqaf* (waqf, singular) have been an important pillar of the religious, social, cultural, scientific, economic and political life of Islamic society for centuries. However, the institution of religiously protected foundations appears to have completely lost its status in Pakistan as an instrument of social finance. Other than awqaf for mosques and religious madrasas, there are hardly any new waqfs created for socioeconomically beneficial purposes, such as universities, schools, libraries, hospitals, orphanages, and charity for the poor, destitute, and the disadvantaged.

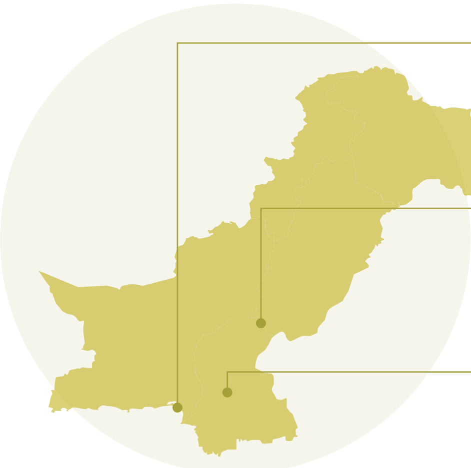
In Pakistan, before the nationalization of waqf properties in 1960, the individuals, local voluntary groups and the descendants of saints managed waqf. Some waqf properties were mismanaged and misused for purposes other than specified by the waqif, and they were exploited by *Pirs* (sufi leaders), *sajjddah-nashins and mujawars* (waqf administrators), and other ulama. For the purpose of improving the administration and management of waqf properties including shrines, mosques, land and buildings, a Department of Waqf was constituted as legal entity through Waqf Properties Act 1960 in each province—Punjab, Sindh, Baluchistan and Khyber-Pakhtunkhwa—headed by a chief waqf administrator. In the absence of a detailed survey, estimates of existing awqaf are sketchy.

The Sindh province has 4,419 units including shops, houses/flats, plots, rooms and cabins. The department has 10,912 acres of land. The Awqaf Department of Kashmir manages 55 shrines/Darbars with 403 employees. The department is administering 1,329 kanals out of 3,145 kanals of waqf land.

WAQF PROPERTIES OF SINDH

189
GRAND TOTAL PROPERTIES

78 Shrine
80 Mosque
31 Waqf Properties



Karachi (71 Properties)
27 | 32 | 12

Sukkur (48 Properties)
18 | 23 | 07

Hyderabad (78 Properties)
33 | 25 | 12

4419
TOTAL UNITS

2135	1625	174	267	218	10912.05
No. of Shops	No. of Houses /Flats	No. of Plots	No. of Rooms	No. of Cabin /Others	Agriculture Land (In Acres)

Source: Zakat and Ushar Department of Sindh Government

The awqaf Department of Punjab is currently managing 37 important and famous shrines/darbars and 24 mosques. The government of Punjab nationalized 276 shrines/darbars, 406 mosques and 483 other properties. The details of other properties included 73,884 acres of land, 1596 shops and 1741 houses in 1984 (Malik, 1990).

Awqaf Department earns revenues in the form of rents, lease, cash boxes and other gifts. The same is spent on administrative expenses, maintenance of the shrines/darbars and mosques, feeding poor through *langer khanas* (Almshouses), religious and social affairs. The Awaqf Department of Punjab runs one hospital and 14 dispensaries under its social welfare programme and provides *Jahez* (dowry) to 25 girls every month. The awqaf department of Sindh extends welfare and financial assistance to orphans, destitute and disabled persons, on yearly basis.

REGULATORY FRAMEWORK

In Pakistan, the four provinces—Punjab, Sindh, Baluchistan and Khyber-Pakhtunkhwa—have independent waqf administrations led by a chief waqf administrator, who exercises unfettered powers in matters relating to waqf in the given province. The Provisional Waqf Ordinances 1979 provide the regulatory framework for awqaf. Since the laws in four provinces are more or less similar, we will focus on one, the Provisional Waqf Ordinances 1979, in Punjab for further analysis.

Waqf administration demonstrates an extreme case of concentration of authority in the hands of the state. Under the Punjab Waqf Ordinance, the chief administrator has supervisory authority over all awqaf in the province, and in certain circumstances, he may even assume direct responsibility for the administration, control, management and maintenance of a waqf property by notification (Sec. 7). The Chief Administrator is also empowered to evict any persons wrongfully in possession of waqf properties (Sec. 8) and to terminate a lease or resume a tenancy for breach of conditions (Sec. 9). He may also require 'any person-in-charge of or exercising control over the management of any waqf property... to furnish him with any return, statement, statistics or other information regarding such waqf property, or a copy of any document relating to such property. The Punjab *waqf* ordinance also has harsh punitive provisions. If any person obstructs, resists, impedes or otherwise interferes with anyone acting pursuant to the ordinance, he is punishable by fine and/or imprisonment up to five years. Similarly, willful disobedience or failure to comply with any requisition, instruction or direction issued by the Chief Administrator is punished with a fine (Sec. 24).

The inalienability of waqf assets has been grossly compromised because of the unfettered powers granted to the chief administrator, who can actually take over the *waqf* completely and with a few limitations do as it pleases with its assets. This action is subject to no meaningful judicial oversight or other legal intervention.

Only two conditions restrict the take-over of *waqf* property by the chief administrator. First, the chief administrator must give notification (but not necessarily prior notice) to the mutawalli that the chief administrator is taking over the *waqf* property. Second, during the lifetime of a person founding a *waqf* property, the chief administrator may only take over the waqf with the consent of the founder and on such terms and conditions as may be agreed upon between the founder and the chief administrator.

It is evident that awqaf in Pakistan in their current form have limited potential as instruments of social finance or as a tool of social protection or economic and social transformation, until and unless the sector undergoes a major reform. The archaic legal and regulatory framework hardly leaves any room for the development of waqf assets and their use for social purposes. The absolute powers vested with the chief administrator and the government machinery have effectively taken waqf out of the voluntary sector. Not surprisingly, all leading not-for-profit public goods providers, such as higher education institutions, healthcare providers in Pakistan have preferred a secular NGO structure over waqf.

REVIVAL OF WAQF -CASE STUDY OF IHSAN TRUST: A SUCCESS STORY OF MODERN APPLICATION OF WAQF-BASED INSTITUTION BY IFIS

Ahmed Ali Siddiqui | Founding Director, Centre for Excellence in Islamic Finance (CEIF), Institute of Business Administration (IBA)

MR. SIDDIQUI holds a Bachelors and Masters degree in Business Administration from Institute of Business Administration (IBA), Karachi with six gold medals. He has over 14 years of Islamic banking experience and is currently working as Executive Vice President & Head, Product Development & Shariah Compliance (PDSC) and leading one of the largest Research departments in the Islamic banking world with over 40 dedicated team members. He is also the Secretary for Shariah Supervisory Board at Meezan Bank Limited and is part the team to advice the Government of Pakistan on Structuring and Issuance of Local currency Sovereign Sukuk of around US US$ 5 billion dollars. Currently Mr. Siddiqui is also a member of Advisory team for Centre of Islamic Economics (CIE), Jamia Darul Uloom Karachi, Senior Vice Chairman of the Standing Committee on Islamic Finance of Federation of Chamber of Commerce & Industries Pakistan, Member of Islamic Banking Sub-committee of Pakistan Banking Association, Member of Institute of Chartered Accountant of Pakistan committee for Islamic Accounting Standards and a visiting faculty member of Islamic Finance at IBA Karachi. Mr. Siddiqui has also been given the additional role to lead the Institute of Business Administration (IBA) Centre for Excellence in Islamic Finance (CEIF) as its founding Director.

Introduction

Waqf is a centuries-old charitable social institution in Islam. In Islamic history, the first example of waqf was the mosque of Quba in Madinah. Islamic banks can contribute for the advancement of the Muslim Ummah by establishing new waqfs or by supporting existing such institutions. This is a case study of an independent initiative that was formed on the guidance provided by the Shariah Supervisory Board one of the largest Islamic bank in Paksitan

Establishment, Objective and Governance

The Ihsan Trust was established on January 7, 2010. The main objective of the Ihsan Trust is to provide financial assistance by extending interest free loan facilities to deserving and needy students who want to pursue higher education in the country. Other objectives include improving healthcare facilities and infrastructure, offering Islamic microfinance to the lower-income citizens, and providing immediate relief for natural disasters.

The Ihsan Trust is registered under Trust Act 1882 in Pakistan. It was established with the seed capital endowed as waqf by one of the trustees in an independent capacity. The name Ihsan Trust is derived from the Quranic concept of Ihsan.

> "Is the reward of goodness (Ihsan) aught but goodness (Ihsan)?"
> **– Surah Ar-Rahman 55:60**

An independent board of trustees supervises and manages the affairs of Ihsan Trust. The board of trustees consists of professionals and experts from diverse fields who provide rich experience and contribute to the governance of the Trust. **The major donors of Ihsan Trust include different IFIs, and corporate entities. The Trust** is duly registered with the tax authorities of the country and audited by top audit firms.

There are many institutions in the country that run on the modern waqf concept, but very few actually follow the true spirit of waqf for charitable purposes. Ihsan Trust aims to be an impeccable working example of the true Islamic concept of waqf. It dedicates its activities to charitable purposes, and it set a precedent for other Islamic Financial Institutions (IFIs) to create entities on the basis of Islamic law (waqf), to fulfill their social and moral responsibilities as Islamic institutions. We hope this model can be replicated by other IFIs around the world.

Services provided by Ihsan Trust

The services of Ihsan Trust can be categorized into four major areas:

<
Muslim man looking at main prayer hall and courtyard of Badshahi Mosque, Lahore, Pakistan.

Students are busy in solving their question paper during aptitude test of University of Engineering and Technology in Peshawar. Asianet-Pakistan / Shutterstock.com

Education

The main focus of Ihsan Trust is to provide interest-free loans to students in higher education, with an aim to enable all citizens of Pakistan to get an opportunity to pursue their dreams. Currently, Ihsan Trust is working with more than 90 universities in Pakistan including IBA Karachi, LUMS, GIKI, NED, NUST, FAST, and more. More than 800 women and men are currently borrowing from the Ihsan Trust are to complete their professional education.

Following is the year wise contribution by Ihsan trust in the educational sector:

	Rupees in Millions'							
Year	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**Total**
Contribution in Education Sector	6	21	23	20	41	58	46	216
Total Number of Students Facilitated	40	135	148	129	264	376	298	1390

In addition to the educational sector, Ihsan Trust has also made the following contributions:

Sector	Contribution in Millions (till date)
Health Sector	27.8
Microfinance	21
Disaster Recovery and Rehabilitation	11.5

Health

Ihsan Trust collaborates with various charity hospitals to promote health and hygiene by providing funds and hospital equipment. In the health sector, Ihsan Trust is working with more than 15 hospitals.[1]

Islamic Microfinance

Ihsan Trust is collaborating with Akhuwat, Islamic Relief, Muslim Aid, Wasil Foundation, and WWF Pakistan to provide Islamic microfinance to the poor and needy. Ihsan Trust supports these organizations' positive causes to improve the lives of the poor Pakistanis by helping them work towards financial stability and prosperity.

1http://nthp.iba.edu.pk/pdfs/ihsantrustprofile.pdf.

Disaster Relief

In case of natural disasters such as earthquakes, floods, and famine, Ihsan Trust works with credible partner NGOs and relief agencies to provide timely help in the affected area. Some of these partner organizations include Muslim Aid, Islamic Relief, and Helping Hand.

Future Projects

In coming years, Ihsan Trust hopes to provide financial assistance to at least 100,000 needy students seeking higher education across Pakistan, to enter into Islamic Microfinance as a full-fledged MFI, and to increase its assistance programme in the health sector by collaborating with community building organizations, providing them medical equipment and other health-related facilities.

> "THERE ARE MANY INSTITUTIONS IN THE COUNTRY THAT RUN ON THE MODERN WAQF CONCEPT, BUT VERY FEW ACTUALLY FOLLOW THE TRUE SPIRIT OF WAQF FOR CHARITABLE PURPOSES. IHSAN TRUST AIMS TO BE AN IMPECCABLE WORKING EXAMPLE OF THE TRUE WISLAMIC CONCEPT OF WAQF.

Microfinance

The microfinance industry has grown tremendously in Pakistan, especially since the success of Grameen Bank in Bangladesh. Currently, many different institutions including microfinance banks, rural support programmes, microfinance institutions, and NGOs are working in this field. While the number of microfinance services providers has been steadily increasing, a larger part of the potential market still remains underserved.

Microfinance service providers can be classified into three broad categories in Pakistan: microfinance banks (MFBs), rural support programmes (RFBs), and microfinance institutions (MFIs). MFBs are commercial banks licensed and prudentially regulated by the State Bank of Pakistan (SBP) to exclusively serve the microfinance market. About ten MFBs have been licensed under the Microfinance Institutions Ordinance 2001. MFBs are legally empowered to accept and intermediate deposits from the public. MFIs are non-bank non-government organizations (NGOs), including local and multinational, registered under a variety of regulations, including the Societies Act, Trust Act, and the Companies Ordinance for the provision of microfinance services. RSPs are NGOs registered as non-profit companies under the Companies Ordinance to focus on the rural areas only for credit operations. As a group, the RSPs are registered with and supervised by the Securities and Exchange Commission of Pakistan (SECP).

Pakistan was the first country to develop a regulatory framework for Islamic microfinance. In 2007, the SBP released its Guidelines for Islamic Microfinance Business by Financial Institutions, which provided a comprehensive regulatory framework for the establishment and operation of microfinance banks and the provision of microfinance services by financial institutions to poor and low-income people. The following guidelines are aimed at enabling the introduction of microfinance products and services on a Shariah-compliant basis through various channels mentioned in the guidelines.

Islamic microfinance services and products can be offered by various types of financial institutions, in different forms. The guidelines deal with four options:

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

Islamic microfinance providers have used alternative organizational structures available under Pakistani laws governing not-for-profit entities (NPOs). These laws are similar to the not-for-profit laws in India, and in Bangladesh for the creation of societies, trusts and non-profit companies. However, unlike India and Bangladesh, these laws in Pakistan have shaped the country's three major Islamic MFIs. Its leading player Akhuwat was established under the Societies Registration Act 1860. The Centre for Women Co-Operative Development (CWCD), came into existence as a non-governmental organization in 1992, regulated under the Voluntary Social Welfare Agencies (Registration and Control) Ordinance 1961. Currently, CWCD is registered as a company under Section 42 of the Companies Ordinance 1984 by the name of Wasil Foundation, and successfully transferred its assets and liabilities to Wasil Foundation in 2012. The third provider is a cooperative institution, the Karakoram Cooperative Bank, which recently started its Islamic microfinance operations, governed by the Cooperative Societies Act 1925. Depending on the organizational form, NPOs are free to pursue the benefit both of members and the public.

A woman buy bangles and jewellery at a stall ahead of Eid al-Fitr in Islamabad, Pakistan. REUTERS/ Faisal Mahmood

MICROFINANCE INSTITUTIONS IN PAKISTAN

The government in Pakistan has sought to enable the business of all microfinance service providers. According to the Global Microscope 2014,[51] which measures benchmarks for microfinance business environment in 55 developing countries globally, Pakistan ranks in seventh place for its overall business environment.

Microfinance in Pakistan, according to the latest figures, serves about 3.6 million borrowers with a gross loan portfolio of Rs 84 billion (US$800 million) in 2015.

The list of Islamic MFIs in Pakistan includes Akhuwat, Asasah, Wasil Foundation, Islamic Relief Pakistan (IRP), Muslim Aid, Helping Hand, Namet, Khwendo Kor, the Farz Foundation, Karakoram Cooperative Bank, and the National Rural Support Programme. The latter two MFPs are using both the Islamic and the conventional products. Asasah[52] has fully converted its traditional microfinance to Islamic microfinance in 2013.

In Pakistan, many other MFIs are showing interest in using Islamic products alongside conventional products. The data show that all of these were working below operational self-sufficiency and financial self-sufficiency level in 2011 for Akhuwat, Asasah and Wasil Foundation. No data was reported in the case of Farz Foundation, IRP and Muslim Aid.

Akhuwat is providing interest-free microfinance services to poor families including Qardh-e-Hasana, social guidance, capacity building and entrepreneurial training. Akhuwat has achieved a tangible and significant success since its inception in 2001. By March 2016, Akhuwat had served 1.28 million families with a total disbursement of Rs 24 billion (US$228.5 million) in loans.[53] Its active loan portfolio stood at 211,523 loans worth Rs 7.1 billion (US$67.6 million) and with a recovery of 99.93%. Akhuwat is covering 270 cities and towns with 459 branches. Although Akhuwat is working below the OSS and FSS level, it should be noted that this is a non-profit-earning organization, which works based on voluntarism and philanthropy. People donate to these organizations, which are expanding year by year. In addition, Akhuwat's borrowers are becoming voluntary donors, which cover over one-third of total operating costs. Donations from borrowers increased from a modest amount of Rs 20,730 in 2008 to about Rs 30 million (US$285,000) in 2013.

MICROFINANCE OUTREACH

	2011	2012	2013	2014	2015
Active Borrowers	2,073,071	2,355,943	2,832,715	3,142,589	3,633,884
Gross Loan Portfolio (Rs million)	28,845	38,238	52,092	66,761	84,900
No. of Branches	1,739	1,918	2,127	2,538	2,760
Average Loan Balance (Rs)	**21,128**	**16,231**	**18,389**		
No. of Loans Disbursed	608,505	696,884	892,013	1,143,441	1,210,822*
Disbursement (Rs million)	12,858	16,817	23,940	34,994	38,217*
Average Loan Size (Rs)	**21,128**	**24,131**	**26,838**	**30,604**	**33,374**
No. of Active Savors	3,933,496	4,682,422	5,977,426	8,520,718	13,353,777
Value of Savings (Rs million)	15,508	24,974	34,784	43,497	53,596
No. of Policy Holders	2,604,812	2,854,194	3,264,832	3,754,074	4,411,161
Sum Insured (Rs Million)	30,136	36,054	44,182	60,418	76,764
Potential Microfinance Market	**27,407,048**	**27,407,048**	**27,407,048**		
Penetration Rate	**7.56**	**8.0**	**10.3**	**11.47**	**13.26**

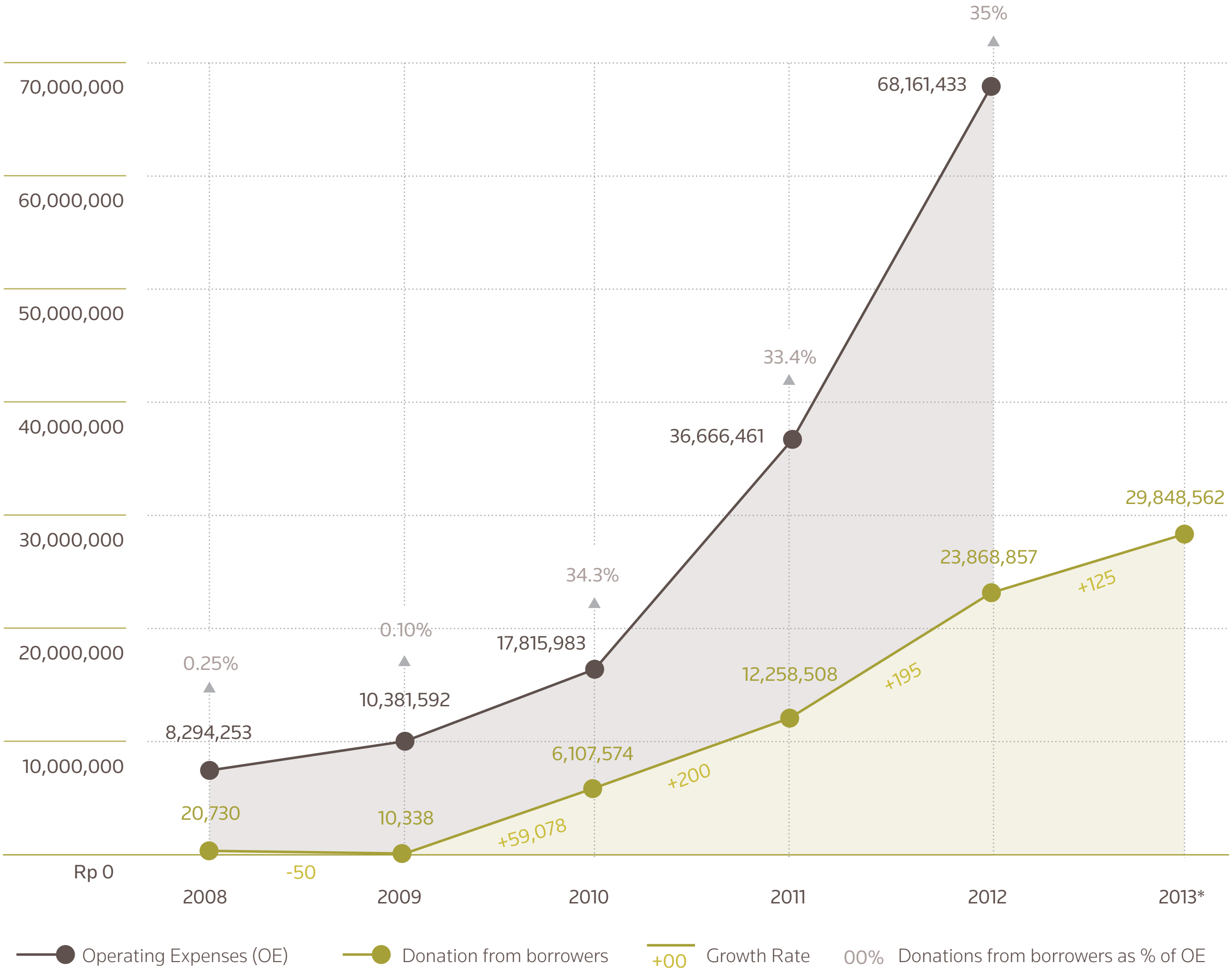
Source: Microwatch, Pakistan Microfinance Network (various issues).
Percentage growth is reported in parentheses.
*Q2, all other figures for 2015 are Q3

IMPORTANT PERFORMANCE INDICATORS (2011)

	Akhuwat	Asasah	Wasil Foundation
Operating Self Sufficiency (OSS)	61.0	58.0	79.3
Financial self-sufficiency (FSS)	59.1	53.4	75.2
Borrowers per staff	95	95	54
Adjusted Cost per Borrowers (Rs.)	1672	6264	6921

Source: PMN, Pakistan Microfinance Review, 2011

DONATIONS FROM AKHUWAT BORROWERS (2008-13)



*till Feb 2013
Source: IRTI, Islamic Social Finance Report (2014)

Asasah was registered as an NGO in 2003 as replica of Grameen bank. In July 2013, Asasah announced its conversion from conventional microfinance to Islamic microfinance. In December 2009, Asasah converted its one conventional (Kasur) branch to Islamic microfinance with the murabahah product. After the success of this branch, Asasah transformed all of its operations from conventional to Islamic structures. Asasah has started musharakah, murabahah, and qardh-e-hasana services (including interest free loans for food security programme). Asasah has replicated the methodology of Akhuwat for giving qardh-e-hasana loans. Before its transformation to Islamic microfinance, Asasah disbursed 170,000 loans, provided 35,000 health insurance policies and provided financial literacy training to 2,800 women in 16 cities.

Wasil Foundation[54], formerly known as Centre for Women Co-Operative Development (CWCD), was established in 1992 aiming to empower poor communities economically and to facilitate developing their businesses with micro-credit and enterprise development programmes. In 2009, Wasil Foundation extended its operations from conventional microfinance to Islamic microfinance and eventually discontinued conventional microfinance in 2010, becoming a purely Islamic microfinance organization.

MODES/PRODUCTS AND BENEFICIARIES AT WASIL

Mode	Target Beneficiary
Zakat and sadaqah	Destitute, unable to work
Qardh-e-Hasana	Poorest of the poor with ability to work
Murabahah	Micro-level traders street hawker small shopkeepers
Salam	Small farmers up to 5 acres land holding
Istisnaa	Micro manufacturers in different sectors
Ijarah	Farmers without land holding (Rental Land)
Diminishing Musharakah	Micro entrepreneur in need of assets
Master Salam (Ijarah + Salam)	Farmers in need of land plus money for cultivation

Source: IRTI, Islamic Social Finance Report (2014)

Wasil Foundation has introduced five products based on murabahah, salam, istisnaa, ijarah and diminishing musharakah. It has been successful in identifying a customized financial product for each section of society within the Islamic framework. Wasil is continuously seeking to develop the product development process in consultation with Shariah scholars with a clear objective to reduce transaction costs and to achieve scale. The following table provides a comprehensive list of modes/ products suitable for a target beneficiary.

Wasil Foundation has 7,257 active borrowers, of which about 19% were active women borrowers in 2012. Its gross loan portfolio stood at Rs 125 million (US$1.19 million).[55]

Wasil Foundation has struggled to successfully operate with Islamic modes of financing. Wasil struggles with a lack of Shariah-compliant funding. Wasil is obtaining interest-based funds to provide Shariah-compliant modes of financing. It faces the lack of meso-level support and other legal infrastructre. Another challenge faced by such organizations is the lack of financial literacy and awareness about the true spirit of Shariah. Customers and stakeholders still only perceive not-for-profit modes such as qardh-al-hasana to be Islamic. Any profit-generating products are perceived to be un-Islamic, even though these are clearly permissible in Shariah.

INNOVATIONS IN ISLAMIC MICROFINANCE IN PAKISTAN

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MR. MUHAMMAD KHALEEQUZZAMAN holds a Master's in Policy Economics from University of Illinois, Urbana- Champaign, USA, and he is a certified Islamic banker from the State Bank of Pakistan. Having served in the banking sector in middle to senior management positions for 25 years, he joined International Islamic University Islamabad in 2003 and served prominently in establishing the School of Islamic Banking & Finance (SOIBAF) as chairman of the school until April 2014. He is convener of the Shariah Advisory Centre of IIUI and Director Product Development for the Islamic Microfinance Resource Centre. Mr. Zaman has been engaged in consultancy and advisory work in the financial sector for institutions including Islamic Development Bank, State Bank of Pakistan, Asian Development Bank, World Bank, Government of Pakistan, Government of Egypt, USAID, Swiss Agency for Development & Cooperation (SDC), and Int'l Fund for Agricultural Development (IFAD).

Introduction

About one third of the population in Pakistan lives below the poverty line, although various reports use different methodologies that produce differing figures. The government has always been cognizant of this fact, and it has initiated a number of poverty eradication interventions. Moreover, the non-governmental sector has supplemented these efforts by extending philanthropic and micro-financial services to disadvantaged Pakistanis with the primary objective of helping them graduate from poverty to self-support. This article analyzes the microfinance environment, initiatives for and innovations in Islamic microfinance, and policy guidelines to develop sustainable microfinance in an Islamic framework.

Microfinance Environment in Pakistan

Conventional institutions dominate the microfinance sector in Pakistan. Over 42 microfinance providers (MFPs), including 28 microfinance institutions (MFIs) such as four Islamic MFIs, five rural support programs (RSPs), and nine microfinance banks (MFBs) meeting minimum membership criteria are represented through the Pakistan Microfinance Network (PMN) and provide the bulk of microfinance in the country. The number of potential microfinance users in Pakistan is estimated at 28 million, of which the microfinance programs currently serve only 11-13%. The gross loan portfolio (GLP)[1] of the industry stood at Rs 63.53 billion (US$611 million) in the year 2014, with 3.14 million active borrowers (of whom 58% were women). Most of the microfinance providers also arrange insurance for their clients and total insured assets stood at Rs 60.40 billion, held by 3.8 million policyholders[2]. Most of the MFPs have achieved operational and financial self-sufficiency (OSS and FSS) above 100%.

Islamic Microfinance — Towards an Inclusive Financial Sector

There is an immense demand for Islamic financial services in Pakistan. The public's overwhelming preference for Islamic finance (95%) has been established by a KAP study[3] conducted by the State Bank of Pakistan (SBP) in 2014. The survey results further reveal that rural and lower income consumers self-exclude themselves from interest-based services, on the one hand, and have relatively limited access to such financial services, on the other, indicating a vast opportunity for Islamic microfinance, especially in rural areas.

Islamic Microfinance Initiatives: Driven by the quickly growing Islamic banking market, a number of Islamic microfinance initiatives have been undertaken in the recent decade. The number of Islamic MFIs (IMFIs) has grown to 16, as reported by the Islamic Microfinance Network (IMFN),[4] and they are gradually diversifying into various custom-built products.

Islamic microfinance companies have built gross loans of over Rs 10.41 billion (US$100 million) with 625,191 clients in 2014. Akhuwat has the largest GLP (88.66% of total lending) as well as outreach (90.78% of total active clients) among IFMIs. The average size of an Islamic micro-loan is Rs 16,647 (US$160), and it typically ranges from Rs 5,000 to Rs 35,000. The IMFIs are operating at different levels of efficiency. Industry average OSS and FSS work out to 91% and 88%, respectively, but they remain lower for the newer IMFIs. IMFIs maintain sound portfolios on average, with only 0.64% at risk for more than 30 days and a recovery rate of 98.36%.

As a new entrant to the industry, Islamic microfinance suffers from resource and policy constraints, product concentration, and an absence of requisite capacity, especially the Shariah advisory and monitoring. Despite these limitations, the growth and new experiences in products and practices are building optimistic outlook for the future.

Innovations in Islamic Microfinance

Despite the limited growth of the IMFIs, innovations in product development and operational modalities have paved a way forward for microfinance to sustain itself and to reach the socially excluded and unbanked populations in Pakistan. Examples of successful experiments in this new industry include:

Master Salam: A Package of Salam and Ijarah for landless poor: Wasil Foundation has used contracts combining ijarah and salam to provide finance to the landless poor since 2010. Land is acquired on lease by Wasil, which sub-leases it to its clients, while working capital is financed in cash through salam. The client delivers the specified quantity of his produce to Wasil to fulfil the salam contract. The rental of the leased land is paid (in both cash and agricultural produce) on a monthly basis by the fruit, vegetable, and flower cultivators, and at the time of harvest in case of rice and wheat farmers. Any genuine defaults of the salam obligations are expected to be met out of a zakat fund. Currently, salam contributes about 10% to the total financing of Wasil Foundation, and farmers have realized a visible comparative advantage over previous practice of selling their produce to the arhties (commission agents). This product has also won the Islamic microfinance challenge contest organized by IDB, CGAP and Al Baraka Banking Group in 2014. The product is changing the lives of the farmers by reducing the cost of cultivation. The loans give them more bargaining power when paying in cash instead of credit to the input sellers of their choice and the ability to produce fodder for their herd of cows and buffaloes at cheaper cost from the leased land.

Musharakah based 'Karobari Sarmaya': In 2015, NRSP introduced a musharakah-based product titled 'Karobari Sarmaya' (business capital), prescribing very soft terms of profit distribution in favor of the client. NRSP participates in the business of commercial enterprises up to Rs 75,000 for a period of 6 and 12 months assessed through projected cashflows, while the rest of the capital is provided by the client in the form of business assets or a fresh injection. Currently, NRSP is operating the product in eight districts with a cumulative financing of Rs 37.33 million (Rs 359,000) provided to 864 partners. Each month, NRSP receives 20% of the profit of the business along with the investment divided into monthly units. NRSP also returns as gift to the client the difference of the amount of profit realized (i.e. 20%) and the operational cost of the program (currently, 28% of NRSP's investment). A reckoner is used to calculate the amount of profit to be recovered up-to the operational cost of the program. The losses, not owing to the negligence or misconduct of the clients, are borne by NRSP in proportion of investment in the business. However, in deserving cases, the losses of the client are also picked up by the institution. Although operating on the principles of musharakah, the product has been examined by Islamic Microfinance Resource Centre (IMRC)[5] and found compliant with Shariah. The request for formal Shariah certification is in process.

A view is seen of a busy street in Karachi. REUTERS/ Akhtar Soomro

Agricultural Value Chain Financing for Small Potato Growers: Socio-Engineering Consulting Islamabad developed a social enterprise styled ACCESS in 2013 to provide better access to Islamic finance, quality inputs, information, and marketing linkage to help addressing value chain issues faced by small potato growers. ACCESS developed an Islamic financial instrument based on qard-e-hasana and salam. Akhuwat provided funds to ACCESS on the basis of qard for the pilot project in Swat in the province of Khyber Pakhtunkhwa, while rest of the arrangements were structured by ACCESS. The potato seed and fertilizer were procured from the dealers of inputs for distribution to the clusters of potato growers at their doorstep as salam capital against the potato crop, meeting certain quantity, quality, and specification standards. Pepsi was contracted to purchase potato from the potato growers against the agreed price. The cost of technical training of potato growers was borne by USAID. The experience is being replicated in other parts of the country by converting ACCESS to a private limited company styled Connecting Agro Value Chains (CAVC). Financing is being provided by Khushali and Apna Microfinance Banks. Currently, the program is reaching out to 1,600 farmers in 11 districts of the country, and annual production is around 3.0 million tons of potatoes. The company, however, is looking for new Shariah compliant funding, as the arrangement with Akhuwat could not be continued.

Policy Implications

The foregoing discussion helps to draw some policy recommendations. Mainstreaming Islamic microfinance a pressing need, and Islamic banks should come forward to assume microfinance as business opportunity, in addition to fulfilling their social responsibility. IMFIs can be linked to Islamic banks to leverage sufficient liquidity carried by the latter. Soft-term Mudarabah capital and qard-e-hasana placed with IMFIs can help provide Shariah-compliant resources and, in turn, sustain their operations, besides providing Shariah advisory and product development expertise in addition.

One way to supplement the efforts of microfinance is to better incorporate zakat into the financial system. This objective can be achieved by linking zakat with microfinance in a phased program. By providing safety nets, business capacity can be developed through training, with business support and startup capital to be provided latter. MFIs can, individually or collectively, establish zakat trusts as separate entities collecting and spending zakat for either or both the safety net and developing enterprise.

1 This is the outstanding principal for all outstanding client loans, including current, delinquent and restructured loans but excluding loans that have been written-off, interest receivable, and employee loans.

2 The data for outreach, loan portfolio, and insurance has been taken from "Pakistan Microfinance Review 2014", published by PMN Islamabad.

3 SBP and DFID, 2014, "Knowledge, Aptitudes, and Practices of Islamic Banking in Pakistan", Karachi.

4 Islamic Microfinance Network (IMFN), based in Lahore, Pakistan, is mandated to promote Islamic microfinance industry and organize data base on microfinance indicators.

5 IMRC represents collaboration of Academia and the Islamic microfinance sector and is mandated with providing diversified services to the Islamic microfinance sector including, Shariah advisory/certification, Shariah audit, product development, and training.

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Pakistani farmers dry fresh dates to preserve them during the July harvesting season in Sukkur. REUTERS/ Mohsin Hassan

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Notes

PAKISTAN ISLAMIC
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INNOVATION AT ASIA'S CROSSROADS

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