
PROSPECTS OF ISLAMIC BANKING: REFLECTIONS FROM PAKISTAN

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ABSTRACT

This study examines the growth and development phases as well as prospects of Islamic banking in Pakistan. The role of Islamic banking is explained with special regards to corporate social responsibility (CSR) as now days this concept is growing vastly. Awareness in public also has been growing and people are moving towards Islamic banking system. As we live in a Muslim country so it is very essential to have some basic knowledge about the Islamic banking. In this paper growth and performance of Islamic banking is discussed and compared among the financial years from 2003 to 2010 in terms of growth parameters like assets, deposits, sources and uses of funds. The performance indicators are also discussed to evaluate the growth and performance of Islamic banking system. In the last eight years, Islamic banking paved with the rapid market share of banking services. Moreover the efforts made by the central bank in Pakistan (SBP) are also remarkable in growth of Islamic banking. By seeing the present growth of Islamic banking, it is anticipated that in near future, Islamic banking will get major share in banking industry in Pakistan.

Keywords: *Islamic banking, Pakistan, Riba, Musharaka, Modaraba, Performance.*

1- INTRODUCTION

Islamic banking is interest free banking, in which there is no fixed rate of return. Islamic banking is the banking system which is run in accordance with the Islamic laws and the Shari a` board; that guides the institutions. This Shari a` board authorizes the products that whether these are Shari a` compliant or not. Islamic banking is the banking that is guided by Islamic law (Shari a`) principles and guided by Islamic economics. In particular, Islamic law prohibits usury, the collection and payment of interest, also commonly called Riba in Islamic discourse". Islamic banking also finds its roots in Islamic finance and all type of transactions are interest free and of risk sharing. The interest is prohibited in Islamic ways of banking as it is also obvious from Quran. In Quran, in Surah Al-Imran, Allah said that; "O you who believe! Do not devour Riba multiplying it over and keep your duty to Allah that you may prosper" (3:130). Same kind of prohibition regard fixed interest is also lead in Surah Al-Rum(39) , Al-Nisa(160-161) and Al-Baqarah(275-281) of Quran.

Riba and Gharar are illegal under Islamic law. Riba refers to fixed rate of interest. Gharar refers to speculation. Islamic banking shows dramatic improvements and developments in Pakistan. Islamic banking is taken as national policy and it is supported but there exist dual banking structure in the Muslim countries. Mostly the banks of conventional system are also opening their separate Islamic banking divisions and branches. The expectation of increase in growth of networking of Islamic banking system is increasing. The Islamic banking has increased in terms of branches, deposits, capital funds, sources. The ratio of income to expenses is high which indicates increasing profitability of the sector.

This paper answers the following research questions;

RQ.1 What is Islamic banking?

RQ.2 What is the role and progress of Islamic banking?

RQ.3 what is the growth and development phases of Islamic banking?

RQ.4 What are the prospects of Islamic banking?

2- HOW 'ISLAMIC' IS ISLAMIC BANKING

Islamic banking has an important characteristic that it supports the risk sharing between investor, bank and user of fund. This feature is not in other banking system. Islamic banking system is Islamic in a way that it is guided by Islamic laws which defines some rules and guidelines for proper functioning of Islamic system and these are described in the following headings;

2.1- Islamic banking in theory

There are 4 basic rules for Islamic banking and finance. These are described bellow;

1) Risk sharing 2) Materiality 3) No exploitation 4) No financing for sinful activities.

Risk is shared among investor, bank and fund user. Materiality means a real transaction must exist.. Contractual parties should not be exploited. Transaction should not be financed which are forbidden by Islamic law. Profit and loss sharing ratio is pre-determined in PLS transactions. Profit and loss sharing in Islamic banking can eliminate inflation, unemployment and poverty (Warde, 2000).

This also promotes long term financing and it is important feature of Islamic banking (Zaher & Hassan, 2001). Islamic banking has two types of transactions one is participatory and second is non-participatory (Sundarajan & Errico, 2002; and Khan, 2010).

2.2- Islamic banking in practice

The PLS financing are: Mudaraba, Musharaka, and Sukuk. While the non-PLS sharing financing are: Murabaha, Ijara, ijara wa iqtina, Bai'salam, Bai'muajjal, Musawama and qarz-e-hassana. Currently there is a criticism about the functioning or features of Islamic banking. Hawary et al (2004) and Zaman (2008) criticize the Islamic banking in the following way;

Mostly Islamic banking transaction are based on non risk sharing so in this way the Islamic banking is not sharing the risk. In the same way non materialistic transactions are there, that is, there is no actual transfer of title in the sale and purchase transfers. Fee charges are also there as in commercial banking and this is exploitation. They also criticize that the transactions named as contract are termed as Islamic as it is very clear from above debate that all the products, functions and certificates are non-Islamic and we are just using the name Islamic.

But criticism at one side, the Islamic banking doing banking in Islamic way; as every bank or institution has its own Shari a` board and this Shari a` board leads by two or three Islamic scholars or ulma who certify the products as Shari a` compliant, which are offered by Islamic bank or Islamic financial institutions.

3- ROLE OF ISLAMIC BANKING FOR CORPORATE SOCIAL RESPONSIBILITY

Islamic banking has also playing the great role in the area of corporate social responsibility. As the social responsibility is emphasized by Islam; Islam said that you must take great care of others as you take care of yourself. So, in Islamic banking sector there is also need of corporate social responsibility and it playing its role by investing in the companies who deals mainly in that or by taking action or steps in the social responsibility of corporate. In ethical principles of Islam social behavior is one of the principles and Islam takes care as a whole

of human well being (Uddin, 2003). “Every soul will be in pledge of its deeds” (Quran 74:38). So every human being has right to be socially respected. If a Muslim investor invest in a company which involve in activities that are forbidden by Shari a` then investor must withdraw his investment (Ullah and Jamali, 2010).

Islamic banking should invest in those companies that are socially responsible and Shari a` compliant (Beekun and Badawi, 2005). If the any Islamic bank or financial institution or company uses the natural resources of the area it should compensate the peoples of that area in which company operates (Ullah and Jamali, 2010).

4- ISLAMIC BANKING IN PAKISTAN

The central bank plays vital role in establishing the Islamic banking in accordance with the rules of Islamic laws. State Bank of Pakistan has framed rules regarding Islamic banking system in Pakistan in December 2001 (Ahmed et al., 2010). The state bank of Pakistan has established the separate Islamic banking department for the proper functioning of Islamic banking in Pakistan. SBP has great effort for the growth of Islamic banking as it introduced the 12 Islamic modes of financing for the proper establishment of Islamic banking while replacing the existing system. The SBP is committed to uplift the Islamic banking in Pakistan. The first full fledged Islamic bank established in Pakistan is the Meezan Bank Limited in March 20, 2002 (SBP Report, 2002).

The Islamic inter-bank market has been changed under the rules of state bank of Pakistan as the Karachi Inter Bank Offered Rate (KIBOR) has been replaced with Islamic Inter Bank Offered Rate (IIBOR) (Kazmi, 2009)

There is always resistance to change, but when change is occurred in any field and processes and convention, this creates a lots of improvements in that area. Same is the case with the Islamic banking system that when this concept comes, less number of people are there to accept but when this banking system implement and working efficiently, peoples become aware of that, then this system run progressively (Akhter et al, 2011).

In December 2010 the SBP reported that the Islamic banking has been introduced parallel to the existing conventional banking system, the Islamic banking was growing tremendously.

SBP provides the fair chance to Islamic banking to grow along with the conventional banking. The total assets of Islamic banks increased to Rs. 323 billion and the deposits increased to Rs. 245 billion (Raza, 2009). Now there are 6 fully fledged banks and 12 conventional banks with 337 branches working in Pakistan in different cities (SBP annual reports, 2003-07).

5- GROWTH OF ISLAMIC BANKING

The growth of Islamic banking can be inferred from many parameters as its products and increase in number of products, its increase in deposits' amounts and its facilities of providing loans to customers through Islamic modes of financing. The growth of Islamic banking can be evaluated from the following parameters.

The products offered by full fledge Islamic banks are discussed below with some specific details.

Asst side

Product	Islamic modes of financing	Type of product
Car	Ijara	Consumer
Easy home	Diminishing musharaka	Easy buy/replace/renovate
Short term financing	Murabaha	Corporate/SME
Long term financing	Ijara/Diminishing musharaka	Corporate
Bill purchase(usance)	Murabaha	Corporate/SME
Bill purchase(sight)	Salam	Corporate/SME
Meezan tijarah	Agency and sale	Corporate/SME/commercial

Export finance	Murabah	Corporate
Commercial construction and purchase	Diminishing musharaka	Corporate/SME
Shirkatul malik	Musharaka	Commercial/corporate/SME
Financing for service	Service ijara	Corporate/commercial
Pre/post-shipment export finance	Export -murabah	Commercial/corporate/SME

Liability side

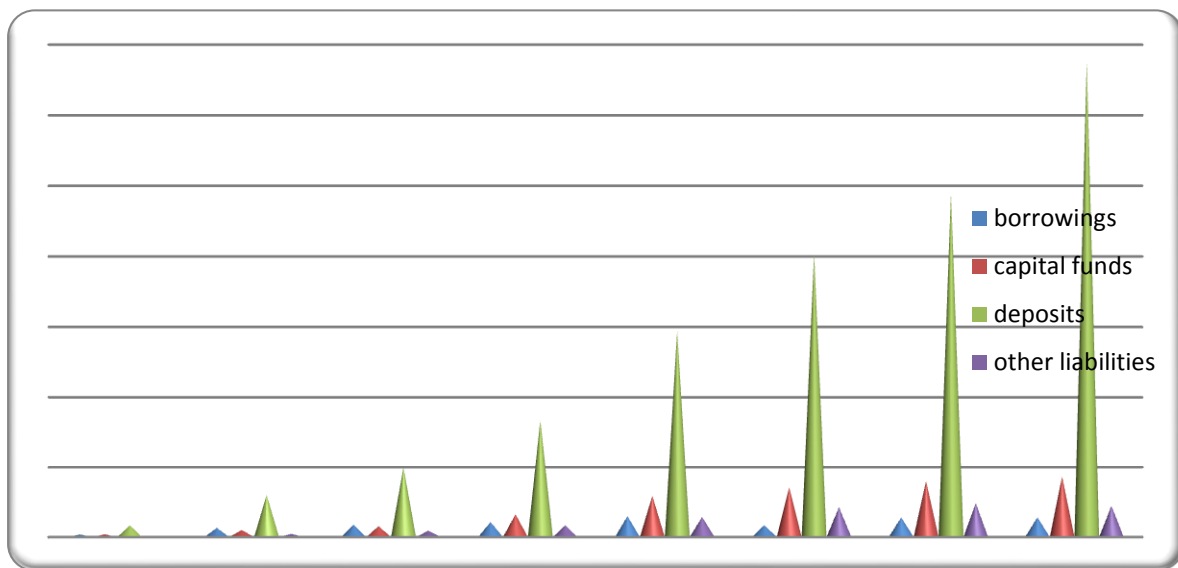
product	Islamic mode of financing	Type of product
Current account	Qard	Current/checking
Saving account	Mudaraba	Checking
Karobari munafa account	Mudaraba	Saving
FCY current account	Qard	Checking
FCY saving account	Mudaraba	Checking
FCY term certificate	Mudaraba	Term deposit
Meezan providence certificate	Mudaraba	Term deposit
Special musharaka certificate	Musharaka	Term deposit
Meezan business plus	Mudaraba	Current account
Albaraka incentive account	Mudaraba	Saving
Charity account	Mudaraba	Saving
Khushal saving plan	Mudaraba	Term

(Source: Islamic banking department, SBP, 2008)

So, it is clear from above tabulation that all the Islamic banks and Islamic branches of conventional banks are offering different products and services parallel to conventional banks with more ease and in accordance with Shari`a. all the products and services are free from fixed return rates. These products are growing very rapidly. It is very clear from above discussion that the Islamic banks are not providing personal loans to the consumer as well as Islamic branches of commercial banks are not offered personal loans. The total assets of Islamic banking have been increased during 2004-08 from 44 billion to 276 billion. Increase in total deposits during 2003-08 from 8 billion to 202 billion. The total market share of Islamic banking to overall banking in investment is 4.4% in 2008 (SBP Annual Report, 2008).

The growth of Islamic banking can be seen from the increase in the sources and uses of funds of Islamic banking. The increase in sources and uses showed in the following table mentioning years from 2003 to 2010 taken from performance review report of SBP;

Figure 1

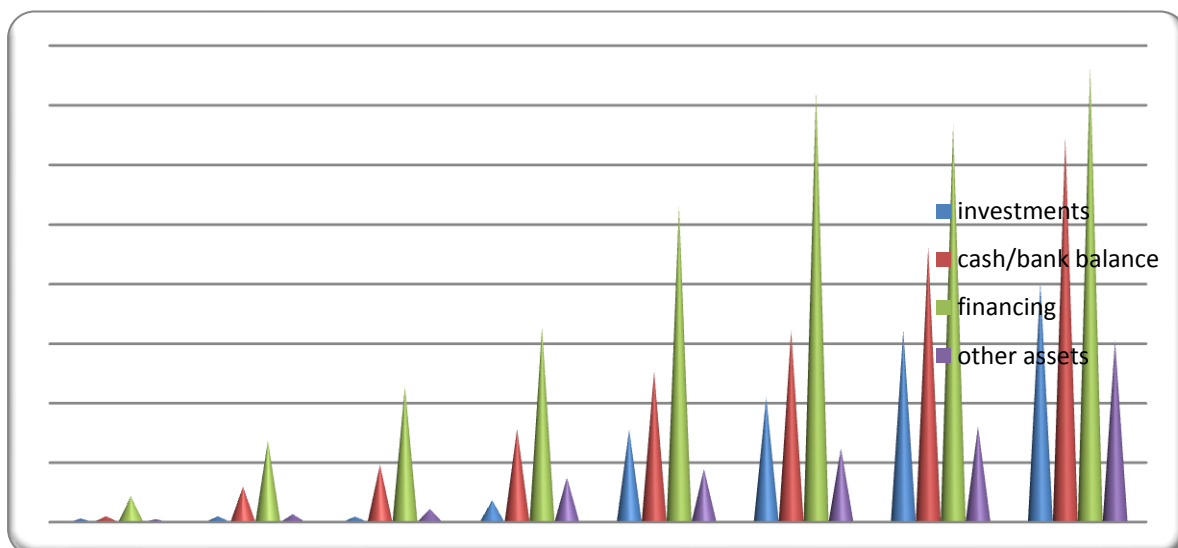


Source: Performance Review Report of SBP, FY 2003-2010

In the analysis of increase in the sources of fund of Islamic banks, it is observed that there is continuous increase in the deposits which shows the growth in the deposit funds. There is also increase in the capital funds up to Rs 43.5 billion. While in case of borrowings there is increase till 2007 but in 2008 borrowings decline dramatically, then it has increased again. So the slump in the borrowings shows betterment in 2008. As when we compared 2007 with 2010, this comparison shows that the borrowings have declined which shows the improvement in the sources.

Figure 2

Source: Performance Review Report of SBP, FY 2003-2010



Analysis of uses of funds shows that there is continuous increase in investments, cash/bank balance and in other assets while in case of financing activities there is small amount of decrease in 2009 while it will again increase. As when we compared year 2008 with year 2010 there is increase in financing activities which shows improvements in the uses of funds. Analyzing the overall picture of sources and uses of funds of Islamic banking we come to know that the Islamic banking sector has been growing rapidly. It also tells that growth of Islamic banking is consistent and steady.

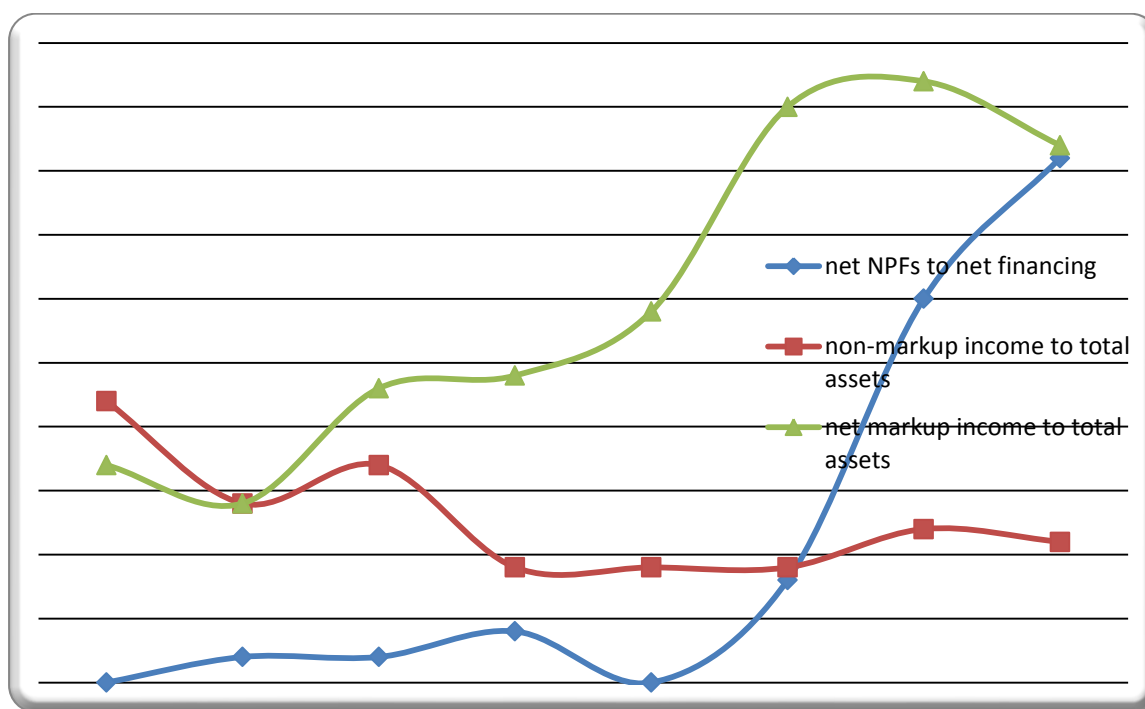
Whenever, there are different types of banking there is increase in efficiency of banks and service quality because of competition (Berger et al., 1993). In the presence of different banking system competition is there and one type of banking may take competitive advantage on the other (Carvallo and Kasman, 2005). The Islamic banks performed better as compared to other system (Bader et al., 2008). As the time passes there is increase in the efficiency of the Islamic banking system (Bader et al., 2008).

The performance of Islamic banking can be seen from the analysis which shows the performance has been increased. In 1998 the performance is 58% and in 2003, the performance is round about 81% (Ahmed et al., 2007). Environmental and cultural differences also affect the performance of Islamic banking (Brown and Skully, 2004). There is improvement in performance of Islamic banking (Hassan, 2005). In recent years efficiency, in terms of cost, of Islamic banking is greater than conventional banking (Ahmed et al., 2007).

There are various performance indicators through which the performance of Islamic banking can be evaluated. Thus in the same way through the evaluated performance the growth of the Islamic banking can be jugged very easily.

It is the common observation that if the organization is performing well it will grow in present as well as in future. So the various measures will be given in the following table with their yearly comparison as the performance will have to be evaluated. In the following table the performance of Islamic banking showed with various performance indicators and through this performance will have to be analyzed from financial year 2003 to September 2010. The following data has been taken from performance review report of State Bank of Pakistan.

Figure 3



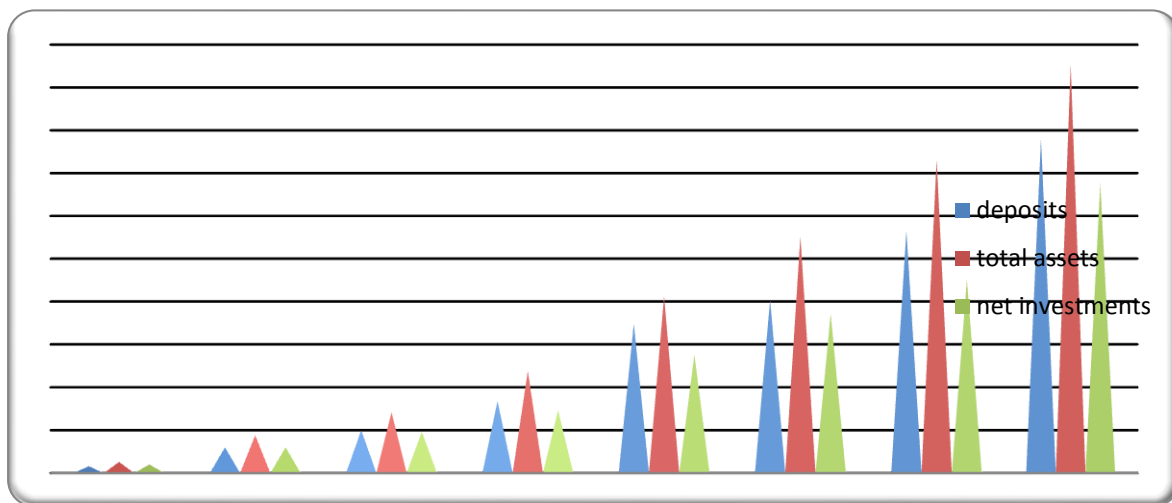
Source: Performance Review Report of SBP, FY 2003-2010

By analyzing the above data we come to know that, the growth in assets, financing and deposits show downward trend. Return on assets also declining while the expenses to income ratio shows upward trend. Non-performing financing also decreasing. Net markup income is increasing up to 4.2% in 2010.

Although the overall performance of the Islamic banking has been decreased but this decrease is less as compared to the conventional banking which shows that the growth in Islamic banking is prevailing in this system. The Islamic banking year on year growth is 27.8% (SBP, 2010). If we looking just on the net income then it will come to know that although there is declining in growth but the income earning on assets has been increasing till September 2010.

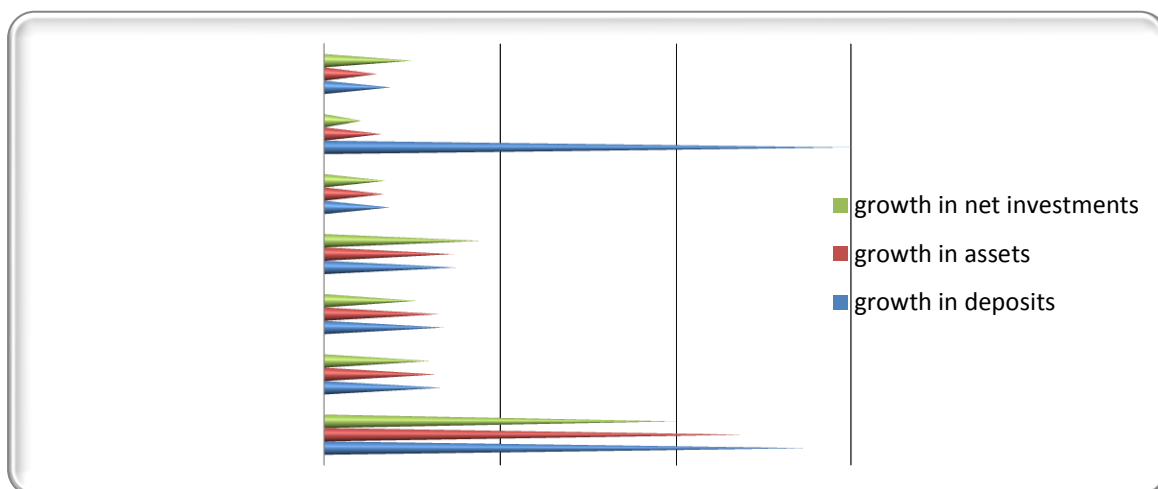
6. MARKET SHARE AND YoY GROWTH OF ISLAMIC BANKING

The growth of Islamic banking can also be observed in the terms of Islamic banking share in overall banking industry and can also be inferred from discussing year on year growth of Islamic banking. All this is showed in the following table of the financial years from 2003 to 2010. This data has been taken from the Islamic banking department of state bank of Pakistan.



Source: Performance Review Report of SBP, FY 2003-2010

Figure 4



Source: Performance Review Report of SBP, FY 2003-2010

This growth table and graphs shows that the deposits has been increased from just Rs 8 billion in 2003 up to Rs 390 billion and the year on year growth in deposits is 38%. The total asset of Islamic banking share has been increased up to 6.7% and the growth of its share is also consistent. The investment growth rate is reached to 49.8%.

The overall year on year growth of Islamic bank is 39.27%. In the same way the overall market share of Islamic banks of the banking industry reached to 6.7%. As well as the overall growth in assets, investments and deposits has been reached up to Rs 401.7 billion. So this analysis shows the consistency in the growth and it also tells that Islamic banking sector is increasing very rapidly and the various improvements are also there which tells that this sector will also grow in the near future.

7- PROSPECTS OF ISLAMIC BANKING

In nut shell from above discussion it is concluded that the Islamic banking sector is growing consistently and it is expected that it will grow in future also. The Islamic banking is different from traditional and conventional banking. As Pakistan is the Muslim country, so there is lots of chances of improving the Islamic banking network and there will be more chances to grow.

Malaysia was the first country who playing vital role in establishing Islamic banking system. Now this trend moved from Malaysia to Pakistan and so in Pakistan a vast network of Islamic banking system has been established. The branches of Islamic banking network will also be increased in future as it is obvious from the comparison of year 2008 and 2010 in the terms of Islamic banking branches that, the number of branches has been increased from 649 to 751 during 2008-10 (SBP Annual Report, 2010).

Now the most of the conventional banks are willing to Islamic banking network. The commercial banks are also opening the new separate branches of Islamic banking under separate head. Due to globalization the Islamic banking network has moved to the other Muslim and non-Muslim countries such as UK, USA, Canada, Malaysia, Spain, Qatar, Kuwait, Iran etc. this also proves that Islamic banking system will be flourished in future not only in the Pakistan but over the world. The expansion of this is the only reason that it is interest free banking network.

Islamic banking is the banking which is Shari a` compliant (Holden). Islamic bank will perform better than conventional banking (Bader et al., 2008). In functioning the Islamic bank performing well, its main function is to promote trade (Humayoun et al., 2010).

In previous decades, the Islamic banking has grown tremendously (Ahmed et al., 2010). As the growth increase the banking sector have to faces some challenges and these must be overcome (Hesse, 2000). The Islamic banking will be more performing if there even low level improvements are taken (Imam and Kapudar, 2010). Islamic banking is playing vital role in the growth of economy with special reference to corporate social responsibility (Ullah and Jamali, 2010). Greater efficiency will more satisfy the customers (Hassan, 2007). As Islamic banking is interest free so it can avert the banking crisis because interest based system is the main troubleshooting in crisis Mehta, 2008).

8- CONCLUSIONS

Islamic banking is Riba free and trade oriented banking system. Islamic banking is based on profit and loss sharing mechanism. The performance of Islamic bank is remarkable. As it is concluded from the above discussion that the performance and efficiency of the Islamic banking is increasing in the Islamic countries as well as in Pakistan. The growth of Islamic banking in Pakistan is also on the fast track as SBP is well committed to promote this sector. Where substitutes are available, there originates competition in financial sector. The same case is in banking sector, there are different types of banking and its functioning in the market and this created competition between conventional banking and Islamic banking. This competition will also create a big challenge for Islamic banking. If in competitive environment the Islamic banking is growing and performing well, it means it has the potential for more betterment and improvements. Cultural differences also affect the Islamic banking. Under the umbrella of central bank, the Islamic banking has great way to go.

Moreover, the deposits, financing facilities of Islamic in previous decade witnessed high ups and further more, Islamic banks are expanding their branch networks. Along with purely Islamic banks, conventional banks are also in this race to target the mass with Islamic banking needs. That is why conventional banks are opening their Islamic banking braches along with conventional banking branches.

This study is conducted with limited parameters while evaluating the performance of the sector, as all the aspects and parameters of growth are not considered, so this may become the basis for future research and analysis.

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