Islamic Banking Industry – Growing amid challenges

Islamic Banking and finance growth has generated considerable interest in the financial world in recent years. The concept of Islamic banking has received encouraging response from different corners of the globe as one discovers its ideological dimensions and practical significance. Given its ability to offer innovative financial solutions for basic financial needs in under-served markets especially in the Muslim worlds to complex financial requirement of the modern times, it is seen as a socially responsible and ethical banking model with considerable growth potential. In the Muslim world and increasingly in the West, significant segments of the institutional and retail markets are choosing Islamic finance for their financing and investment needs. Islamic financial system also draws it strength form it being asset backed nature and directly linkage to the real economic transactions and avoidance of any element of interest and speculative activity.

Building on the very basic of Islamic teaching & philosophy, Islamic Economics thoughts accept that every human being needs involvement in some kind of economic activity for survival and it is a legitimate right for every individual. Thus Islam banking is focused to provide an ideologically superior model to the modern day economic problems and aims for the establishment of a just & fair society. The central philosophy emerges from the divine guidelines allowing trade as an alternative of Riba or usury.

“And Allah has permitted trading and prohibited *riba*. (Al-Baqra)”

Islamic Banking & Finance - Global Growth Trends

The impressive growth track of Islamic banking over the last few years has created high expectations in the stake-holders and has compelled the major players of the banking industry, investors as well as regulators and government to view it as a separate segment in the banking industry. Keen interest in this discipline has already extended beyond Islamic countries and to non-Islamic financial institutions. In the recent times, the global financial services industry is witnessing a sharp rise in the demand for Islamic financial services. Today, more than 700 Islamic Financial Institutions are operating across the globe with around $1.2 trillion assets under management in more then 85 countries. Financial Institutions from Middle East, Far East, US and Europe to Africa, South and Central Asian republics are offering Islamic banking services. The industry is growing at a rate of roughly 15-20% percent per year, and could serve 40 to 50 percent of the world's Muslim population within a decade. According to a recent estimate by Standards & Poors the market potential for Islamic banks is estimated at $ 4 trillion.

Recently countries like Oman, Nigeria, Tanzania, Uganda & Maldives have opened their doors for Islamic finance and encouraging new and existing financial institutions to offer Islamic financial services to their customers.

Understanding the Difference

When we look at the differences between Islamic Financial Institutes and the Interest-based conventional Institutes, we find out that the differences are on three levels:

1. Conceptual & Socio-religious level
2. Business model & Governing framework
3. Product Level Implementation

Without a clear understanding of these differences, some people, even experts tend to make a common mistake of equating Islamic banks with other conventional banks with mere change of name

Key Differences between Islamic Banks & Conventional Interest Based Banks

<table>
<tr><th colspan="2">At Conceptual & Socio-Religious level</th></tr>
<tr><td>- Islamic banks (IB) are not money lending institutes but they work as a trading/investment house.
- Islamic banks work under the socio-religious guidelines that prohibit charging and paying interest and avoid all impermissible transactions like gambling, speculation, short selling & Sale of debts & receivables.
- Islamic banks do not permit financing to industries which can cause harm to the society such as alcohol, tobacco etc.</td><td>- Conventional Interest based banks (CB) are in the business of lending & borrowing money based on interest.
- In CB we see no such restrictions. Interest is the back-bone of this system and short sale, sale of debts and speculative transactions are common.
- In CBs all type of industries are financed, only businesses deemed illegal by law of land are not supported.</td></tr>
<tr><th colspan="2">At Business Model & Governing Framework</th></tr>
<tr><td>- IBs business model is based on trade, thus IBs need to actively participate in trade and production process and activities.
- IBs have a strong Shariah governing framework in terms of Shariah Advisor &/or Shariah Supervisory Board, which approves the transactions & product in the light of the Shariah rulings</td><td>- On the other hand, generally CBs did not involve themselves in trade and business as they act only as a money lender.
- In CBs no such framework is present and actually it is a key litmus test to judge the claim of those who fails to see differences between IBs & CBs</td></tr>
<tr><th colspan="2">Product Level implementation</th></tr>
<tr><td>- Islamic banking products are usually asset backed & involve trading of assets, renting of asset and participation on profit & loss basis.
- IBs recognize loan as a non commercial and exclude it from the domain of commercial transaction. Any loan given by IBs must be interest free.</td><td>- CBs treat money as a commodity and lend it against interest as its compensation
- In CBs almost all the financing & deposit side products are loan based.</td></tr>
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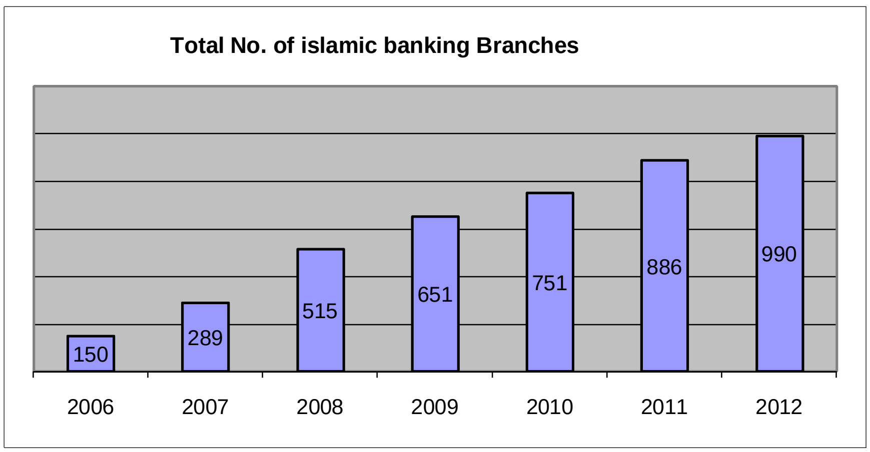
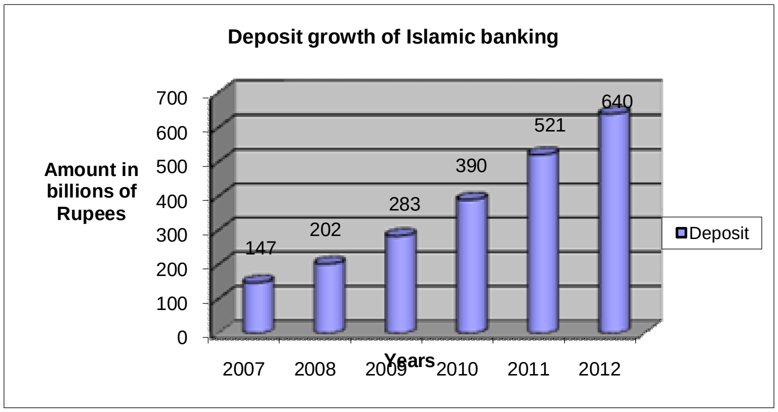
Growth of Islamic Banking in Pakistan

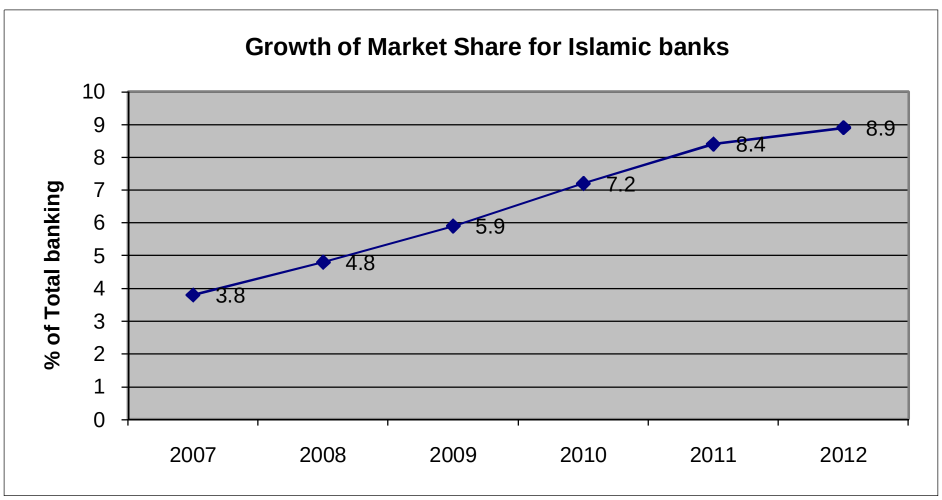
In Pakistan, we have seen steady growth of Islamic banking during the last decade when the first license for Islamic commercial banking was given in 2002 to Meezan Bank. Alhamdulillah, since 2002 the progress and success of Islamic Banking in Pakistan has been admirable despite all challenges. Currently there are seventeen financial institutions licensed by State Bank of Pakistan to offer Islamic financial services including five licensed full fledged Islamic Banks and twelve Islamic banking windows of conventional banks operating with more then 950 branches in different cities of Pakistan. During the year, addition of 2 new Islamic banking windows are expected to start their operations The expanding branch network and offering of Islamic financial products and services by the large conventional banks will boost the growth of Islamic banking and would increase its reach to the under served population that are sensitive to Riba.



According to the SBP figures of June 2012, the market share of Islamic banking in terms of overall banking deposits the Islamic Banking share stands at 8.9% at Rs. 603 billion up from the June 2011 figures of 7.6%. Islamic banks are now offering competitive saving and deposit products that are targeted to all segments of the society including senior citizens, pensioners, household and even for kids and teens. In the recent years, despite competition from conventional counter parts and government saving plans Islamic banks are witnessing healthy growth in their deposits figures and customer base.



In terms of financing transactions, the challenge is much greater for Islamic banks as Islamic banking modes are either trade based (like Murabaha – buying and selling of raw material and assets, Istisna – manufacturing contracts) or rental based for assets owned by Islamic banks (like Ijarah or Diminishing Musharakah) or partnership based (like Musharakah or Mudarabah – where sharing in profit or loss is done). However, Islamic bank are working their way up by focusing on research and new product development and now we can find Islamic financing solutions starting from microfinance and SME clients, agri-industry, middle market customers and large corporate houses to large infrastructure and projects. In Pakistan, the Islamic banking assets now constitutes more than 8.2% share of overall banking industry's assets and now stands at of Rs. 711 billion.



In terms of profitability, the Islamic banking industry has shown stable progress and the Return on Asset (ROA) and Return on Equity (ROE) of the Islamic banking industry is recorded at 2 percent and 17 percent as on Dec 2011 surpassing the overall banking system averages of 1 percent and 15 percent respectively.

Key Drivers for Growth and Competitiveness

Some key drivers for growth and competitiveness of Islamic banking industry includes

- Product Innovation, Development and Research.
- Flexible and practical application and enforcement of Shariah principles and injunctions and its acceptability by public.
- Creation of global financial hubs and regulators' support for Islamic finance industry.
- Separate governance and prudential regulations and supervisory guidance for Islamic banks
- Development and adoption of simple, standard and cost effective legal frameworks for contracts associated with the new and hybrid products.

With all the success and growth – Islamic Banking Industry is still in its childhood stage and there is a long way to go. This industry has to overcome many challenges in order to achieve a larger market share and sustain its growth.

New Challenges for the Industry

Some of the challenges that the Islamic banking industry faces today includes:

- Lack of awareness & skepticism at different levels – including investors, bankers, regulators, researchers & customers.
- Being a new industry, a major challenge in its growth is the worldwide shortage of trained Human Resource in Islamic banking & finance.
- Limited number of Shariah Scholars that create over-reliance and raise questions about Shariah compliance of the institutes involved.
- Focus efforts needed for New Product Development & Research
- Solutions for Liquidity Management & creation of Islamic Inter-bank Market
- Absence of a separate Regulatory, Legal & Risk Management framework to cater the specific need of Islamic banking Institutes.

Conclusion

Islamic banking has proved over time that it is based on firm and sound economic principles and has a good potential for become an alternative system of banking especially in view of the global financial crises. However, there is a need for dedicated research & steps from the government to develop a sound legal and regulatory framework for Islamic financial industry. Attempts should be made to modify the existing structure to provide better products and quality service within the ambit of Islamic laws. While interest-based banking has taken hundreds of years to mature to the level where it is today, expecting the same maturity from Islamic banking in its nascent stage will be expecting too much. To develop an economic system truly reflective of the sacred principles of Islam, all stakeholders should understand the limitations at this stage and work towards its advancement.

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Profile

Ahmed Ali Siddiqui is currently working as Executive Vice President at Meezan Bank and is also the Head of Product Development & Shariah Compliance department at Meezan Bank. – the research and Shariah advisory arm of the bank. He holds a Master and Bachelors degree from Institute of Business Administration, Karachi. He is a visiting faculty member at IBA, Karachi and also Senior Vice Chairman of Islamic banking & Takaful committee of FPCCI. He is also a frequent speaker at different local and international forum about Islamic banking and member of several working groups on Islamic banking State Bank of Pakistan.