State and need of an

Islamic Inter-Bank Market in Pakistan

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Outline

1. The backdrop – industry growth
2. Current scenario - Islamic IB Market in Pakistan
3. What constitutes a good Islamic IB market
4. Potential Products
5. Cross-border inter-bank market
6. Structure of an Islamic inter-bank market
7. Implementation
Islamic Banking market share - Assets

Islamic banking expected CAGR is 100%+

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The backdrop – Islamic Banking in Pakistan

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Banking industry deposits</th>
<th>Islamic banking deposits</th>
<th>Total Islamic banking branches</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>$48 B (Historical growth rate 16% p.a.)</td>
<td>$1 B (Historical growth 122% p.a.)</td>
<td>110</td>
</tr>
<tr>
<td>2010</td>
<td>$78 B (Projected growth rate 13% p.a.)</td>
<td>$12 B (Projected growth 81% p.a.)</td>
<td>440</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Year</th>
<th>Islamic Banking market share</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>2%</td>
</tr>
</tbody>
</table>

2010: Islamic Banking Deposit market share

<table>
<thead>
<tr>
<th>% share</th>
<th>$ B</th>
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<tbody>
<tr>
<td>Pessimistic</td>
<td>10%</td>
</tr>
<tr>
<td>Average</td>
<td>15%</td>
</tr>
<tr>
<td>Optimistic</td>
<td>20%</td>
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Islamic Inter-bank market in Pakistan – Current scenario

• Islamic banks managing reserve requirements by high cash reserves and low liquidity reserve
• Absence of level playing field with conventional banks,
  – unavailability Shariah compliant securities
  – no lender of last resort
• Quantum requirement of Islamic inter-bank market estimated at US$ 1- 1.5 billion
• Number of players on the increase (2 in 2001 to 16 in 2006)
Islamic Inter-bank market in Pakistan – Current scenario

- Listed issues of WAPDA Sukuk (Rs.8B) & Al Zamin Modaraba Trust Certificates
- Floatation of the 1st Pakistan Soveriegn Sukuk in the International Market in 2005
- Privately placed Sukuks of Sitara Chemicals & Al Wateen Telecom during 2006
- Around US$ 150 M – US$ 200 M Sukuks in the pipeline
# Constituents of a good Interbank Market

<table>
<thead>
<tr>
<th>FEATURES</th>
<th>IMPLEMENTATION</th>
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<tbody>
<tr>
<td>Wide Range of securities</td>
<td>• Government paper</td>
</tr>
<tr>
<td></td>
<td>• Corporate paper</td>
</tr>
<tr>
<td>Large number of players</td>
<td>• Islamic institutions</td>
</tr>
<tr>
<td></td>
<td>• Conventional institutions</td>
</tr>
<tr>
<td></td>
<td>• Foreign players</td>
</tr>
<tr>
<td>Efficient Principal Dealership</td>
<td>Promote Liquidity thru active trading and 2 way pricing</td>
</tr>
<tr>
<td>Efficient Settlement System</td>
<td>An SGLA system (Security transfer against cash transfer)</td>
</tr>
<tr>
<td>(transparency)</td>
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</table>

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Potential products

- Sukuks of various tenors, issued or guaranteed by Federal Government
- Musharaka certificates (work-in-progress at SBP)
- Commodity Murabaha – short term fixed income product (allows for interaction between Islamic and conventional banks)
- Equity (Shares) not ideal for use in an inter-bank market
- Islamic benchmark rate should be developed (although KIBOR can be used initially)
- Islamic rating needs to be developed
Cross-border Market

Where Pakistani Banks can invest in international Shariah compliant securities and vice versa

• To benefit from frequent sukuk issues in the GCC market (International Islamic Sukuk issues over US$ 8B)
• Will result in 2 way capital flow (in USD and EUR)
• However Net inflows from (capital exporting) GCC countries will far exceed outflows into foreign issues
• Foreign currency exposures would be controlled through regulatory / risk limits
Structure of Islamic inter-bank market

- Islamic banks should be given prime dealer roles to avoid crowding out by stronger conventional banks
- Islamic banks should take the lead in market making to create an actively traded secondary market
- This market will not be limited to Islamic players, conventional banks will also actively participate if risk/return features are attractive
Implementation

• Islamic banks must securitize exposures to enhance the quantum and quality of the inter-bank market
• This will compel obligors to adopt good corporate governance and seek ratings, (this will improve the quality of the overall banking market)
• Islamic industry grouping needed to encourage issuance of Shariah compliant government securities
• Need for a robust Islamic regulatory framework