STATE BANK OF PAKISTAN

DFID Department for International Development

KAP STUDY

KNOWLEDGE, ATTITUDE AND PRACTICES OF ISLAMIC BANKING IN PAKISTAN

Project Supervisor: Saleem Ullah

Team: Dr. Mian Farooq Haq (Team Leader), Bushra Shafique, Muhammad Usman Abbasi and Edbiz Consulting (Private) Limited

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Disclaimer

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Acronyms

Accounting and Auditing Organisation for Islamic Financial Institutions	AAOIFI
Assets Under Management	AUM
Azad Jammu and Kashmir	AJK
Banking Company Ordinance	BCO
Bank Control Department	BCD
Confirmatory Factory Analysis	CFA
Corporate Social Responsibility	CSR
Council of Islamic Ideology	CII
Demand Index for Business	DIB
Displaced Commercial Risk	DCR
Exploratory Factor Analysis	EFA
Federally Administered Northern Areas	FANA
Federally Administered Tribal Areas	FATA
Global Islamic Finance Forum Report	GIFF
Household	HH
International Centre for Education in Islamic Finance	INCEIF
International Islamic Financial Markets	IIFM
International Shari'a Research Academy for Islamic Finance	ISRA
Islamic Banking and Finance	IBF
Islamic Banking Department	IBD
Islamic Corporation for Development	ICD
Islamic Financial Services Board	IFSB

Kaiser-Meyer-Olkin	KMO
Knowledge, Attitude and Practices	KAP
Non Performing Financing	NPF
Pakistan Council of Islamic Banks and Financial Institutions	PCIBAFI
Principal Component Analysis	PCA
Profit Equalisation Reserve	PER
Primary Sampling Units	PSU
Profit and Loss Sharing	PLS
Return on Assets	ROA
Return on Equity	ROE
Secondary Sampling Units	SSU
Securities and Exchange Commission of Pakistan	SECP
Small and Medium Enterprises Development Authority	SMEDA
Small/Medium Enterprises	SME
State Bank of Pakistan	SBP
Supreme Court of Pakistan	SCP
Federal Shariat Court	FSC
Union Council	UC

Executive Summary

First study of its kind, Knowledge, Attitude and Practices of Islamic Banking in Pakistan (KAP), is the most comprehensive analysis of Islamic banking sector in Pakistan. The study quantifies demand for Islamic banking in the country both for retail and corporate customers, and identifies demand-supply gaps. It is based on a nation-wide survey of 9,000 households (Banked and Non-Banked) and 1,000 Corporate. Focus group meetings with the top management of Islamic banks (100 interviews) were conducted to gain the supply side perspective.

It is not improbable to assume that demand for Islamic banking is primarily a religious phenomenon. This owes to the prohibition of riba (which is commonly known as interest) in the Holy Quran. There are, however, few segments of the society who are not entirely convinced that the interest paid and charged by banks is prohibited in Islam. This is, however, a minority view as 94.51% of Banked respondents believed in the prohibition of interest, and 88.41% considered that the contemporary practice of interest in banks is prohibited. The results are not different for Non-Banked respondents rather are more profound than those of Banked respondents; over 98% Non-Banked believed in the prohibition of interest while over 93% considered the interest charged and given by banks as prohibited.

The findings of the report identify an overwhelming demand for Islamic banking in the country that is evenly distributed amongst rural and urban areas. According to the analysis overall demand for Islamic banking is higher (95 %) amongst household (retail) than the businesses (73%). In 26 districts out of 41 districts covered by the survey for retail respondents Khayber Pakhtoon Khowan (KPK), northern Punjab and southern Sindh exhibited more than 95% demand for Islamic banking. It must be considered that religious beliefs are not the only factor in determining demand for Islamic banking. There are other factors that may influence the choice of a bank – Islamic or conventional, and preference for one over the other. In terms of significance of contribution towards demand, factors are summarised in four main categories; (i) Satisfaction (S), (ii) Knowledge (K), (iii) Use (U) and (iv) Religious Beliefs (R).

Religious beliefs contribute exclusively 23% to demand for Islamic banking, while the most dominating factor remains the level of satisfaction (39 %), the users of banking services draw from the products and services offered by Islamic banks. The Category of "Use" that mainly covers outreach of Islamic banking, past banking experience, documentation and procedures contribute to 22 percent in demand index while Knowledge of Islamic banking model, practices and products contribute to only 15% demand for Islamic banking – the least significant of the four determinants of demand. One of the possible reasons for knowledge playing a limited role in determination of demand for Islamic banking in the country is widespread unawareness of Islamic banking amongst the respondents – both Banked and Non-Banked.

Demand for Islamic banking amongst businesses is more evenly distributed across all districts. There is no conclusive evidence that demand for Islamic banking by businesses located in large and industrial cities is more intense than businesses located elsewhere.

The contribution of various factors affecting demand of corporate is divided in five main categories (SKURO); (i) Satisfaction (S) (ii) Knowledge (iii) Use (iv) Religious beliefs and (v) others. Satisfaction leads with 41 percent followed by Use of various banking services (28 percent), Religious beliefs (15 percent), Knowledge (10 percent) and Others (6 percent).

Survey results further reveal that the majority of Non-Banked have never used financial services with only 7% having used some kind of banking services in the past. 220 Banked representing 5% of surveyed population are using micro finance services while this number is only 2% for non-banked who have used these services in past. The study indicates that individuals in rural areas or in low income brackets have relatively limited access to financial services. This highlights a huge opportunity for Islamic microfinance in rural areas.

The survey shows 18 percent incidence of voluntary financial exclusion. Among factors that contribute towards this exclusion religion was the most important (7.5 %) followed by lack of awareness (4 %), cost of commuting to bank (1.5 %), cultural reasons (3 %) and others (2 %). Among religious sensitive financially excluded group, majority (65 %) are not convinced of the Shari'a compliancy in Islamic banks, though majority of them do not have much knowledge or information about Islamic banking model. This demonstrates the need to address perception issues by conducting awareness raising programmes.

The study recommends that the role of Shari'a scholars needs to be further enhanced and made more public in promoting Islamic banking and finance. It can be inferred from the qualitative information that cultural dynamics need to be considered while designing awareness campaigns for different areas e.g the approval of Islamic banking by local religious scholar (imam masjid), that might relatively have higher impact in KPK and Baluchistan than other provinces. The role of the ulma in promoting Islamic banking and finance cannot be over-exaggerated, as the majority of those who are doing Islamic banking feel that it is a Shari'a board that makes a bank Islamic. So far, a very limited number of Shari'a scholars are involved in Islamic banking. It is important that scholars are trained in Islamic banking, so that they are able to offer concrete perspectives on the issues related to the field.

Lack of general awareness about Islamic banking should be a major concern for stakeholders of the Islamic banking industry. The vast majority of respondents do not understand the Islamic banking model, the nature of deposits, nature of contracts and Shari'a compliance mechanism. The knowledge about Islamic contracts and terminology was almost non-existent. Therefore, educating the masses with basic Islamic terminology and the way Islamic banking products work remain an important challenge for the Islamic banking industry. Without a robust awareness campaign about Islamic banking, the task of promoting Islamic banking will at best be difficult.

Of those who have heard of Islamic banking, most Banked and Non-Banked gained their awareness from the television, which would mean visual media is the best tool for marketing. Other media sources were less consumed, papers and radio are less popular means from which respondents gathered awareness. While 16% of Banked respondents heard of Islamic banking from bank staff, there is less than 5% of Non-Banked that can claim the same. Islamic banks need to significantly improve their investments in expanding their outreach to 2nd , 3rd and 4th tier cities both to improve their visibility across the country and also to increase their interaction with local business and trading communities. Personal interaction gives potential customers more time to determine their choice.

The supply side interviews show that about 60% respondents believed that growth of Islamic banking is a demand driven phenomenon. Very few saw the growth of industry as a purely supply side phenomenon. 33 % of respondents believed that both supply and demand forces together drive the growth of Islamic banking. As the growth in Islamic banking is perceived to be demand driven, Islamic banking institutions have not pursued very aggressive business generation campaigns. Though demand will certainly play an important role, supply side players would have to play a more active role to win additional business. This will certainly make it a demand-supply phenomenon, as suggested by 33% of the respondents.

Several respondents felt that customer brand loyalty makes it difficult for Islamic banks to draw in customers who have got history with conventional banks and according to them Islamic banks have to offer more competitively priced products to attract such clientele. Legal system was also viewed as a challenge for the industry as the same legal principles, statutes and cases are used to adjudicate both conventional and Islamic banking. Almost all respondents stated that a real challenge of being in a dual banking system was the need to continuously educate the public about Islamic banking.

This comprehensive survey on Islamic banking in Pakistan clearly indicates that there is an overwhelming demand for Islamic banking in the country. Given the supply-demand gaps there is huge potential for further development of Islamic banking in Pakistan. As a very large segment of demand for Islamic banking is yet to be met, and a significant proportion of demand lies amongst those who are still financially excluded, greenfield growth in Islamic banking has a huge scope.

CHAPTER 1
Introduction

Islamic banking continues to grow at a rapid pace because of its value-orientated ethos, enabling it to draw business from both Muslims and non-Muslims alike. The rapid growth of Islamic banking may enhance financial inclusion by providing an alternative to those faith-sensitive Muslims who have voluntarily excluded themselves from the conventional financial system due to its interest based nature. With the worldwide proliferation of Islamic banking and finance, a need is being felt to determine what proportion of a country's population is interested in Islamic banking.

In a country like Pakistan, where the growth of Islamic banking is outpacing that of its conventional counterpart, it is important to investigate the effect of religious beliefs on the incidence of financial exclusion. While the consistent growth and increasing market share is indicative of rising acceptability of Islamic banking, it is important to explore reasons behind its expansion. There is a need to analyse whether Islamic banking is a demand driven phenomenon or spurred by the availability of Islamic financial services by banks, it is not unrealistic to assume that it is primarily influenced by the religious and ethical beliefs of people.

The State Bank of Pakistan, which regulates Islamic banks alongside other conventional banks in the country, is interested in determining the nature and scope of Islamic banking to draw policy implications for its further growth and development. In a country, where a significant proportion of population still resides in the rural areas (where agriculture is a major economic activity), and financial exclusion is rampant, it is necessary to understand dynamics of the industry to ensure conducive policy environment and future growth potential. Also, it is important to look into the possibility of using Islamic banking to decrease incidence of financial exclusion in the country.

As primary data on demand for Islamic banking does not exist in the country, such a study involves quantification of demand for Islamic financial services through a survey of retail and corporate clients of banks and also of those who are at present not using mainstream methods of banking and finance. The study attempts to quantify demand for Islamic financial services in Pakistan by creating a demand index based on multivariate analysis. For a comprehensive analysis, while demand side is an important consideration, the importance of supply side issues and trends cannot be overlooked. Hence, a supply side survey based on focused interviews of senior and middle management of Islamic banking institutions was also conducted.

After this brief introduction, following Chapter 2 provides an overview of the Islamic banking industry in Pakistan. This chapter breaks down the growth, legal and political developments, that underpin the Islamic banking industry in the country. Chapter 3 describes the statistical methodology used to construct the demand index. It also discusses the method to assess suitability of the data for factor analysis as well as how different factors have been selected. Chapter 4 is a detailed account of sampling and different stratification measures used to ensure that the data set obtained from the survey adequately represents the sample population. This chapter also explains themes of the questionnaires given to retail and corporate respondents, and higher management of Islamic banks.

Chapter 5 is first of the three core chapters. It focuses on a preliminary demand analysis in light of the results from the survey conducted on three data sets – drawn from Banked, Non Banked and Corporate respondents. Analysis on the usage of banking services, the demand for Islamic banking, and perceptions on Islamic banking are presented in this chapter. Chapter 6 presents quantification of demand for Islamic banking in Pakistan. Chapter 7 provides a supply side perspective on Islamic banking. The last chapter, chapter 8, offers some policy implications in light of the findings of this report.

Chapter 2
Islamic Banking in Pakistan

2.1. Pakistan and the Global Islamic Finance Industry

Islamic banking and finance (IBF) represents about 1 percent of the global banking and finance industry. According to Islamic Financial Services Industry Stability Report 2013 by Islamic Financial Services Board (IFSB), the Islamic financial services industry was worth US$1.6 trillion at the end of 2012, a substantial increase from a modest figure of only US$150 billion at the start of 1990s. The IBF industry has witnessed considerable growth in the last few decades with an average annual growth of approximately 20 percent. The IBF industry now comprises in excess of 400 Islamic banks and financial institutions and around 191 conventional banks with Islamic windows operating in more than 75 countries[1]. Pakistan, with the second largest Muslim population in the world, is among the three countries (others being Iran and Sudan) that fully committed to IBF.

2.2. History of Islamic Banking in Pakistan

The history of Islamic Banking in Pakistan can be traced back to the independence of the country in 1947 and the vision and statements of the founding father, Quaid-e-Azam Muhammad Ali Jinnah, who emphasized the importance of IBF in his inauguration speech at SBP in 1948:

"I shall watch the work of your 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 of equality of manhood and social justice."

Consistent with the vision of the Quaid-e-Azam, the Council of Islamic Ideology (CII)[2], a research based institution, was given the task of developing a comprehensive framework for implementing the economic doctrines of Islam to Pakistan's economy. It was mandatory for the government to consider the recommendations of CII in all matters pertaining to law and economy, as it was CII's responsibility to safeguard the Islamic character of the country while developing a policy framework for Pakistan's economy. Interest based banking was first referred to CII in 1963 after the government expressed concerns as to whether interest based lending fell under the definition of interest mentioned in the Holy Quran. In 1969, after detailed discussions, CII advised the government that interest based lending does indeed fall under the rubric of riba. After further investigations and discussions, the CII passed a resolution stating that interest is prohibited in all its forms, and the government should constitute a committee to assist CII in reforming the interest based system in light of Islamic principles. General Muhammad Zia ul Haq, after assuming his role as President of Pakistan, directed CII to produce a blueprint for an interest free economy within 3 years. In 1980, the CII with the help of 15 committee members submitted a draft outlining the processes to bring the economy in conformity with Shari'a. Some important developments over the period between 1980 and 1990 include:

- A regulatory framework for Mudaraba[3] Companies in 1980 followed by Mudaraba Rules and Prudential Regulations for Mudarabas in 1981 as two tier fund structure for undertaking Shari'a compliant businesses.
- Elimination of riba from the banking system under the SBP issued BCD Circular No. 13 in 1984. In 1985, all financing to the federal and provincial governments, public sector corporations and private companies were directed to be interest free.
- In 1985, all commercial banking in Pakistan rupees was made interest free, and profit and loss sharing (PLS) deposits increased from 9.2 percent of the total deposits in 1981 to 62 percent by 1985.

By the late 1980's, however, there were growing concerns and complaints over the practice of IBF in Pakistan. The Federal Shariat Court (FSC) challenged some emerging products and processes and gave a verdict on November 14, 1991 that those products were directly or indirectly based on interest. The FSC ordered the government to adopt measures for eliminating interest from the economy of Pakistan by June 1992. However, an appeal was filed by the government and financial institutions to the SCP. The appeal was delayed until 1999, and on December 23, 1999, the SCP affirmed the FSC's decision, and recommended the government to abolish the prevailing interest based system by June 30, 2001. Though the government took steps to implement the Supreme Court of Pakistan (SCP) order, it failed to meet the deadline and sought for an extension till June 30, 2002. The government at that time, realising the need for prescribed parameters for enforcing an Islamic economic system, decided

[1] Rahman. N, 2012, Attitudes of Muslims towards Islamic Banking and Finance in the North West of England: A socio-economic perspective, Durham University, UK

[2] CII was initially established in 1957 under the first constitution of Pakistan in 1956 and was then recognized in 1962 and further ratified in the 1973 constitution of Pakistan

[3] The term is spelled as Modaraba in the legal documents in Pakistan but we shall retain the more widely used spellings of Mudaraba in this report.

eliminating interest from the economy in a phased and gradual manner, and therefore Islamic banking was re-launched in 2001 as a parallel system to conventional banking. In this regard, as a first step, SBP established a dedicated department – Islamic Banking Department (IBD) to develop and strengthen the Islamic banking sector. In 2001, SBP issued an exclusive Islamic banking policy with detailed criteria for setting up Islamic banks. In 2002, a new clause was added to the Banking Company Ordinance (BCO) 1962 that allowed commercial banks to open subsidiaries for Shari'a compliant operations. The new paradigm allowed three types of Islamic banking institutions to be operational in the country:

- Full-fledged Islamic banks
- Islamic banking subsidiaries of conventional banks
- Islamic banking branches of conventional banks

In 2002, Meezan Investment Bank became the first full-fledged Islamic banking institution. The Shari'a compliance framework introduced by SBP for Islamic banking institutions required: (i) Shari'a board at the SBP (ii) Shari'a advisors at all individual banks (iii) Shari'a internal audit and (iv) Shari'a inspections by SBP.

SBP over time has issued permissible Islamic modes of finance, model Islamic financing agreements besides adapting Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) Shari'a Standards for the Pakistani market to encourage standardization and Shari'a harmonization.

To capitalize on innate strengths of Islamic finance to promote broad based growth, SBP is focused on encouraging the Islamic banking industry to explore sectors like agriculture, Small and Medium Enterprises (SME), Housing and micro finance. Furthermore, the detailed instruction on Profit & Loss Distribution and Pool Management for Islamic Banking Institutions (IBIs) is a significant milestone towards improving public perception and comfort on Islamic banking. Withdrawal of the mandatory requirement of a minimum rate of return on savings deposits for Islamic banking institutions along with these instructions is expected to build the confidence of masses by enhancing the credibility and reputation of the industry.

The central bank is also playing a vital role in raising awareness and building capacity of the industry. To address awareness and tackle misconceptions about Islamic banking SBP in collaboration with many national and international players is conducting seminars, conferences, targeted programmes and focused discussions for different stakeholders. SBP, through its training subsidiary, is not only offering regular certification courses for Islamic banking, but is also extending customised programmes for national and international participants.

2.3. Industry Progress

By December 2013, size of the Islamic banking industry in Pakistan comprised 9.6 percent of the total banking assets of the country. There are now 5 full-fledged Islamic banks and 14 conventional banks with Islamic banking branches. Going forward this number is likely to increase as one bank has been granted in-principle approval to start Islamic banking operations while another has been granted in-principle approval for establishing an Islamic banking subsidiary. It is interesting to note that all the five full-fledged Islamic banks in Pakistan, i.e., Al Baraka (Pakistan) Bank, Meezan Bank Limited, Bank Islami Pakistan Limited, Burj Bank Limited and Dubai Islamic Bank Pakistan Limited, have been set up with the help of foreign investment. There are 1304 branches in 87 districts across the country. Figure 2.1 highlights the growth in the number of Islamic banking branches (including full fledged and Islamic banking branches of conventional banks) between the years 2004 and 2013.

According to the SBP data, total assets under the management (AUM) of Islamic banks in Pakistan reached above Rs.1 trillion by end December 2013 from Rs 6.97 billion in December 2002. During this period the share of Islamic banking assets in the overall banking sector has reached to 9.6 percent. Figure 2.2 shows that growth in Islamic banking deposits is in line with the increase of Islamic banking branches. This phenomenon is consistent with the findings of the current study that demand for Islamic banking grows with the visibility of Islamic banks and increased awareness of Islamic banking. This implies that pent-up demand for Islamic banking is significant and consumers having a choice between Islamic and conventional banking are inclined to opt for the former.

Total Islamic banking deposits reached Rs.868 billion in December 2013 from Rs 5 billion in 2002 which now account for 10.4 percent of the total deposits of the banking sector in the country (Table 2.1).

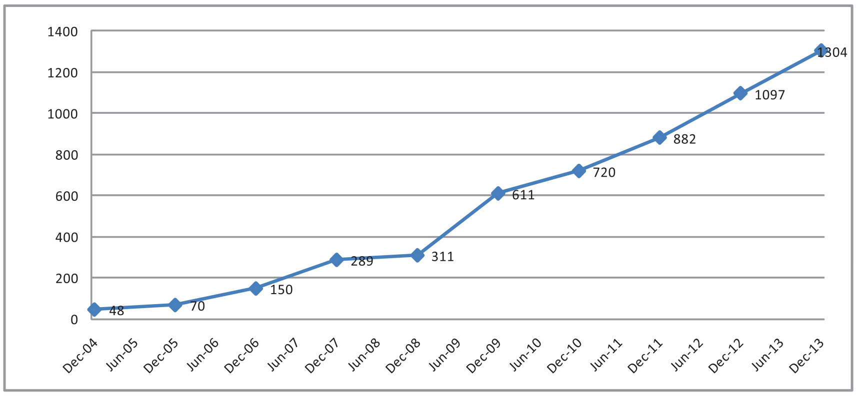


Figure 2.1: Growth in Islamic Banking Branches in Pakistan

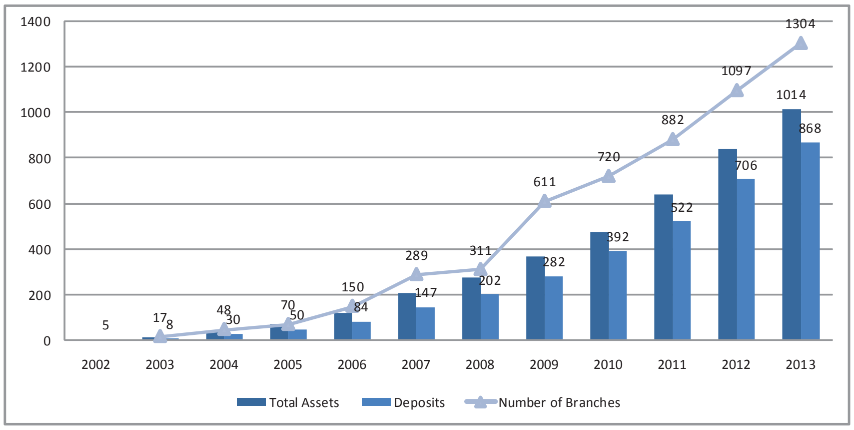


Figure 2.2: Growth in Islamic Banking Deposits, Assets and Islamic Banking Branches

Growth in Islamic banking	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Share in banking Industry (Percent) 2013
Total Assets	7	13	44	71	119	206	276	366	476	641	837	1014	**9.6**
Net Financing and Investments	5	10	30	48	73	138	186	226	338	475	626	709	**8.5**
Deposits	5	8	30	50	84	147	202	282	392	522	706	868	**10.4**
Number of Branches		17	48	70	150	289	311	611	720	882	1097	1304	

Table 2.1: Growth in Islamic Banking (Figures in Billion Rupees)

Percentage Growth of Islamic banking	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Average Growth
Total Assets	85	242	62	67	73	34	33	30	35	30	21	65
Investment and Net Financing	100	200	60	52	89	35	22	50	41	32	13	63
Deposits Growth	65	259	65	68	76	37	40	39	33	36	23	67

Table 2.2: Percentage Growth in Islamic Banking

During the period 2003 – 2013, net financing and investments have seen an impressive growth from Rs 10 billion to Rs 709 billion (Table 2.1). By end December 2013, total size of net financing and investments reached 8.5 percent of the overall banking industry mainly due to increase in invest ments. Islamic banks, in the past, faced difficulty due to the unavailability of Shari'a compliant investment avenues however, with the frequent issues of sukuk by the government Islamic banks have got the opportunity to place their funds. Since 2008, the growth of investments in federal government securities has increased from Rs 9.62 billion to Rs.267 billion by end December 2013. Out of the total Islamic banks investments, government securities approximately account for nearly 70 percent, highlighting the increasing trend of using these securities for liquidity management. On the other hand the growth in Islamic finance has staggered in the last few years due to deteriorating economic conditions and reduced confidence in the private sector. Growth is likely to remain stable as the country attempts to improve its economic position.

2.4. Modes Wise Financing

The growth in Islamic financing is mainly a result of growth in the fixed-return modes of financing like murabaha, ijara, istisna', and salam which in aggregate captures 58 percent of the total financing. The total financing under murabaha has reached above Rs.134 billion (40.6 percent) and ijara Rs. 25.4 billion (7.7 percent) (Figure 2.3). Financing based on diminishing musharaka is Rs 101.8 billion (31 percent). On the other hand, mudaraba and musharaka in their pure forms constitute only 7 percent of overall financing of Islamic banks. While fixed-return modes are preferred by bankers (consistent with international practices in Islamic banking and finance), there is a concern about their excessive use. An analysis of the trends in Islamic modes of financing reveals that murabaha has remained the most preferred mode for financing followed by diminishing musharaka (Figure 2.4).

Low proportion of Islamic financing based on mudaraba and musharaka can be attributed to issues like moral hazard, undocumented industry, and issues in legal and regulatory framework. In addition, the overall economic condition of the country does not allow Islamic banks to use these products effectively. Banks are of the view that such contracts can be carried out with only reputed clients, who have well-established verifiable cash flows and good corporate governance practices and track records (see Chapter 7 for further details). Hence, once this is accomplished it is expected to improve the confidence of Islamic bankers in these participatory modes of financing.

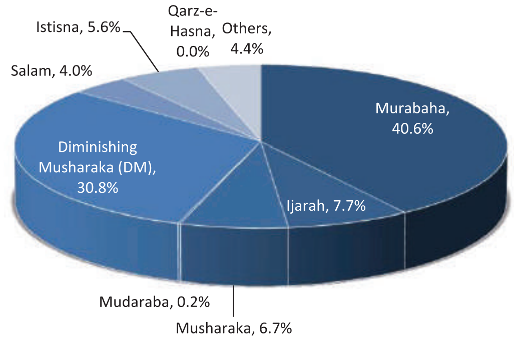


Figure 2.3: Mode Wise Financing

2.5. Sector Wise Financing

More than 70 percent of total Islamic financing portfolio is represented by the corporate sector, followed by consumer finance (11.6 percent) (Figure 2.5). Most of the corporate financing is extended to textiles (19.1 percent), energy (8.9 percent) and chemicals & pharmaceuticals (6.3 percent). The SME sector represents only 5 percent of the total financing. Along with agriculture, these two sectors have received minimal financing and remain neglected[4].

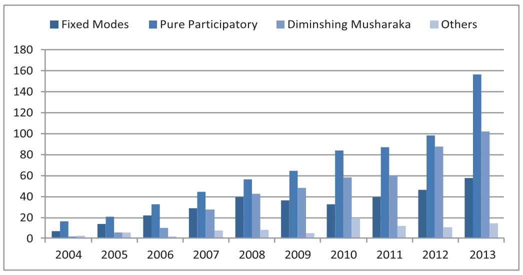


Figure 2.4: Trends in Islamic Modes of Financing

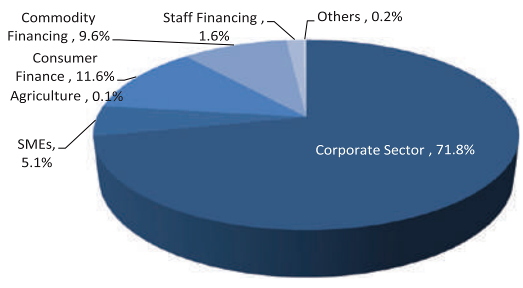


Figure 2.5 Trends in Financing Different Sectors

Non Performing Financing (NPF) in the Pakistani banking sector increased significantly between 2008 (when it was Rs 3.4 billion) and 2013 (when it reached Rs18.9 billion). The increase in NPF for Islamic banking is in line with the industry norm and represents approximately 4 percent share in overall banking industry NPF. The NPF to financing ratio in Islamic banking reached 5.7 percent in December 2013 but encouragingly it is still below the overall banking industry average of 12.7 percent.

[4] Chapter 7 highlights the concerns of Islamic banking practitioners as to why Islamic banks have not been able to finance these sectors effectively.

Both ROA and ROE of the Islamic banking industry are still below the industry averages. The net mark up income to gross income has reduced between 2008 and 2013, from 83.65 percent in 2008 to 78.54 percent in December 2013, which happens to be above the industry average of 72.01 percent. The non-mark-up to gross income has been below the industry average of 27.99 percent and stood at 21.46 percent in December 2013. The operating expense-to-gross income ratio remains above the industry average and can be attributed to the higher cost, economies of scale due to small size of the industry and expansionary programmes of Islamic banks.

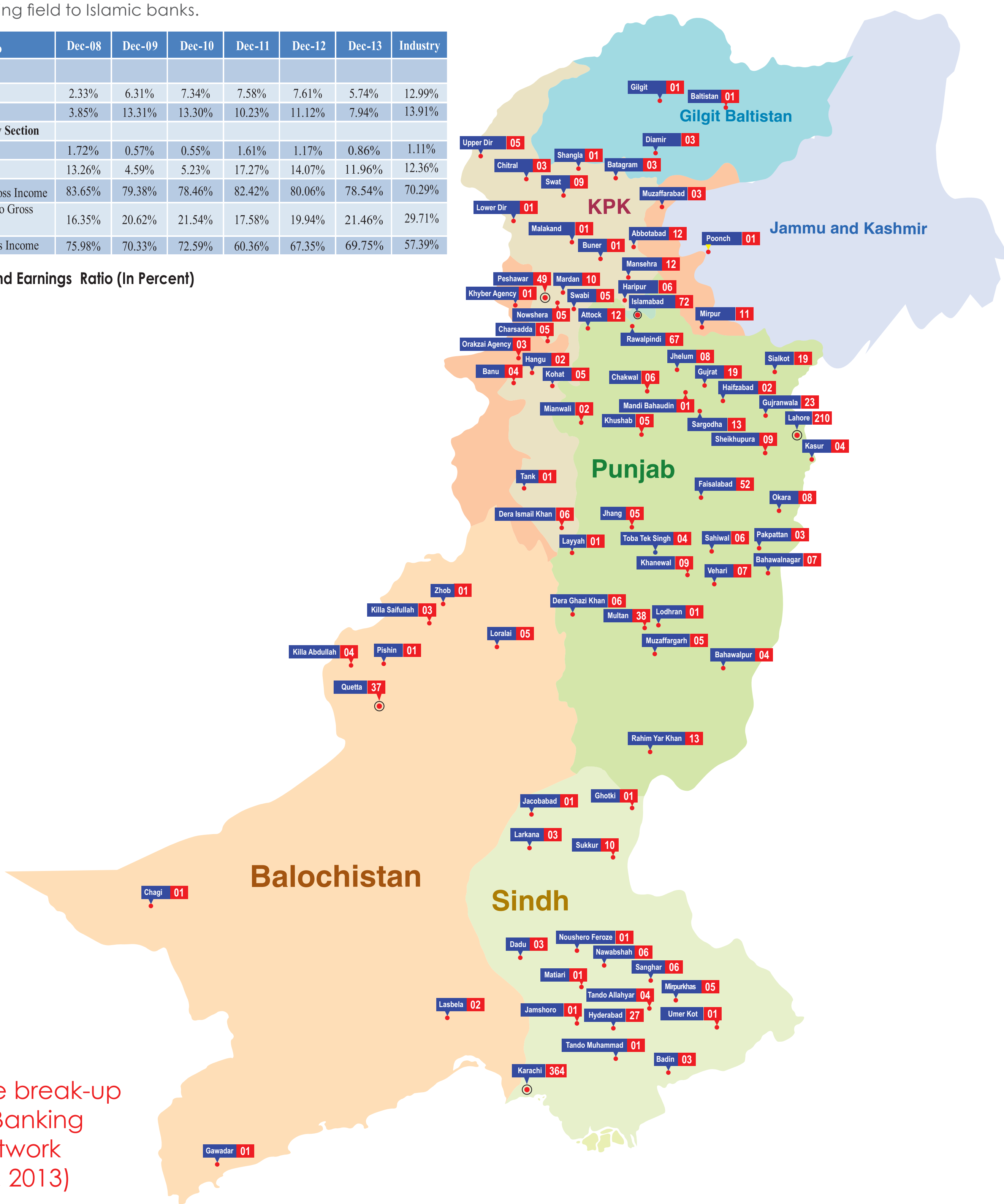
In summary, Islamic banking in Pakistan has progressed well since the dual banking model was adopted at the start of the century. SBP has ensured that the system runs smoothly by providing a level-playing field to Islamic banks.

Non-Performing Financing (Rs billion)8	Dec-08	Dec-09	Dec-10	Dec-11	Dec-12	Dec-13
Non- Performing Financing	3.4	10	13.8	15.9	18.5	18.9
Provisions Held Against Financing (Specific + General)	2.3	5.2	8.1	10.1	12.3	14.1
Net Non-Performing Financing	1.1	4.8	5.7	5.9	6.2	4.8
Recovery Against NPF (year to date)	0.2	0.8	1.2	1	0.9	1.2
Non-Performing Assets (NPA)	3.9	11.7	15.8	18	21.7	22.3
NPF to Financing %	2.3	6.3	7.3	7.6	7.6	5.7

Table 2.3: Non Performing Financing

Assets and Earnings Ratio	Dec-08	Dec-09	Dec-10	Dec-11	Dec-12	Dec-13	Industry
Assets Quality Ratio							
NPF to Financing	2.33%	6.31%	7.34%	7.58%	7.61%	5.74%	12.99%
Net NPA to Total Capital	3.85%	13.31%	13.30%	10.23%	11.12%	7.94%	13.91%
Earnings and Profitability Section							
Return on Assets (ROA)	1.72%	0.57%	0.55%	1.61%	1.17%	0.86%	1.11%
Return on Equity (ROE)	13.26%	4.59%	5.23%	17.27%	14.07%	11.96%	12.36%
Net Mark-up Income to Gross Income	83.65%	79.38%	78.46%	82.42%	80.06%	78.54%	70.29%
Net Non-Mark up Income to Gross Income	16.35%	20.62%	21.54%	17.58%	19.94%	21.46%	29.71%
Operating Expense to Gross Income	75.98%	70.33%	72.59%	60.36%	67.35%	69.75%	57.39%

Table 2.4: Assets and Earnings Ratio (In Percent)



District wise break-up of Islamic Banking Branch Network (as of Dec. 2013)

Chapter 3
Methodology

3.1. Introduction

The study involves a large primary data set that has national representation. Such a rich data set based on the opinions of retail and corporate respondents provides valuable insights for policy formulation. Moreover, the study is comprehensive since it not only explores demand side dynamics of Islamic banking but also analyses supply side issues and challenges. This chapter explains the statistical techniques used to quantify the demand for Islamic banking in Pakistan.

After ensuring data health it was envisaged to use at least three statistical techniques - Factor Analysis, Principle Component Analysis (PCA) and the Path Model - for grouping of collected information into variables determining demand for Islamic banking. However, given the statistical properties of the data set at hand and similarities of the initial results, it was decided to continue with factor analysis that employed principle component analysis to extract significant factors influencing demand for Islamic banking in the country. The path model was eventually ruled out as factor analysis produced coherent and consistent grouping of the variables for factor formation. This favourable behaviour of the data for factor formation was an added advantage and a more objective technique for group formation as compared to the path model that allows discretionary choice of variables. A brief explanation of factor analysis is given as follows.

3.2. Factor Analysis

Factor analysis investigates whether variables of interest V_1, V_2, V_3 etc. are linearly related to unobservable factors F_1, F_2, F_3, etc. It is primarily used to reduce a large number of variables into a smaller number of groups, based on correlation between the variables. Factor analysis does this by seeking underlying unobservable (latent) factors that are based on the observed variables collected from a primary source such as a survey (as is the case in the present study) or from a secondary source. The real benefit of this technique is that it reduces a large number of variables into smaller, relatively manageable number of factors, while retaining maximum original information. Figure 3.1 presents a hypothetical graphical representation of factor analysis.

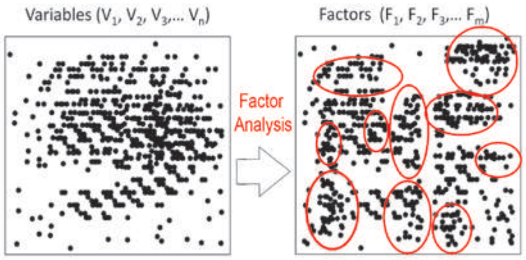


Figure 3.1: A Hypothetical Graphical Representation of Factor Analysis

There are two main approaches to factor analysis: exploratory and confirmatory. Exploratory Factor Analysis (EFA) is usually used in the early stages of research where the aim is to gather information or explore relationships among different variables. Confirmatory Factor Analysis (CFA) is used in later stages of a research to confirm a hypothesis or theory that relates to the underlying variables.

The aim of this present research is to explore the demand for Islamic banking in Pakistan and hence exploratory factor analysis is used.

There are three main steps in carrying out factor analysis.

(1) Assessment of suitability of data for factor analysis

The following conditions are considered in determining whether the data set is suitable for factor analysis:

a) Sample size; and

b) Adequacy of Data (Strength of the shared variance between the variables)

Since factor analysis is based on correlation matrix[5] of the variables involved it requires a relatively large data set. According to Comrey and Lee (1992), a sample size of more than 1,000 is excellent, 500 is very good, 300 is good, 200 is fair, 100 is poor and 50 is very poor. A minimum of 10 observations per variable is necessary to avoid computational difficulties.

The second condition relating to the strength of inter correlations among variables can be assessed by the Kaiser-Meyer-Olkin (KMO) test. KMO, a measure of sampling adequacy, represents the ratio of the squared correlation between

[5] Correlation matrix usually requires a significant sample size

variables to the squared partial correlation between variables. The KMO measures range between 0 and 1. A value close to 0 indicates that the sum of partial correlations is very large relative to the sum of correlations, suggesting diffusion in the pattern of correlation. Hence factor analysis is likely to be inappropriate. A value close to 1 indicates that patterns of shared variance are relatively compact and, therefore, factor analysis should yield distinct and reliable factors.[6]

As this study is based on data set comprising of 9,000 retail and 1,000 corporate respondents, it adequately fulfils the requirement of a large sample size. In this analysis, the KMO value for each of both the retail and corporate sample was above the acceptable limit of 0.7 hence fulfils the second condition as well.

Additionally, Bartlett's test is used to determine homogeneity of variances, i.e., whether the correlation matrix is suitable for factor analysis. It tests the null hypothesis that the original correlation matrix is an identity matrix[7] (all pair wise correlation is zero).

H_o = all pair wise correlation is equal to zero

H_a= not all pair wise correlation is equal to zero

For factor analysis to work there needs to be a relationship (correlation) between variables implying that there is a need to reject the null hypothesis. Therefore the test has to be significant, which means that correlation between the variables is not zero.[8] For the data of this study, Bartlett's test is significant, i.e., ($p < .001$) and hence factor analysis can be used.

(2) Factor Extraction

Once the adequacy of data and sample size are checked for suitability, the next step is to run factor analysis to extract factors. Factor extraction involves determining the smallest number of factors that can be used to best represent the interrelations among the set of variables. There is a variety of approaches that can be used to extract underlying factors or dimensions. However, for the purpose of this research, the Principle Component Analysis is chosen.[9] It is challenging to determine the number of factors that best describe relationships among the variables. This requires balancing two conflicting needs: the need to find a simple solution with as few factors as possible, and the need to explain as much of the variance in the original data as possible. For the purpose of this research Kaiser (1960) is used, which recommends retaining all factors with Eigenvalues greater than 1.[10] Eigenvalues are a group of values related to a linear system of equations known as characteristics roots, characteristic values or latent roots. It shows the variance in all the variables, which is accounted for by that factor.

The first part of factor extraction is to determine linear components within the data set by calculating Eigenvalues of the R-matrix. When several variables are measured, the correlation between each pair of variables can be arranged in a R-matrix. A R-matrix is just a correlation matrix: a table of correlation coefficients between variables. The diagonal elements on a R-matrix are always one because each variable will correlate perfectly with itself. The off diagonal elements are the correlation coefficients between pairs of variables. The existence of groups of large correlation coefficients between subsets of variables suggests that those variables could be measuring aspects of the same underlying dimension. These underlying dimensions are known as factors. By reducing a data set from a group of interrelated variables to a smaller set of factors, factor analysis explains the maximum amount of common variance in a correlation matrix using the smallest number of explanatory constructs. In factor analysis the aim is to reduce this R-matrix down to its underlying dimensions by looking at which variables seem to cluster together in a more meaningful manner. This is achieved by looking at variables that correlate highly with a group of other variables, but do not correlate with variables outside of that group. In this research a set of 98 variables for retail sample has been reduced to 20 factors and 153 variables for corporate sample have been reduced to 21 factors with the help of the Principal Component Analysis (PCA). The PCA is the most widely used method for determining the set of loadings that bring the estimate of the total communality[11] as close as possible to the total of the observed variances.

These factors chosen on the basis of Eigenvalues collectively explain 70.5% of variance for retail and 83.1% for corporate sample. It is suggested that factor analysis is usually considered effective if total retained factors explain at least 70% of overall variance of the variables.

Once the factors have been extracted it is important to check how much variance of variables is explained by these underlying factors by checking the communalities. Communality explains the amount of (common) variance in each variable that can be explained by the factors. A variable with a communality value 1 means that it does not have any unique variance, whereas a communality value of 0 means there is no common variance in the variable and all the variance is unique (Field, 2011).[12] This is because before extraction there are as many factors as variables but after extraction only 20 factors (retail) and 21 factors (corporate) are retained and hence some of the information is lost. This means that the underlying factors will not be able to explain the variables completely. It is also important that reasonable common variance is explained by the underlying factors i.e. all the communalities variance is greater than 0.7 if the total variables are less than 30. However, if the sample size is more than 250 then the average communalities should be more than 0.6. Since the sample of this study was more than 250 and the variance for both retail and corporate was above average communalities' benchmark, this satisfactorily explains the shared variance.

(3) Factor Rotation and Interpretations

After factor extraction it might be difficult to interpret and name the factors on basis of their factor loadings.[13] This is due to the criterion of the Principal Component Analysis where, the first factor accounts for the maximum part of the variance; this will often ensure that most variables have high loadings on the factors with high variance, and small loadings on all other factors (Field, 2000). This makes interpretation of factors difficult. Factor rotation is one way of tackling this problem where this method alters the pattern of the factor loadings, and improve interpretation. The factor rotation does not change the underlying solution; it is an attempt to improve the interpretability of the factors. It maximizes the loadings of each variable on one of the extracted factors while minimising the loadings on all other factors. Factor analysis does not interpret each of the factors for the analyst; it just shows which variables clump together.
There are two main approaches to rotation: 1) or

[6] Kaiser (1974) recommends accepting a value greater than 0.5 as barely acceptable. Values between 0.5 and 0.7 are mediocre, values between 0.7 and 0.8 are good, values between 0.8 and 0.9 are great and values above 0.9 are superb (Hutcheson & Sofronio, 1999)

[7] Identity matrix is a square matrix in which the diagonal elements are equal to one and off diagonal elements are equal to 0.

[8] If correlation-matrix is an identity matrix then all correlation coefficients would be zero, which means that factor analysis will not work.

[9] Other methods include, Principle Factor, Image Factoring, Maximum Likelihood Factoring, Alpha Factoring, Unweighted Least Squares, and Generalized Least Squares.

[10] This criterion is based on the idea that Eigenvalues represent a substantial amount of variation. There are a number of techniques that can be used to assist in the decision concerning the number of factors to retain. Most commonly used techniques are Kaiser criterion, scree test and parallel analysis.

[11] The total variance for a particular variable will have two components: some of it will be shared with other variables or measures (common variance) and some of it will be specific to that measure (unique variance). Unique variance refers to variance that can be attributed to only one measure. However, there is also variance that is specific to one measure but not reliably so; this variance is called random variance. The proportion of common variance present in a variable is known as communality. A variable that has no specific variance (or random variance) would have a communality of 1; a variable that shares none of its variance with any other variable would have communality of 0 (Field, 2009).

[12] A main difference between the Principal Component Analysis (PCA) and factor analysis is that the former assumes that all the variance in the variable is common, where as the latter assumes that there are two types of variances in a variable, unique and common variance. It is the common variance that factor analysis is interested in.

[13] This correlation between original variables and the factors is called factor loadings. Squared factor loadings indicate what percentage of the variance in an original variable is explained by a factor.

[14] It is a linear model in which one variable or outcome is predicted from a single predictor variable. Regression analysis is a statistical tool for the investigation of relationships between variables. Usually, the investigator seeks to ascertain the causal effect of one variable upon another—the effect of a price increase upon demand, for example, or the effect of changes in the money supply upon the inflation rate.

thogonal rotation; and 2) oblique rotation.

A. Orthogonal Rotation

This matrix contains the same information as a component matrix except that it is calculated after rotation. According to Tabachinck and Fedell (2001), orthogonal rotation results in solutions that are easier to interpret, however they do require the researcher to assume that underlying constructs are independent. Before rotation, all factors are independent and orthogonal rotation ensures that factors remain independent. In addition, Tabachink & Fidell (2001) suggests looking at the correlation matrix for values around 0.32. If the values are above 0.32, then there is 10% overlap in variance among factors and this is enough to consider using oblique rotation unless there are compelling reasons to use orthogonal rotation. Orthogonal rotation (or varimax) is used as the low correlation between the variables (value below 0.32) did not support oblique rotation for this research.

B. Oblique Rotation

In an oblique rotation, the factor matrix is split into two matrices, the *pattern matrix* and the *structure matrix*. It is assumed that variables are not independent. The pattern matrix contains factor loadings and is similar to factor matrix interpreted for orthogonal rotation. The structure matrix on the other hand takes relationships between factors (in fact it is the product of pattern matrix and the matrix containing the correlation coefficients between factors). It is also understood that researchers prefer oblique rotation because it contains information about the unique contribution of a variable to a factor.

Once the above is completed, the next step involves identification of factors. As mentioned above, the factor analysis reduced variables into 20 factors for retail and 21 for corporate. The factors are normally named roughly, because constituting variables are not necessarily from the groups with similar economic interpretations. In our case, however, the data behaved well and it was easy for us to interpret individual factors, as constituting variables were drawn from the groups with similar economic characteristics.

After factor identification, the next step involves quantification of demand for Islamic banking. This is represented through an index that is constructed by including the individual factors determining demand, weighted by the individual contributions of these factors. A generalised demand index is given in the following:

$$\text{Demand} = \sum_{i=1}^{20} \alpha_i X_i$$

where α_i are the weights given to different factors X_i.

The above measure of demand is the most objective given the data set at hand. It includes the factors that determine demand for Islamic banking derived through factor analysis, which minimises the level of subjectivity.

Once the demand index is created, regression analysis[14] is carried out to understand the relationships between demand for Islamic banking and a selected number of economic and demographic variables, and to measure the causal effect of such variables on the demand. While regression analysis produced some meaningful results for retail data, the corporate sample did not produce any statistically useful results. Chapter 6 provides further details on the construction of demand indices for retail and corporate. Figure 3.2 presents a summary of the methodological approach taken in this study.

3.3. Conclusion

The methodology employed in this research is Exploratory Factor Analysis (EFA). This appears to be the most appropriate technique to quantify demand for Islamic banking in Pakistan in the absence of a well-defined and coherent theory for determining demand for Islamic banking. This present study may help in developing a theory for demand for Islamic banking if repeated for other countries where Islamic banking and finance is a significant activity.

The primary goal of the EFA is to identify latent variables by reducing a large set of variables into a smaller set of factors, which can be used to develop a theory for determining demand for Islamic banking. However, the primary objective of this research is to identify the factors that may influence demand for Islamic banking in Pakistan. The primary focus is not development of theory.

Although the research at hand is objective in terms of its statistical methodology, one must bear in mind that subjectivity cannot be completely ruled out in such studies, especially in the construction of questionnaires. In the absence of a coherent theory for determining demand for Islamic banking, the level of subjectivity was minimised by consulting different stakeholders, including the Islamic Banking Department at SBP, in construction of three sets of questionnaires used to collect information from the Banked, Non Banked and Corporate segments of the market.

Demand analysis was complemented with a supply side analysis based on personal interviews of middle and top management of Islamic banks and conventional banks with Islamic banking operations in the country.

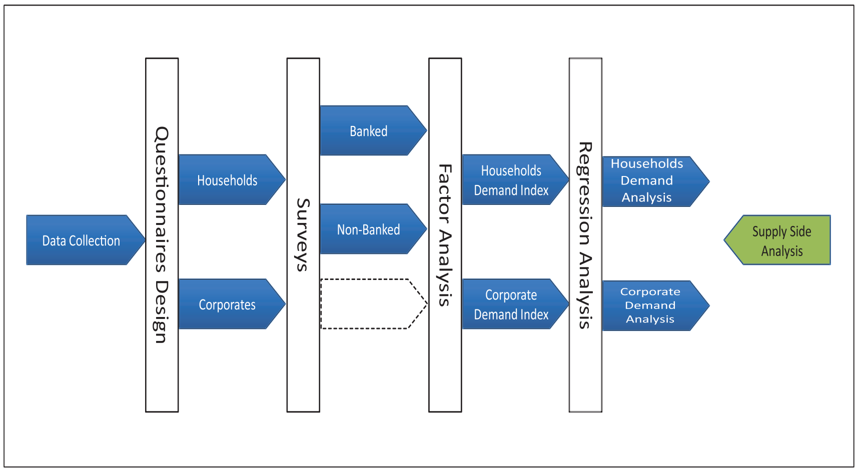


Figure 3.2: Summary of Methodological Approach

Chapter 4
Survey and Questionnaire Design

In the absence of any known comprehensive research and well-established theoretical framework for studying demand for Islamic banking, this study focuses on three fundamental areas, knowledge, attitude and practices (KAP), to collect relevant data for quantifying demand of Islamic banking in Pakistan. This chapter explains data collection and generation process with a focus on survey design, construction of questionnaires, sample selection and composition along with description of survey administration and its management.

4.1. The Survey Instrument

A sample of 10,000 households and businesses was drawn from all regions of Pakistan, excluding the federally and provincially administered tribal areas – Federally Administered Tribal Areas (FATA), and Provincially Administered Tribal Areas (PATA). 100 interviews of Islamic banks' senior and middle management were conducted to collect information on supply side issues.

4.1.1. Questionnaires

The study used closed-ended questionnaires for data collection of the demand side while information for the supply side was collected through focused interviews. The demand side survey was based on three questionnaires: (i) Banked households (ii) Non-Banked households and (iii) businesses; and supply side interviews were carried out using an open-ended questionnaire.

Questionnaires were further refined in light of the pilot survey (see Box 4.1 for pilot details). Given that most respondents spoke Urdu, the questionnaires were translated into Urdu for optimal response. Respondents were surveyed on the following major areas:

- Personal demography of respondents
- Socio-economic demography
- Banking history
- Patronage of banks and factors affecting the selection of a bank
- Incidence of financial exclusion
- Need for banking products
- Knowledge of Islamic banking and the underlying principles
- Awareness of Islamic banks and their products
- Attitude towards Islamic banking
- General knowledge about Islamic banking
- Supply side issues

Modules		Households	Businesses
Basic demographics			
	Location	√	√
	Religion	√	
	Marital status	√	
	Age (the number of years in operations in case of businesses)	√	√
	Level of education	√	√
	Source of income	√	√
	Size of the business		√
Knowledge			
	Awareness of banking products	√	√
	Awareness of Islamic banking products	√	√
	Use of banking services	√	√
	Use of Islamic banking services	√	√
Satisfaction with banking services			
	Satisfaction with conventional banking	√	√
	Satisfaction with Islamic banking	√	√
Relevance of Islamic banking products			
	Need for banking services	√	√
	Need for Islamic banking services	√	√
	Willingness to switch to Islamic banking	√	√
Income			
	Income of the household	√	
	Total annual revenue of the company		√

Table 4.1: Key Modules Used in Questionnaires

Box 4.1: Pilot Survey

A pilot survey was conducted before the main survey to test the questionnaires and identify possible issues and challenges that survey teams might be confronted with in the field and, as a result, affects the study if not managed a priori. It was decided to take a sample representative of all the provinces and Kashmir to cover all three categories of respondents: Banked, Non-Banked and Corporate. For this purpose, a sample of 350 respondents (300 retail and 50 corporate) was selected from five capital cities in the country in addition to Gligit and Muzaffarabad.

Out of the total 300 retail questionnaires, 136 were found to be valid for Banked and 129 for the Non-Banked respondents while 36 valid questionnaires were received from the Corporate. Though the pilot survey suggested a fair representation of the Banked and Non-Banked respondents, the turn out of female respondents was very low; only 3% of the Banked respondents and none of the Non-Banked respondents were female. In order to have a better representation of female respondents it was decided to increase the number of female enumerators for the main survey given the cultural dynamics of Pakistani society. The feedback from the pilot survey helped in improving questionnaires and increasing the response.

4.1.2. Sample Design

The survey was designed in consultation with the Islamic Banking Department (IBD) of the State Bank of Pakistan (SBP). It covered all four provinces in Pakistan (Baluchistan, Sindh, Punjab and Khyber Pukhtoon Khawa (KPK)), in addition to Islamabad, Gilgit-Baltistan and Azad Jammu and Kashmir (AJK). However, the tribal areas (FATA and PATA) were excluded due to security concerns. A sample of 10,000 respondent comprising 9000 retail and 1000 corporates was drawn from across the country.[15] 100 interviews of banks' senior and middle management were conducted to collect information on supply side issues.

The retail sample was selected from 28 randomly chosen districts, 7 capital cities (Karachi, Lahore, Islamabad, Peshawar, Quetta, Muzaffarabad and Gilgit) and 6 other industrial cities (Hyderabad, Multan, Gujranwala, Faisalabad, Sialkot and Rawalpindi). In order to capture adequate urban-rural representation, the sample was drawn in accordance with the proportionate urban-rural[16] population. Given the relatively high level of financial exclusion in the country, the following measures were taken in order to ensure fair representation of banked population:

a. Inclusion of 45% of the respondents from capital and industrial cities.

b. Representation of the higher income strata in the sample by picking up around 30% of the Union Councils from relatively better off areas in the cities.

c. 30% of the respondents were directly drawn from bank branches.

A two-stage stratified sample design was adopted for this survey:

i. Primary sampling units (PSUs): Union Councils (UCs) in rural and urban areas were used as primary sampling units (PSUs). The decision to choose a UC as a PSU was based on two reasons (i) a UC is the smallest administrative unit; and (ii) a UC is easily identifiable compared to other electoral units like wards, etc.

ii. Secondary sampling units (SSUs): Households (HH) within each sample PSU was considered as secondary sampling unit (SSU). Forty two SSU respondents were selected from each PSU by a random systematic sampling scheme.

3 UCs were randomly picked from each district and in each UC, a total of 60 respondents were surveyed in accordance with the following criterion[17]:

Total: 60[18]

Bank customers (30% of 60): 18

General sample (households): 42

Formation of Cluster: The supervisor ensured that the direction of the entrance to the UC was randomly chosen. After entering the UC, the supervisor looked around to find a prominent landmark such as a school, hospital/dispensary, mosque, etc. The closest landmark to the point where supervisor was standing was considered as the starting point for the formation of a cluster of 42 households.

Enumerators moved from household to household in a serpentine manner to form a cluster. During the survey if a house was locked or empty it was decided to exclude that household from the cluster. If a household refused to give information, then after the approval from the supervisor the enumerator moved to the next household. In such cases supervisors were responsible to ensure that all efforts were undertaken to gain access to the household before replacing it with another household.

In urban areas UCs more or less exist in a compact form, but in rural areas a UC may cover a village or many hamlets. In case of many hamlets, the largest hamlet was picked up and was approached by following the procedure as explained earlier. However, in cases where a hamlet was found to have less than 42 households, the nearest hamlet was covered in a continuous way to complete the cluster size.

With regards to customers drawn from banks, it was decided to pick up respondents by visiting banks in that particular UC in such a way that all banks in the UC were fairly represented. In UCs where there were no banks, banks in the neighbouring UCs were included. It must be noted that an individual can be banked even if picked up from a household and at the same time an individual can be Non-Banked even if picked from a bank[19].

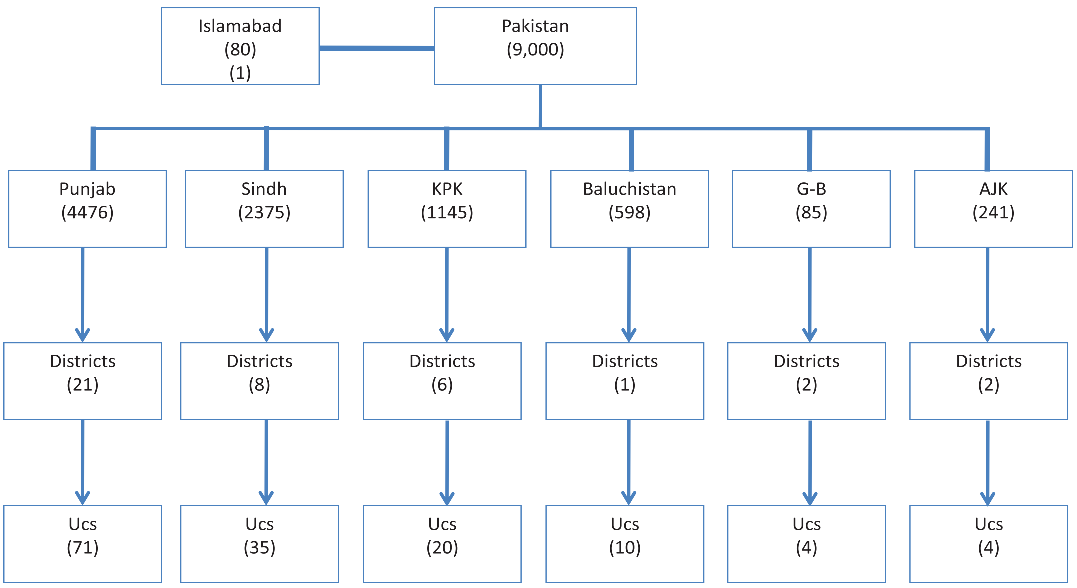


Figure 4.1: Breakdown of the Retail Sample

[15] 4 % additional respondents were surveyed to cover the margin of error.

[16] Rural population refers to people living in rural areas as defined by Pakistan Bureau of Statistics.

[17] If a general sample (HH) would have been used, it was very likely that the proportion of Non-Banked respondents would have been high as a vast majority of the population is actually Non-Banked. However, by having 30% of the respondents from the existing bank customers, it was still expected that 35%-40% of the respondents would be Non-Banked.

[18] For larger cities (Lahore and Karachi), due to a larger sample size the number of respondents from each UC was increased to 100.

[19] An individual may, for example, have come to a bank to cash a cheque on behalf of someone else or to pay a utility bill.

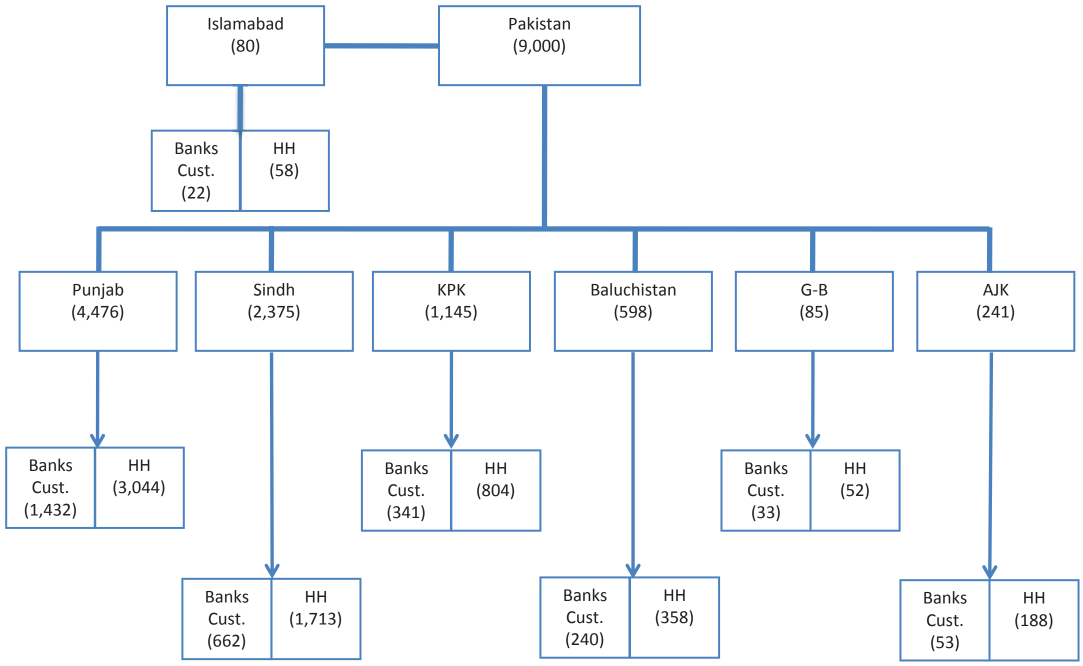


Figure 4.2: Provincial Breakdown of the Retail Sample

Male-Female Mix: Despite increasing the number of female enumerators after an initial low number of female respondents, the actual surveyed population still had a low mix: 49 males to 11 female respondents, due to cultural factors.

Income Strata: To ensure that all income strata are fairly represented in the sample, 30% of UCs were picked from the relatively better off areas (selected on the basis of local/indigenous knowledge). For example, from Lahore a total of 849 respondents were surveyed, out of which 699 came from urban areas and the remaining 150 were drawn from rural areas. In terms of UCs, a total of 10 UCs were selected from Lahore, out of which 7 were from urban and 3 from rural areas. Of the 7 urban UCs, 3 were selected from the relatively better off areas. This ensured that all income strata are fairly represented in the sample.

4.2. Sample Size

a) Retail Sample: Retail Sample of 9,000 respondents was drawn from seven regions; five regions, AJK and Islamabad (see Figure 4.1 and 4.2). Among the total retail respondents, 45 % were surveyed from capital and industrial cities and the remaining were drawn from other areas in the country. In total the retail sample included 41 districts and 147 UCs, both randomly selected.

Sample for Capital & Industrial Cities: About 45 % (4,035) of the retail sample was drawn from 13 big cities: 7 capital cities (Karachi, Lahore, Peshawar, Quetta, Gilgit, Muzaffarabad and Islamabad) and 6 other major industrial cities of the country; Hyderabad, Faisalabad, Sialkot, Gujranwala, Rawalpindi and Multan (see Figure 4.3 & Figure 4.4). The respondents from these cities were drawn in accordance with their respective population; Quetta being the only exception as due to the security concerns the entire sample of Baluchistan was drawn from one city.

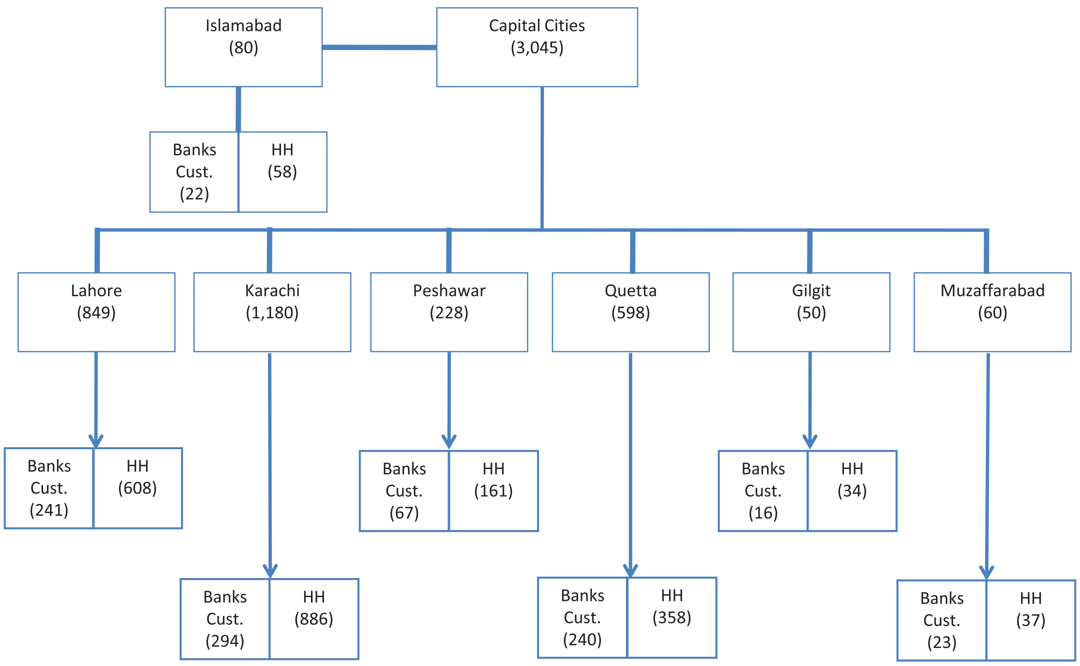


Figure 4.3: Breakdown of the Sample from Capital Cities

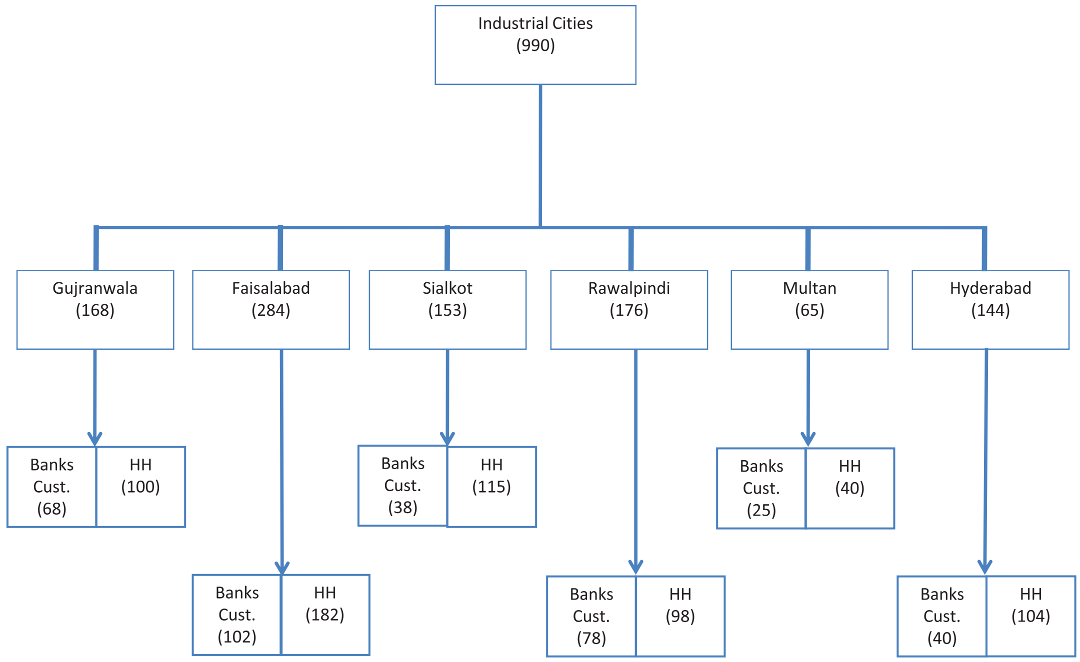


Figure 4.4: Breakdown of the Sample from Industrial Cities

b) Corporate Sample: A total of 1,000 respondents were drawn from the corporates; 53 % of the sample comprises small businesses, 30% are medium size enterprises and the remaining 17% are large corporate (Figure 4.5). An employment-based[20] definition of small, medium and large businesses was used:

Small business: Less than 50 employees

Medium business: 50 - 249

Large business: 250 and above

It must be noted that small corporates included in the survey were picked up from the UCs. However, this was not possible for medium and large corporates; as such businesses are found in a particular area of the city or district. Hence, the medium and large corporate were chosen from industrial areas of the nearby city or from within the district in which the particular UC fell. The information for medium and large corporates was obtained from the Securities and Exchange Commission of Pakistan (SECP) and local chambers of commerce and industry. These businesses were, however, selected randomly.

Figures 4.6 and 4.7 provide information on the distribution of sample small, medium and large corporates in capital and industrial cities. It is evident from these figures that the corporate respondents were drawn from the cities by and large proportionate to their size. One exception is Peshawar, which generated more than the expected response, owing to the cooperation of the owners and managers of the businesses. In other areas, the enumerators found it rather difficult to solicit cooperation from the management of businesses visited.

4.3. Survey Administration and Management

Survey Teams: In total six teams were formed comprising 40 enumerators for conducting the survey. The survey areas were divided into seven regions (in addition to AJK and Islamabad) for logistic ease: Punjab I[21], Punjab II[22], KPK, Baluchistan, Sindh I[23], Sindh II[24] and Gilgit-Baltistan. Survey teams had native speakers to provide comfort to the perspective respondents in case they preferred to communicate in local language.

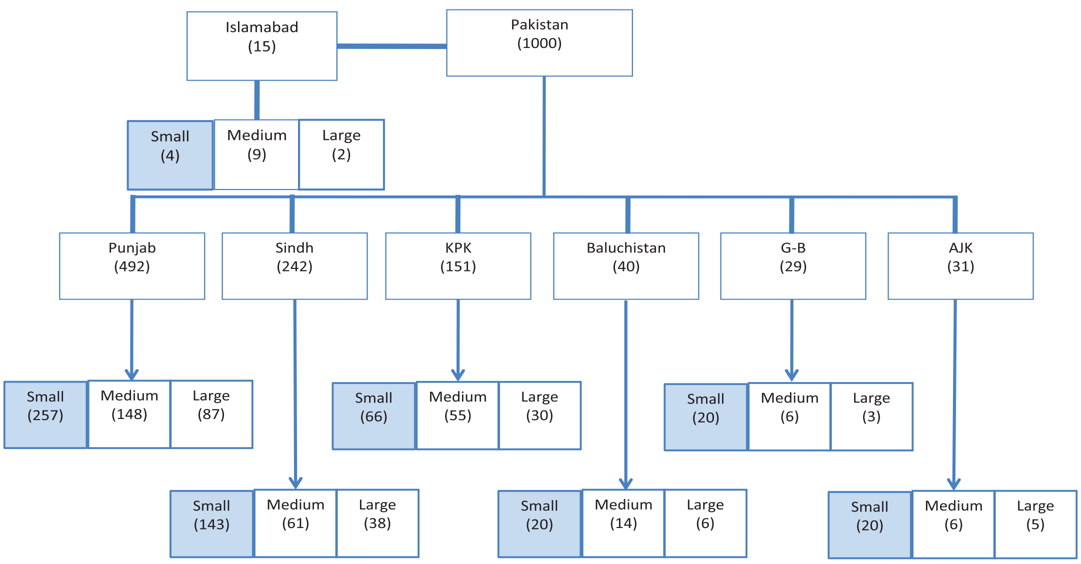


Figure 4.5: Breakdown of the Corporate Sample

[20] The employment based bifurcation was chosen because it was more authentic compared to others, e.g: total assets. SBP has recently (May 2013) revised the definition of SME according to which businesses having employees up to 20 will be considered small while for medium the range has been defined between 21-250 for Manufacturing & Service MEs, and 21-50 for trading.

[21] Punjab I included the following districts: Rawalpindi, Attock, Chakwal, Khushab, Mianwali, Gujrat, Narowal, Gujranwala and Sialkot.

[22] Punjab II included the following districts: Lahore, Sheikhupura, Sahiwal, Faisalabad, Toba tek Singh, Jhang, Khanewal, Multan, Muzaffargarh, Bahawalpur and Rajanpur.

[23] Sindh I included the following districts: Dadu, Nawabshah, Sangarh, Umerkot, Ghotki and Jacobabad.

[24] Sindh II included the following districts: Karachi and Hyderabad.

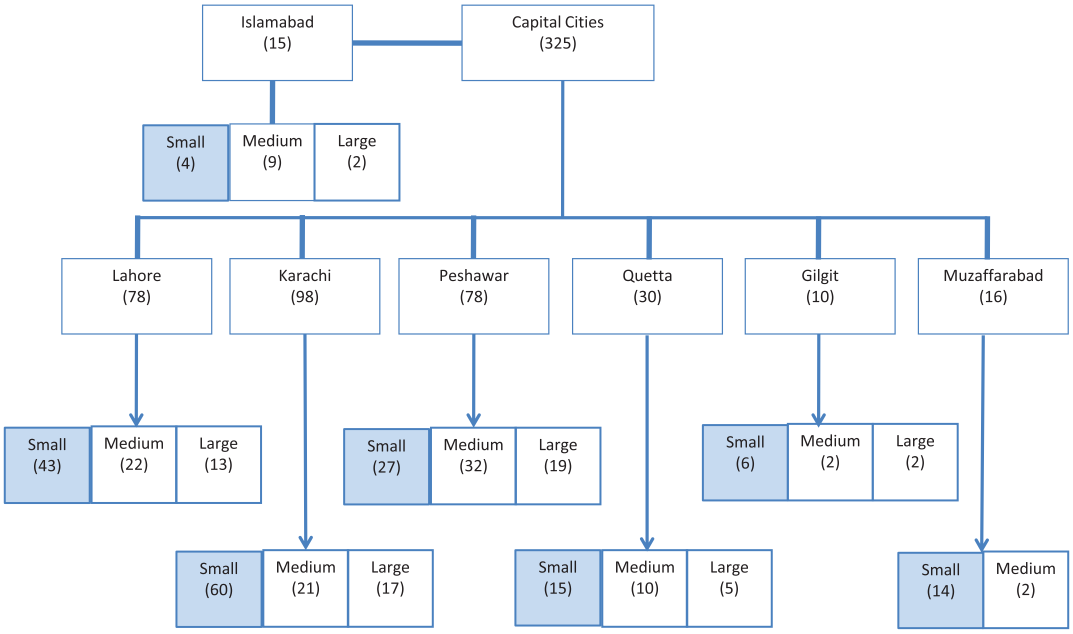


Figure 4.6: Breakdown of the Drawn Sample from Capital Cities

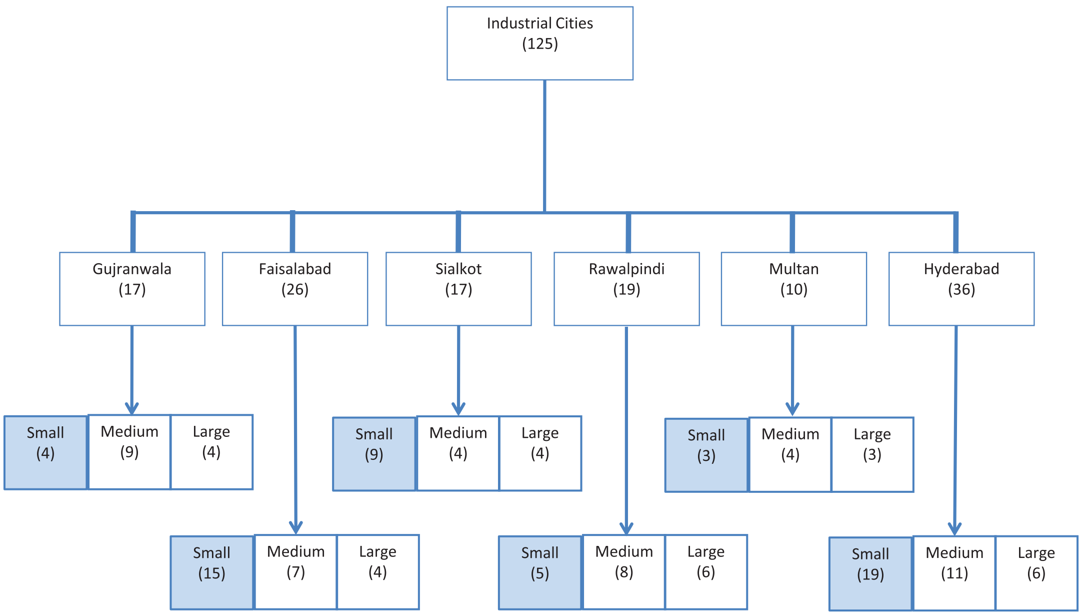


Figure 4.7: Breakdown of the Drawn Sample from Industrial Cities

It was decided that each team would have two female enumerators. The reason for this was to ensure effective feedback from women as there was a possibility that there would be some women respondents who would not be comfortable giving an interview to male enumerators. Despite taking this measure, the actual representation of women in the survey was only 18%. This is because most of the visitors in banks and household respondents happened to be male.

For supervision and management of survey teams, five team leaders were appointed who reported to the national survey coordinator. It was a practice that the supervisor would go through the questionnaires together with enumerator who carried out the survey to ensure they were properly filled and all the codes were input correctly. The supervisor was required to sign off a questionnaire once he had gone through it and ensured that it was duly completely.

Training: Training workshops were conducted both before and after the pilot survey. These training sessions focused on possible issues that the team might be confronted with during field visits and equip them with adequate interviewing techniques for soliciting information from respondents. This included among others how to approach a respondent and making them comfortable to share information.

Data Validation: A codification scheme was devised according to which codes were assigned to each question. Data management teams recorded the received questionnaires from the field using this coding scheme. The accurate use of the coding system was an essential requirement for overall health of the data. Data validation checks were introduced into the data base that prevented data entry errors. Random check of the data with respect to original filled questionnaires was a routine procedure. Further to this end, while transferring the data from Excel to SPSS the system gave an error message when there was an incorrect or incomplete information.

CHAPTER 5

Data Description and Perception Analysis

5.1. Introduction

This chapter describes the data set that was created following the survey amongst Retail (Banked and Non-Banked) and Corporates picked up from all over the country through a process of stratified sampling (for details see Chapter 4). It aggregates findings of the survey while revealing awareness, understanding and interest of respondents in Islamic banking. The chapter also looks into the profiles of Banked and Non-Banked respondents with respect to their inclination towards Islamic banking.

By creating an aggregated picture of the financial behaviour of the three groupings of respondents, this chapter reveals their perception and preferences in banking services in general and in Islamic banking in particular. A general profile of the respondents helps us in understanding the nature of demand for Islamic banking in the country, an exclusive focus of Chapter 6. The discussion in this chapter presents a microcosm of the opinions of the Pakistani population on Islamic banking.[25]

The chapter is structured as follows:

1) Users of financial services in Pakistan

2) Users of Islamic banking

3) Knowledge of Islamic banking services

4) Attitude towards interest

To ensure simplicity in terminology, terms have been defined as follows:

Banked: Respondents that are part of the formal financial system

Islamic Banked: Respondents that use Islamic banking services

Conventional Banked: Respondents that use conventional banking services

Non-Banked: Respondents that are not part of the formal financial system

5.2. Users of Financial Services

This section describes the type of financial services used by the surveyed population.

5.2.1. Breakdown of Users of Financial Services

According to survey findings 4028 individuals out of the total 9000 retail respondents were banked.[26] In terms of type of banking availed, 77% of these individuals were users of Conventional banking, 16% were using Islamic banking, while remaining 7% were users of both Conventional and Islamic banking (Table 5.1). As expected, conventional financial services are far more popular than Islamic financial services though the responses do reveal that there is a significant interest for Islamic financial services.

Overall, 933 of the banked respondents were users of Islamic banking, with 487 dealing with full-fledged Islamic banks, 144 having accounts in Islamic banking branches of conventional banks and 302 were those who maintained accounts with both Islamic as well as conventional banks. Customers of Islamic banks constitute 23% (including users of both conventional and Islamic banks) of the surveyed banked population; this more than adequately reflects the Islamic banking market, which at present is more than 9.6 percent of the total banking (in terms of assets) and 10.4 percent (in terms of deposits) in Pakistan.

	Banked	Non-Banked[27]	Total
Fully Fledged Islamic bank	487	4	491
Islamic Banking Window	144	4	148
Conventional Bank	3095	324	3419
Both	302	0	302
Never used	0	4,640	4640
Total	4,028	4,972	9,000

There were 933 existing users of Islamic banking services (including those using both conventional and Islamic banking services)

Table 5.1: Type of Banking Availed by Retail Respondents

[25] Practice of Islamic banking is a focus of the supply side analysis (presented in Chapter 7).

[26] This number is not conclusive in nature for interpreting the level of financial exclusion in the country since a significant part of the sample was drawn from banks and 13 big cities (for details see chapter 4). 30% of the sample was drawn from the banks out of which 30% was picked from Islamic banks.

[27] The 332 Non-Banked users in this table have previously used these banking services but are not using them now.

This relatively higher representation of Islamic banking clients in the sample was in accordance with the sampling strategy, as 30% of the sample was supposed to be drawn from the banks out of which 30% was to be picked from Islamic banks. In this way, 835 Islamic Banked respondents were drawn from Islamic banks while the household sample consisted of 98 users of Islamic banks.

For Non-Banked respondents, 94% have never used banking services. The majority of the remaining respondents had previously used conventional banking services with only 2 percent among them having prior experience of Islamic financial services. This may be indicative of the lack of supply of Islamic banking services, especially in the rural areas and small towns.

5.2.2. Product Usage

Banked respondents mentioned the primary reason for opening a bank account is to conduct basic transactions. Figure 5.1 shows that 42% of the banked respondents had salary accounts, 32 percent had accounts for making payments while 26 % maintained accounts for savings. The percentage of respondents was 5% and below who quoted reasons like availing financial services, lockers etc.

hensive range of products and accelerate programmes to raise awareness of different products and their utility.

5.2.3 Non-usage of Banking Services – Financial Exclusion

Of the surveyed population, 44.8% are found to be either users of conventional (34.4%) or Islamic banking (10.4%). This leaves 55.2% that remained financially excluded. This is certainly an under-representation of financial exclusion from the formal sector in the country, which happens to stand at 85.7%.[28] As mentioned earlier, this study is not a determination of incidence of financial exclusion in Pakistan; rather the focus is on quantification of demand for Islamic banking and exploring its dynamics. Hence, the sampling methodology employed here ensures that a representative sample must include data that has a sufficient number and proportion of Banked population. The over-representation of the financially included[29] was by design as it provided a better understanding of the impact of factors such as the knowledge, attitude and practices of Islamic Banking. In this backdrop, the study indicated a few interesting results about financial exclusion.

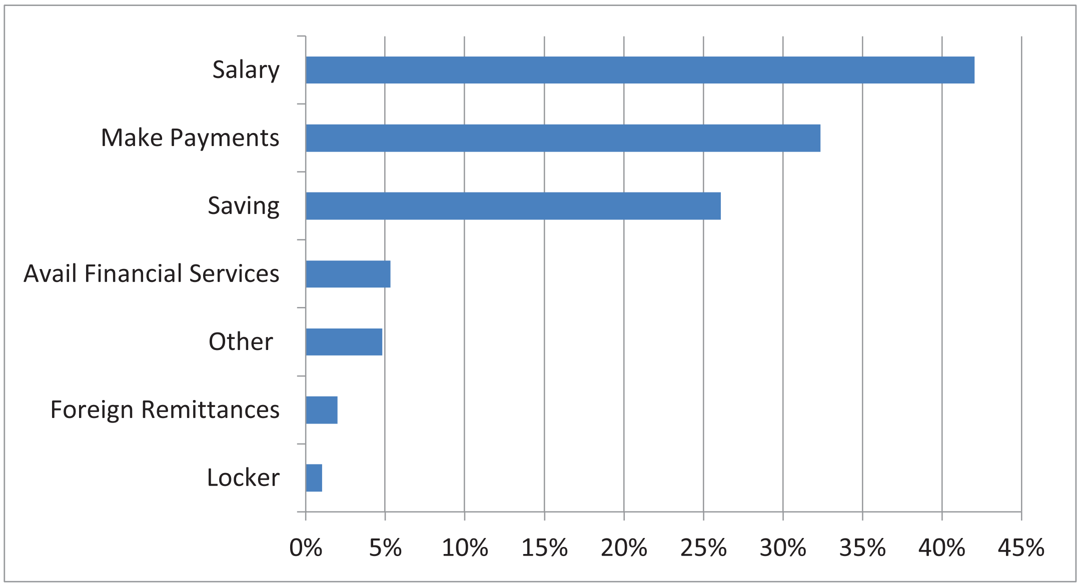


Figure 5.1: Reasons for Opening a Bank Account

The survey found relatively low usage of banking products at large as the utilization is mainly concentrated in few products; 67% were using current accounts, 44% were using saving accounts and 34% were using debit cards. For other products such as personal loans, remittances, fixed deposit accounts, insurance, less than 5% of respondents were availing these services.

Similar results were found with Corporates with 62% using current accounts while less than 10% of respondents were using other products. As the majority of Corporates were small, their product appetite is expected to be basic as opposed to larger companies.

Secondly, in Pakistan there prevails a low level of financial literacy and consequently masses in general lack awareness of available products. Thirdly, banks are not catering to financial needs of all segments and are shy in doing business given the prevailing economic conditions. Therefore, banks need to start offering a compre-

There were more rural Non-Banked (38%) than rural Banked (26%). According to the World Bank study,[30] rural areas are underserved by banks leaving relatively higher levels of financial exclusion. The survey found that the average income for Banked is Rs 33,000 per month, with the corresponding figure for Non-Banked to be merely Rs 17,400. 47% of Banked earn less than Rs 20,000 per month compared to 74% of Non-Banked. Survey results depicted that Banked respondents have achieved higher educational levels than Non-Banked. This research corroborates the findings from the aforementioned study that individuals with higher incomes and further educational progress are more likely to be using banking services.

Survey results further reveal that the majority of Non-Banked have never used financial services with only 7% having used some kind of banking services in the past. 220 Banked and 109 Non-Banked have used or are using microfinance services representing 5% and 2% of the respective surveyed population. The study indicates that in

[28] Nenova, T. et al (2009) "Bringing Finance to Pakistan's Poor" The World Bank

[29] Users of formal banking channels are assumed to be more financially literate

[30] Nenova, T. et al (2009) "Bringing Finance to Pakistan's Poor" The World Bank

dividuals in rural areas or in low income brackets have relatively limited access to financial services. This highlights a huge opportunity for Islamic microfinance in rural areas.

56% of the Non-Banked stated that they were interested in having a bank account showing that there is a strong demand (Figure 5.2). But since they are not using banking services, there is an obvious discrepancy between desire and execution. This does not sufficiently explain why they have chosen not to have a bank account as there is clearly an interest. It is more likely that while they would like to have a banking account, they are unable to do so for reasons including low income levels, lack of formal documentation, non-availability of bank branches in the near vicinity and banks having not done enough to attract such individuals. Similarly 44% that would not like to have a bank account or are not sure can once again be attributed to reasons like lack of education/financial literacy , unable to fulfil account opening criteria specially minimum balance requirements and absence of banking facilities within the vicinity. Hence, banks are required to do more to attract customers.

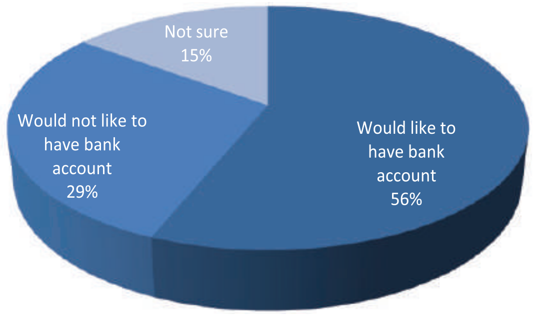


Figure 5.2. Non-Banked Demand for Bank Accounts

According to the study non-banked group interested in availing financial services are primarily having demand for basic saving and financing products. The low inclusion despite the prevailing demand can be due to limited outreach of financial services to the said groups. This finding appears in conformity with the overall banking penetration level in the country that is particularly lower in rural areas as well as for low income groups. This is indicative of huge potential of expanding financial services to hitherto grossly underserved areas like agriculture (both farm and non-farm) and Small and Medium Enterprises SME.

A significant majority showed their demand for financial services other than saving accounts (for payment purposes) reflect a demand supply gap between the current and potential market size of SME. Islamic finance having strengths of extending financing on the basis of feasibility of projects and without collateral can enable this unique industry to cater to SMEs.

Along with significant involuntary financial exclusion, the survey depicted 18 % incidence of voluntary exclusion. No single factor came as the most prominent and dominating reason for opting out of the financial system. Amongst these factors religion was the most important reason (7.5 %) followed by lack of awareness (4 %), cost of commuting to bank (1.5 %), cultural reasons (3 percent)[31] and others (2 %). Among religious sensitive financially excluded group, more than 65 % were not convinced of the Shari'a compliancy in Islamic banks, though majority of them did not have much theoretical knowledge or information about Islamic banking. This demonstrates the need to address perception issues by conducting awareness raising programmes. Furthermore, it can be inferred from the qualitative information of these respondents that cultural dynamics need to be considered while designing awareness campaigns for different areas e.g the approval of Islamic banking by local religious scholar (imam masjid), that might relatively have higher impact in KPK and Baluchistan than other provinces.

[31] This includes reasons like family restrictions

5.3. Users of Islamic Banking

5.3.1 Usage of Islamic banking services

Survey findings show that among Islamic bank respondents, 52 % are from full fledged Islamic banks, 15% from Islamic windows of conventional banks and the remaining 32 % are users of both conventional and Islamic banks. Islamic banking in Pakistan, in its current form, is a relatively new phenomenon, and it will take some time before believers in Islamic banking will completely move away from the more established conventional banking. Furthermore, as most of the Banked only use basic banking services, it still makes sense for the believers in Islamic banking to also maintain a non-interest bearing current account with a conventional bank. The complete switch from conventional to Islamic banking will take some time, as banking relationships tend to be sticky. 68% of the users of Islamic banking (see Figure 5.3) have been with an Islamic banking institution for less than three years, indicating that there has been a significant rise in the numbers of customers over the last few years (44 % have been using Islamic banking services for 1-3 years, slightly under 24% of respondents have been using services for less than a year while a little over 24% have been using for between 3-6 years; 8% of respondents have been using Islamic banking services for over 6 years). This parallels the growing number of Islamic banking branches in Pakistan.

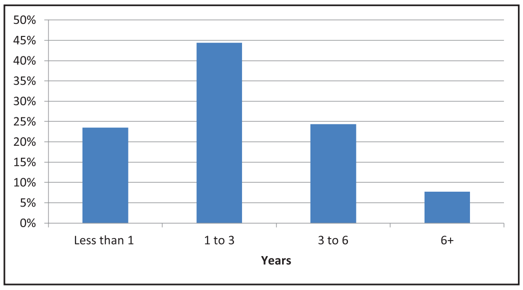


Figure 5.3 Numbers of Years at Islamic Bank

5.3.2 Profile of Islamic banking users

The majority of Islamic banking users surveyed were male and the head of household. The survey data further indicates that the incidence of demand for banking services is stronger among the young.

There is not much difference between the users of Islamic and conventional banking in terms of their educational background, although Islamic banking users tend to be slightly more educated than their conventional counterparts. Table 5.3 provides a general sketch of an Islamic banking user and compares it with its conventional counterpart. The majority of Islamic banking users are from urban areas: around 20% of urban respondents are users of Islamic banking services compared to 10% of rural respondents

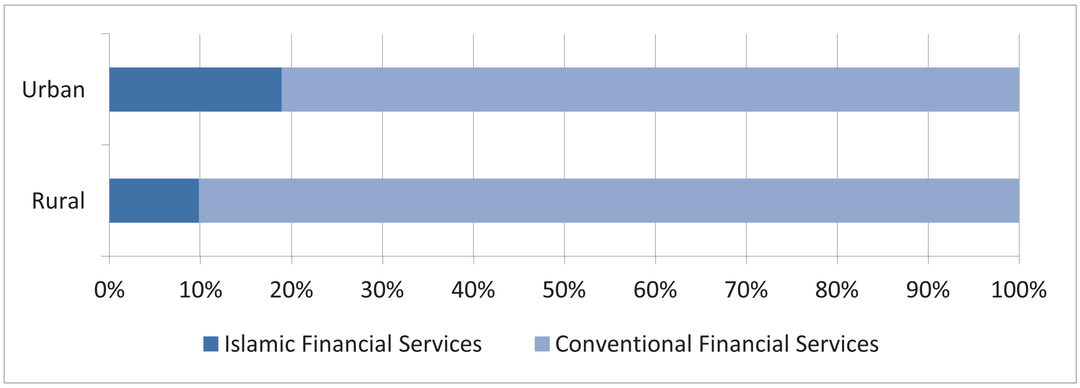


Figure 5.4: Usage of Islamic banking services according to geography

(see Figure 5.4). In both urban and rural areas, conventional banking domination can mainly be attributed to their longer presence and relatively wider network, especially in rural areas where Islamic banks lack in presence.

Table 5.2 summarises the professional affiliation of the respondents. 49% of the overall Banked respondents worked in non-corporate business and the private sector while for Islamic Banked respondents this number was 65%.

There are proportionally less government employees who deal with Islamic banking institutions. With a relatively small number of respondents using Islamic banking services associated with this profession, a favourable decision of government to use Islamic banks for disbursement of salaries would not only provide a stimulus to growth of the industry but also create awareness among this segment of society. The remaining other sectors have less representation.

	Banked (%)	Islamic Banked (%)
Non-Corporate Business	31	42
Salaried (Private Sector)	18	23
Salaried (Government)	22	10
Other	9	8
Agriculturalist	7	8
Salaried (Financial)	3	3
Corporate Business	2	3
Pensioner	5	3
Remittance Receiver	1	2
Technician	1	2
Teacher	4	1
Religious Teacher	< 1	1

Table 5.2: Distribution of Profession

Characteristics		Conventional	Islamic
Gender	Male	•••••	•••••
	Female	•••	
Age (Years)	18-30	••••	•••••
	>30-40	•••	••
	>40-50	••	•
	>50-60	•	
	>60		
Education	Primary/No education		
	Secondary	•••	
	Higher Secondary	••••	•••
	Graduation	••••	•••
	Post graduation	•••	•••
	Higher education		
	Religious education		
	Vocational		
Income (Rs. '000)	Up to 5		
	>5 – 10		
	>10 – 15	•••••	
	>15 – 20	•••••	
	>20 – 25	••••	••
	>25 – 35	••••	•••
	>35 – 50	•••	•••••
	>50 – 70	•••	••••
	>70 – 90	••	•••
	>90 – 110	••	••
	>110 – 150	•	•
	>150	•	•••••
Profession	Non-Corporate Business	••••	•••••
	Private Sector Employment	••	••••
	Government Sector Employment	•••	
	Religious Teaching		
	Agriculturalist		
	Financial Sector Employment		
	Corporate Business		
	Retirement (with pension)		
	Remittance Receivership		
	Technical		
	Teaching		
	Other		
Religious sects	Deobandi	•••	•••
	Berelvi	•••	
	No affiliation with a sect	•••	••••
	Sunni	••••	•••••
	Ahle Hadith	•••	
	Shia	•••	
Location	Urban	•••••	•••
	Sub-urban	••••	
	Rural	•••	

Table 5.3: General Profile of User of Islamic Banking

From the Corporate survey, which aggregated both Corporates and Non-Corporates (SMEs), 67% were sole proprietorship or partnerships, and had small teams with low annual sales, profits and assets. The most important reason for Corporates using Islamic banking services was the religious inclination of owners. This again establishes religious preference to be one of the key factors for choosing between a conventional and Islamic bank.

5.3.3. Reasons for choosing Islamic banking: Retail

Those who are currently using Islamic banking services opened a bank account either to make payments – which proved to be the most popular – or for saving and/or depositing salary (Figure 5.5). These proportions generally remain the same when compared with the responses of the conventional Banked. There are however, a few significant variations observed. Firstly, 37% of the overall Banked population had "other reasons" for opening a bank account whereas only 2% of Islamic Banked population stated the same. One of the most probable reasons for having low number of Islamic Banked respondents quoting "other" as reason for opening bank account may be rudimentary banking needs, and the attraction is not to the offering of complex products but to meet basic banking requirements. The other significant variance between Conventional Banked and Islamic Banked was with reference to salary accounts ; 42% of Conventional Banked opened a bank account to deposit their salary compared to 24% Islamic Banked. We have seen that there is proportionally more Islamic Banked than Conventional Banked working in non-corporate business. As these are smaller entities, Islamic Banked may have little need to deposit their salary, leaving it as cash.

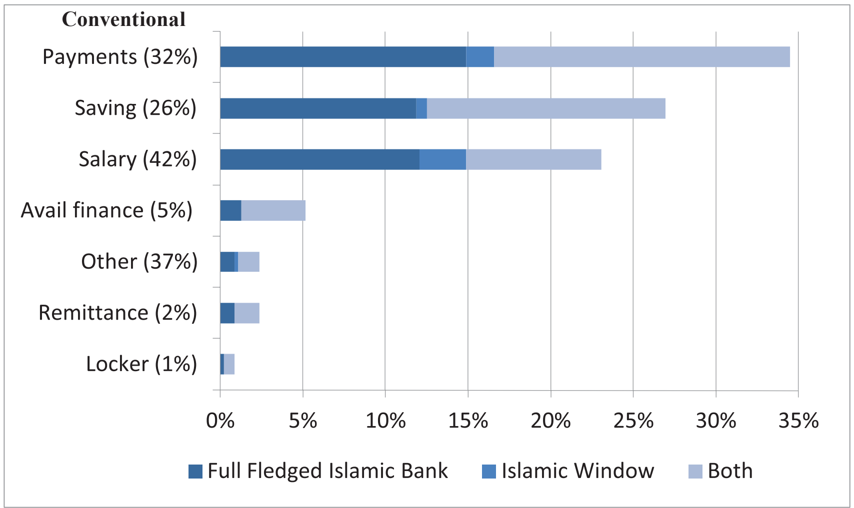


Figure 5.5: Reasons for Opening a Bank Account

*Percentages in parenthesis represents portion of Conventional Banked population

5.3.4 Satisfaction with Islamic Banking

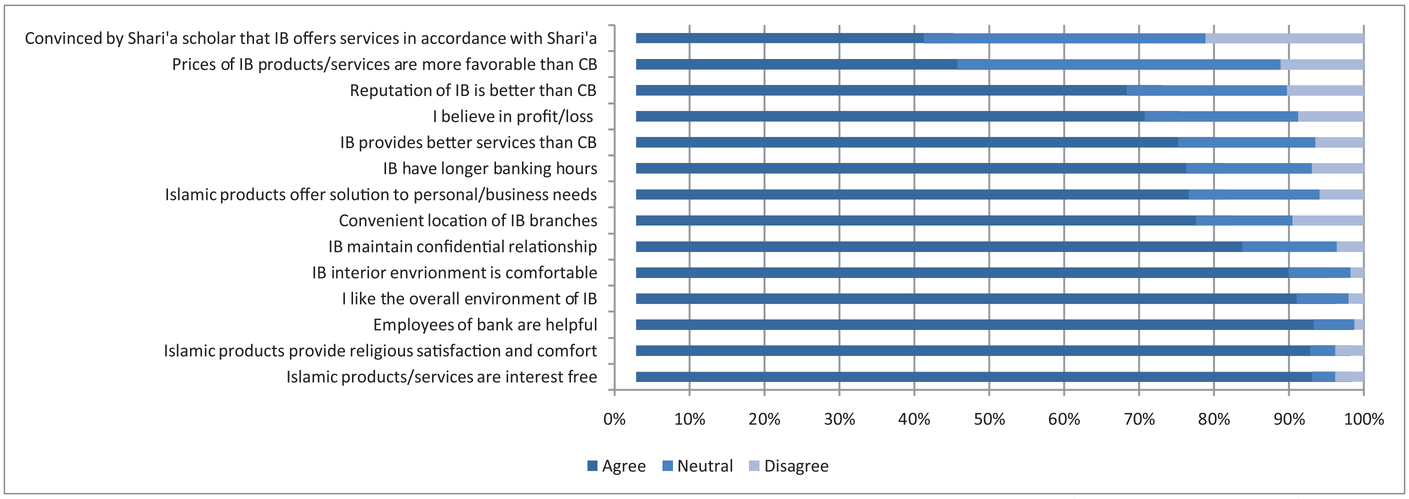
89% of Islamic Banked were satisfied with their banking services. Three most important factors contributing to the satisfaction were (i) Islamic products are not based on interest, (ii) they provide religious satisfaction and comfort and (iii) Islamic bank employees are helpful (Figure 5.6). Arguably, the first two reasons are the same: customers banking with Islamic banks are primarily concerned with the "Islamicity" of the product. However, the least number agreed that they consulted an independent Shari'a expert. It would suggest that for most Islamic Banked respondents, the mere fact that it is labelled as an Islamic bank, or that it has a Shari'a Board, means that the bank is offering Shari'a-compliant products. They do not have to be personally convinced by a Shari'a expert.

The ambiance of an Islamic bank does have an effect on satisfaction. With confidentiality garnering less disagreement, it can be proposed that high quality customer services and care are likely to draw attention of those who believe in the principles of Islamic banking.

Overall, 84% of Islamic Banked respondents stated they would recommend others to utilise Islamic banking services. This is 5% less than the numbers of respondents who were satisfied with Islamic banking services but the high percentage of those who would recommend nevertheless bodes well in terms of spreading knowledge and information about Islamic banking.

5.3.5. Reasons for Choosing Islamic Banking: Corporate

There were notable differences between the profile of Islamic (the businesses using Islamic banking) and Conventional (the businesses using conventional banking) Corporates. From those using Islamic banking, 65% were private limited companies compared to 24% using conventional banking services. The majority of both groups had assets, sales and profits less than Rs. 5 million. 37% of those using Islamic banking had between 50 and 150 employees while the corresponding proportion was 15% for conventional banks.



*IB = Islamic Bank CB = Conventional Bank

Figure 5.6: Factors Determining Satisfaction from Islamic Banking Services

From among the businesses surveyed, 86% chose Islamic banking because the owners were religiously motivated (Figure 5.7). Once again religion gives Islamic banking its unique characteristic creating a nexus with the religious sentimentalities of people. The second most expressed reason was that Islamic banking is in line with the religious and moral philosophy of the company. With these two options ranking highly, it can be concluded that religious association is an important consideration. This complements findings from the retail banked population that are satisfied with Islamic banks due to religion.

The third most popular reason was that the service quality of Islamic banks is better than conventional banks. Such a result suggests that Islamic banks are going beyond their religious proposition, and attempting to compete with conventional banks on general business standards. Business solutions, pricing of products, service quality, are platforms on which Islamic and conventional banks compete on an equal footing. They are comparable, while religious norms are unique and specific to Islamic banks.

Service quality was a more persuasive choice than expedient solutions and pricing. Service quality refers to response time, banking environment, the affability of managers, bank location, availability, etc. Solutions and pricing characterise the commercial aspects of banks. Service quality along with religious image held greater attraction than commercial reasons.

5.4. Awareness and Understanding of Banking Services

In this section, we take a closer look at the awareness of financial services, particularly of Islamic banking, in Pakistan, and the understanding of its products and model. The first subsection explores awareness of Islamic banking, and compares and contrasts the awareness of conventional and Islamic banking services. Section 5.4.2 focuses on understanding. Survey results show that the majority of respondents have heard of Islamic banking. However, awareness of products and understanding of Islamic banking models is limited.

5.4.1. Awareness of Banking Services

The survey reveals that there is growing awareness of Islamic banking in the country. Understandably, however, there is less awareness of Islamic banking services amongst the Non-Banked population. 78% of Banked respondents have heard of Islamic banking, while 51% of Non-Banked respondents have stated likewise (Figure 5.8).

When looking into awareness of Islamic banking contracts, qard hasana was the most heard product than any other amongst the Banked, and Non-Banked (retail). However, only 33% of Non-Banked have heard of qard hasana, and for all other contracts, there was less than 10%. Non-Banked, therefore, have very little awareness of Islamic banking contracts.

On the other hand, more Corporates knew about a greater range of Islamic contracts than retail respondents. Musharaka follows qard hasana, but there appears to be a 20% difference between those that have heard of musharaka and mudaraba (see Table 5.4). Mudaraba companies in Pakistan are common, and it was expected that

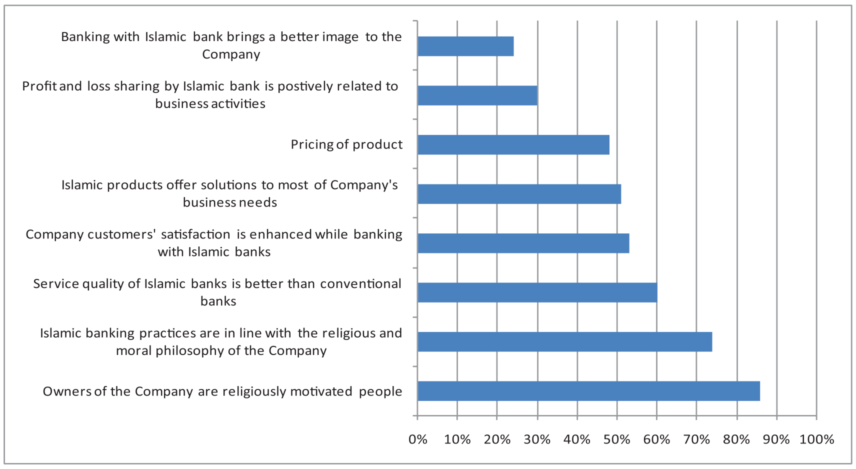


Figure 5.7: Corporate Reasons for Choosing Islamic Banking

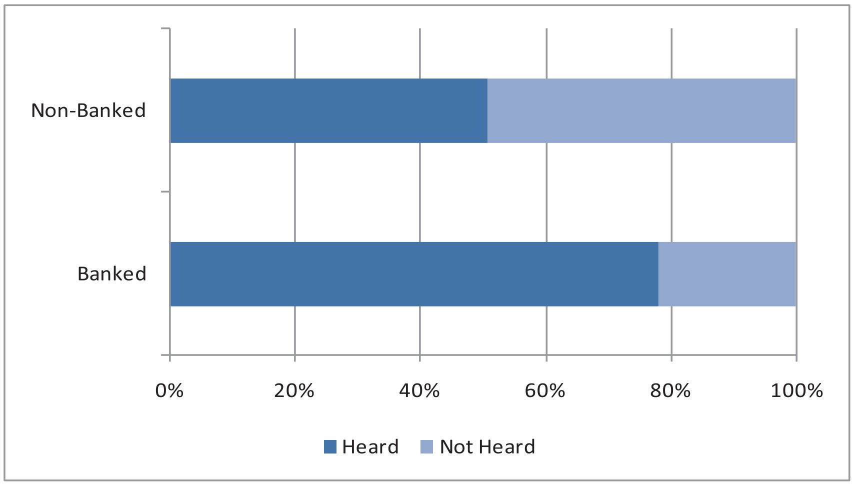


Figure 5.8: Awareness of Islamic Banking

	Corporate	Banked	Non-Banked
Qard Hasana	73%	65%	33%
Musharaka	54%	21%	7%
Ijara	35%	19%	6%
Mudaraba	34%	23%	5%
Murabaha	23%	9%	2%
Istisna	19%	7%	2%
Salam	17%	7%	2%
Diminishing Musharaka	15%	6%	2%

Table 5.4: Awareness of Islamic Banking Contracts

these two products would have similar awareness. One can hypothesise that companies are not aware of these mudaraba companies, but more research has to be done to assess this. There are almost an equal percentage of respondents that have heard of ijara and mudaraba. Respondents had heard more about partnership contracts and ijara as compared to debt-based products such as murabaha, istisna and salam.

Similar trends can be seen with Banked although there was a low awareness among respondents that have heard of qard hasana and mudaraba. There were slightly more people that have heard of mudaraba than musharaka, which differs to the significant difference in awareness seen with Corporates for the same products. Approximately 20% have heard of these products. For the remainder, mostly debt/trade based finance products, there was less than 10% awareness.

Overall, the survey shows that the population have heard more of Islamic equity contracts (with the exception of diminishing musharaka) than of debt contracts. In Islamic banking, 40% of the financing contracts are murabaha contracts, but fewer respondents have heard of this type of contract. General lack of awareness of murabaha, and greater awareness of equity, explains the prevailing perception about Islamic banking of being based on profit and loss contracts; Qard hasana being an exception.

5.4.1.1 Sources of Information

Of those who have heard of Islamic banking, most Banked and Non-Banked gained their awareness from the television, which would mean visual media is the best tool for marketing (Figure 5.9). According to Gallup Pakistan in 2009,[32] there were 86 million television viewers in the country - approximately 50% of the population. The TV population has been increasing since 2004 especially in the rural areas and provides a potent instrument through which to spread information. Other media sources were less consumed, and we see from Figure 5.9. papers and radio are less popular means from which respondents gathered awareness. Radio especially has been a poor disseminator of information on Islamic banking. Colleagues are the third most popular source for Banked and the second most popular for Non-Banked. While 16% heard of Islamic banking from bank staff, there is less than 5% of Non-Banked that can claim the same.

Hearing from bank staff about Islamic banking would imply that an individual has gone into the bank, and was informed about Islamic banking. Non-Banked are less likely to go into a bank making it more difficult for them to have heard of the industry through the staff. Islamic banks need to invest more into outreach around their local communities to increase awareness. Otherwise Islamic banks would be limited to more visual types of media, which can be brief and not provide enough information. Personal interaction gives potential customers more time to determine their choice.

An individual could have heard of Islamic banking from a number of sources. We see that Banked respondents are more likely to have heard about Islamic banking from a greater number of sources compared to Non-Banked respondents. Awareness is created through various ways and multiple sources can embed the concept of Islamic banking.

5.4.2 Understanding of Islamic Banking Services

While awareness about Islamic banking is found to be adequate, when it comes to understanding Islamic banking the situation is not that encouraging. The majority of both Banked and Non-Banked do not understand the Islamic banking model, the way Islamic bank deposits operate, the mechanisms of Islamic financial products, contracts under which deposits are collected and their adherence to Shari'a principles. The numbers of Banked who have an understanding of these five aspects is low, as can be seen from Table 5.5, with over 80% of Banked respondents stating that they do not have any understanding. The number of respondents who understand the adherence to Shari'a principles is approximately the same as those who understand the nature of contracts suggesting that respondents either do not have enough information about the legal process behind the products or do not have the interest to know. Understanding of Islamic banking, however, is far lower for Non-Banked (Table 5.6). Such a low figure is perhaps expected given that most Non-Banked respondents have never banked previously.

Very few Corporates understood the six aspects of Islamic banking (Table 5.7). Once again, more respondents stated that they do not understand the Islamic banking model.

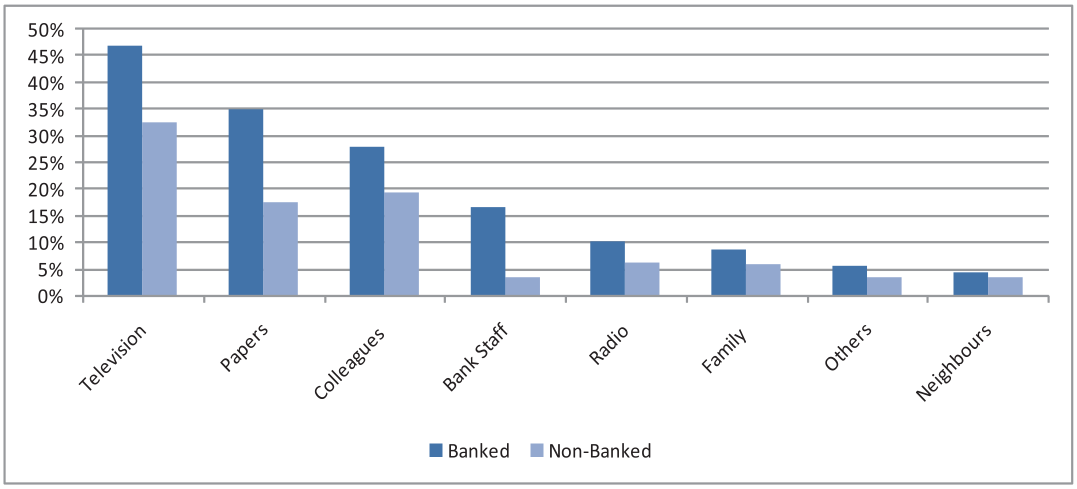


Figure 5.9: Sources of Information on Islamic Banking

[32] http://www.gallup.com.pk/News/Media%20Cyberletter%20June%2009%20(2nd%20version).pdf

Understanding of the adherence to Shari'a principles is rather low as below 10% of respondents expressed understanding. More than 90% of Corporates expressed that they do not understand Islamic financial products as well as the concept of weightages and profit sharing mechanism. Even though there was relatively more understanding of deposits (12%) and the nature of contracts (11%) under which deposits are collected. This shows that like retail, Corporates at large remain unaware about the underlying dynamics of Islamic banking model and structures. These aspects require deeper investigation by respondents, while most are satisfied with a basic level of knowledge.

As we have seen above, many Corporates have heard of the Islamic banking terminology. They, however, have less understanding of the contract itself. Aside from qard hasana, musharaka and mudaraba, less than 14% of the respondents understood concepts such as salam, istisna, diminishing musharaka and murabaha (Table 5.8). For Banked, and especially Non-Banked, understanding of the products is far less, although more respondents understood qard hasana.

The results appear to show that Corporates have more of an understanding of terminologies than Banked with the latter having more understanding of the technical aspects of Islamic banking. The dichotomy suggests that there is more awareness of Islamic banking as a system and what it offers, but less understanding of how it works amongst Corporates. Banked respondents have marginally better understanding of the technical aspects.

5.5. Perception analysis

In this section, we analyse responses to questions that were included to test some commonly held opinions amongst different stakeholders of the Islamic financial services industry. These include:

1. Perception of Riba

2. The choice between a full-fledged Islamic bank, Islamic subsidiary, and Islamic branch/window of a conventional bank

3. Objectives of an Islamic bank

The responses of all three groups show almost similar trends.

There were was a significant number of respondents that believe that contemporary interest is riba, and therefore prohibited, (Over 95 percent believed interest is prohibited while above 90 percent perceive contemporary interest as riba Figure 5.10) but are still using conventional banking services. This ambivalence may suggest that Islamic banks need to offer more of a value proposition than just interest free services, or that the services are not readily available to customers, or respondents are content with using conventional services and ignoring religious proscriptions. What is particularly interesting is the similarities of responses between Banked and Non-Banked. The latter, even though are financially excluded, appear to share the same opinions as Banked. While overall understanding of Islamic banking is weak and overall financial literacy is low, Non-Banked have similar conceptualisations as to how Islamic banking should be and how it should be offered.

	Islamic Banking Model	Islamic Bank Deposits	Islamic Financial Products	Nature of Contracts	Adherence to Shari'a Principles
Understand	17%	14%	12%	9%	10%
Do not understand	83%	86%	88%	91%	90%

Table 5.5: Understanding of Islamic Banking Model and Products: Banked

	Islamic Banking Model	Islamic Bank Deposits	Islamic Financial Products	Nature of Contracts	Adherence to Shari'a Principles
Understand	5%	4%	3%	2%	3%
Do not understand	95%	96%	97%	98%	97%

Table 5.6: Understanding of Islamic Banking Model and Products: Non-Banked

	Islamic Banking Model	Nature of Contracts	Islamic Banking Deposits	Weightages and Profit Sharing	Islamic Financial Products	Adherence to Shari'a Principles
Understand	14%	11%	12%	9%	9%	8%
Do not understand	85%	89%	88%	91%	91%	92%

Table 5.7: Understanding Islamic Banking Models and Products: Corporate

	Corporate	Banked	Non-Banked
Qard Hasana	56%	47%	20%
Musharaka	33%	9%	3%
Ijara	13%	9%	3%
Mudaraba	15%	10%	2%
Murabaha	7%	4%	1%
Istisna	5%	3%	1%
Salam	5%	3%	1%
Diminishing Musharaka	4%	3%	1%

Table 5.8: Understanding of Islamic Banking Contracts

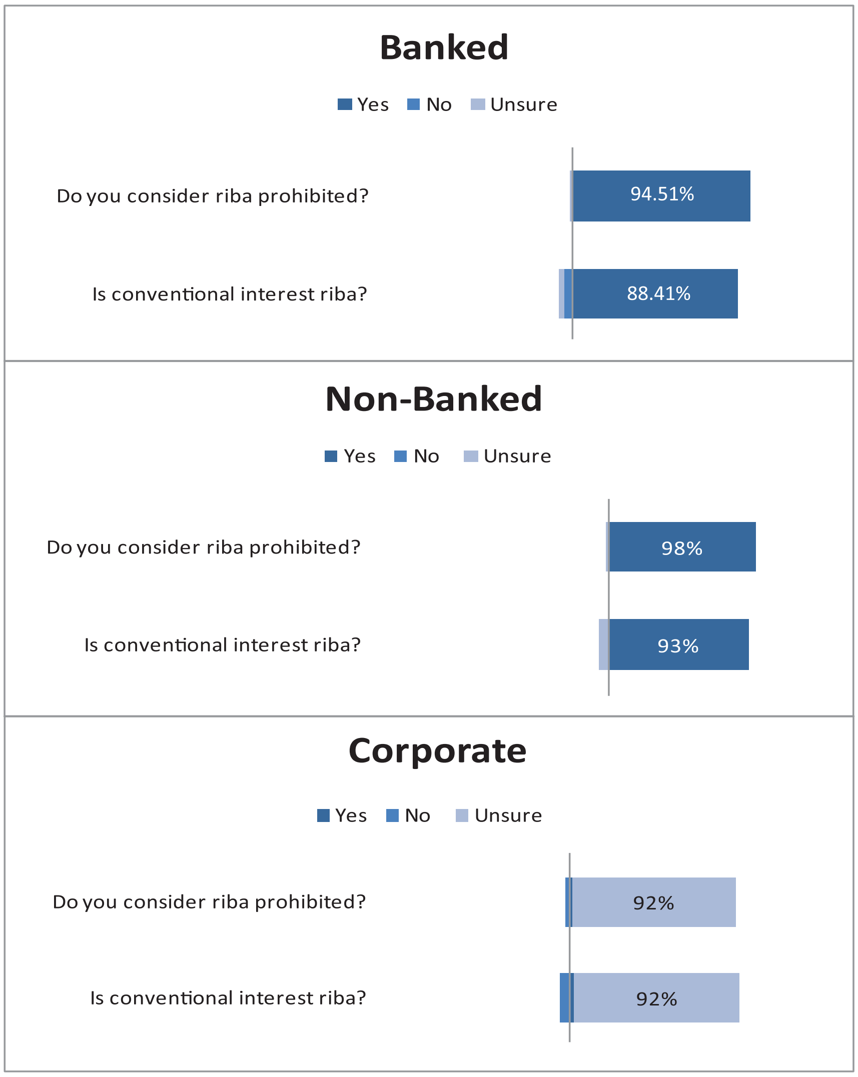


Figure 5.10: Perceptions on Interest and Shari'a Compliancy

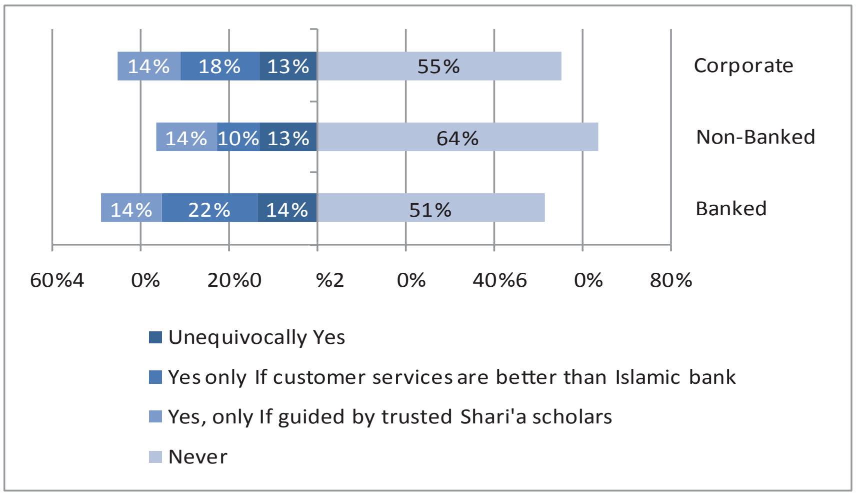


Figure 5.11: Would you prefer to be a customer of conventional bank offering Islamic banking services?

51 % of banked respondents prefer to be customers of only full-fledged Islamic bank while remaining 49% expressed that they would accept the option to bank with Islamic branch/window model. However, amongst the later mentioned group, 14% stated that they were comfortable in dealing with a conventional bank offering Islamic financial services. 22% respondents expressed better customer services to be a necessary condition for choosing an Islamic window over a full fledged Islamic bank, while the remaining14% stated that they would use an Islamic window only if it was guided by Shari'a scholars that they trust (Figure 5.11).

Corporates showed similar opinions as Banked, although more Corporates (55%) stated they would never use an Islamic window.

For Non-Banked, 64% would never choose a conventional bank offering Islamic banking over a full fledged Islamic bank. It has to be remembered that there was a low proportion of Non-Banked that understood Islamic banking. Preference for full fledged Islamic banks over conventional banks offering Islamic financial services indicates that Non-Banked were more comfortable with separate institutions.

If a conventional bank were to offer Islamic banking products, the majority of both banked (retail and corporate) respondents would prefer the creation of a separate body (fully independent company or full fledged Islamic bank) to offer Islamic banking products (Figure 5.12). Between 68 % Banked and 72 % Non Banked and Corporate would prefer the conventional bank to create a separate entity to offer Islamic banking products. Fundamentally, the majority of the population prefer Islamic banks to be separate institutions suggesting that the value propositions of the two systems are quite different and accordingly should be regarded as such. A hybrid conventional-Islamic banking model is not a favoured option.

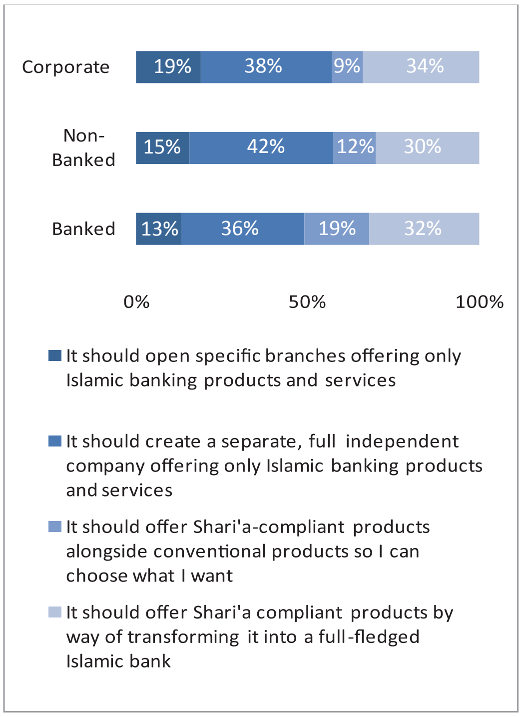


Figure 5.12: Revealed Preference on the Involvement of Conventional Banks in Islamic Banking

The combined results of Figures 5.11 and 5.12 have possible policy implications. While a significant proportion of the population may opt for using Islamic banking services offered by conventional banks (subject to service quality and Shari'a assurance), they would nevertheless wish to see these conventional banks evolve their Islamic operations into independent Islamic banking institutions, whether as a subsidiary or a full-fledged Islamic bank.

In garnering the opinions of Banked and Non-Banked on philanthropic activities and social responsibility, we see many similarities but on certain questions there are obvious differences. There is almost unanimous agreement that Islamic banks should offer interest free loans (qard hasana) to help the community (Figure 5.13). Arguably, the response is intuitive as interest free loans would mean simply a payback of the principle. Yet we still see some disagreement; 4% Banked respondents and 2% Non-Banked respondents disagree with the provision of qard hasana.

A vast majority of the respondents perceive an Islamic bank to be a community-oriented institution. There are at least two questions that one may ask:

1. The study shows that there is a strong interest in Islamic banking. What would be the effect on their interest if an Islamic bank does not offer interest free loans (and hence is not a community-oriented institution)?

2. Is it feasible to run Islamic banks as community-oriented institutions by giving them the specialised task of collecting charity (zakat, donations, and other forms of general giving by people and social contributions by the government), managing the charitable funds and disbursing them to the general public in accordance with their needs and income status?

In Figure 5.14, the majority of both Banked and Non-Banked respondents were neutral as to whether conventional banks products are cheaper than Islamic products suggesting most respondents were unaware about cost differentials between the two types of products. 24% of Banked respondents agree that they are while 13% disagree with the said notion. Therefore, more retail respondents believed that conventional bank products are cheaper than those of Islamic banks.

Irrespective as to whether conventional products are cheaper than Islamic products, 62% of Banked respondents were willing to pay more for Islamic banking products because these are Shari'a compliant as compared to 45% of Non-Banked respondents (Figure 5.15). A significant proportion of Banked respondents (47%) strongly agree that they would be willing to pay more as compared to 31% of Non-Banked. On the other hand, 45% of Non-Banked respondents were neutral when it came to paying more for Islamic banking products, which is the same amount of respondents who agree.

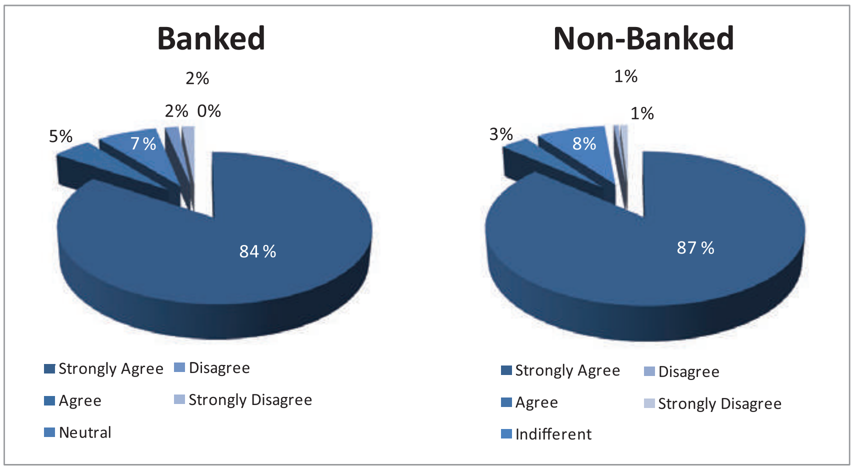


Figure 5.13: Do you believe Islamic banks should offer interest free loans?

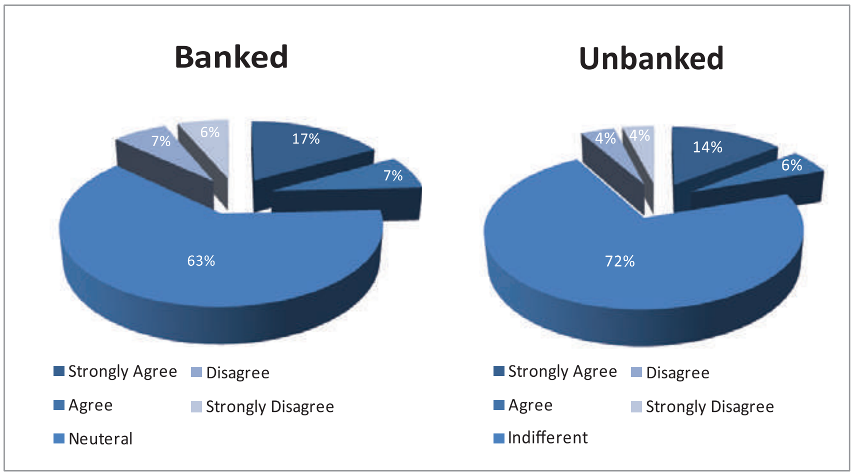


Figure 5.14: Do you think conventional bank products are cheaper than Islamic banks?

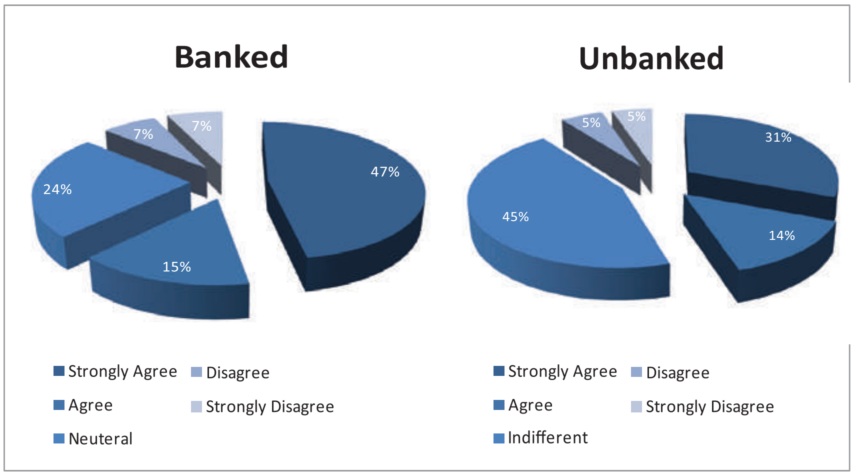


Figure 5.15: Are you willing to pay more for Islamic banking products because they are Shari'a compliant?

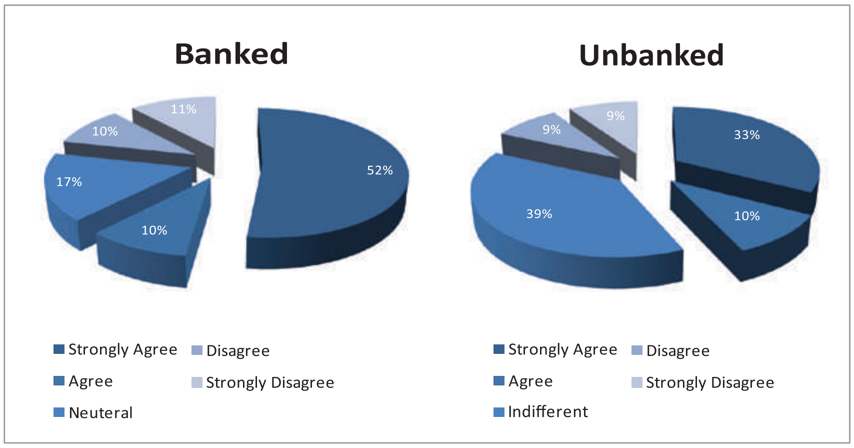


Figure 5.16: Are you willing to deposit money into an Islamic savings account even if there is a chance of loss?

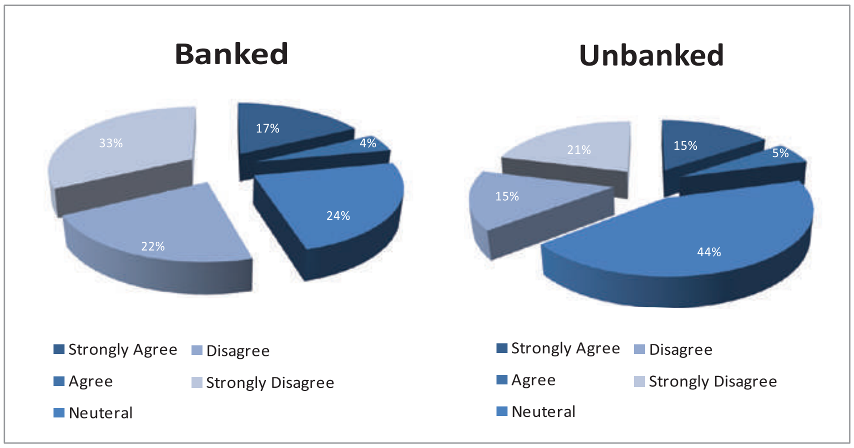


Figure 5.17: Would you withdraw your money from an Islamic savings account if the Bank announces loss?

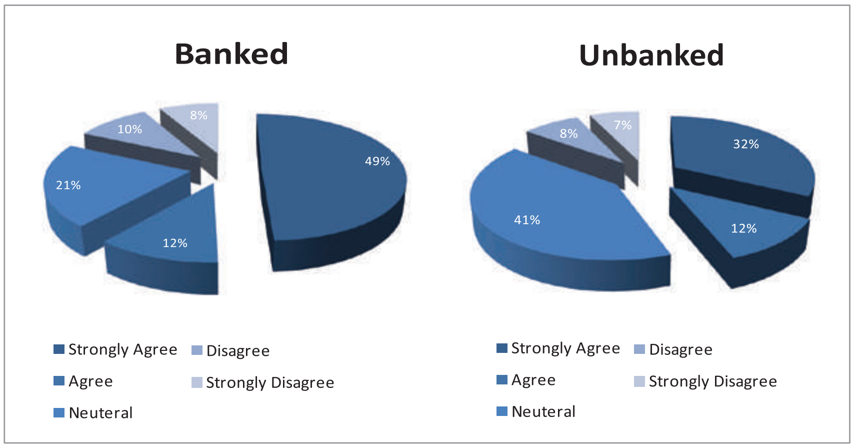


Figure 5.18: Would you keep your money in an Islamic savings account if it offers benefit from profit, even if there is a possibility of loss?

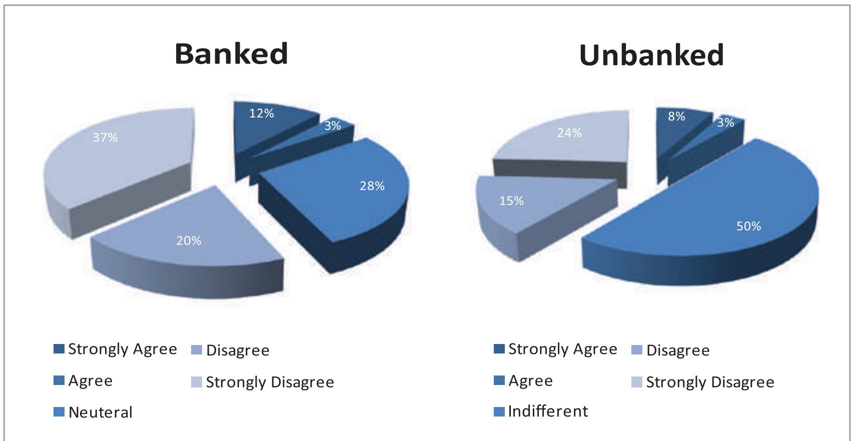


Figure 5.19: In the event of loss, would you withdraw you money from an Islamic savings account and deposit in a fixed return account with a conventional bank?

In figure 5.16 62%[33] of Banked would be willing to deposit money into an Islamic savings account even if there is a chance of loss. This is the same percentage as of the previous question, though less Banked strongly agree with sharing the loss. Taking the two Figures together, it would suggest that while some respondents would be willing to pay more for Islamic services, they are less willing to suffer a loss.

This is an extremely interesting response, and one must look into it carefully to draw any conclusions. This can be interpreted as willingness of a significant number of respondents to use purely profit loss sharing accounts, as opposed to those that provide capital guarantee and certainty of returns. Profit-loss sharing is presented by the advocates of Islamic banking as the real substitute for interest-bearing deposits. More than 6 in 10 of Banked population (both who are using Islamic banking and those banking with conventional banks) were willing to accept the risk of loss, with a similar trend for the Non-Banked (albeit with less intensity).

If an Islamic bank announces loss, 55% of Banked respondents disagreed to withdrawing money from savings account with 33% strongly against it (Figure 5.17). There is therefore a 7% decrease in numbers implying a difference in perception between the potential of loss and the actuality of loss. There is an increase of 7% with regards to the number of respondents who were neutral suggesting that some Banked respondents were unsure as to what they would do if there is an actual loss. Similar trends can be observed with Non-Banked respondents although 36% stated that they would not remove their money if the bank announces loss. The marginal change only confirms that respondents are willing to deposit their money into an Islamic savings account even if there is a chance of loss.

Figure 5.18 serves to clarify the above analysis. 61% of Banked would keep their money in a savings account with an Islamic bank if it means sharing in profit and loss. Figure 5.17 looked into whether respondents would be willing to deposit, but does not mention about sharing the profit while Figure 5.18 does. We can infer that some of those who disagreed to depositing their money were attracted to the idea of profit, but still remained uncertain about Islamic banking.

In the event of loss, 15% of Banked respondents would transfer their money from an Islamic savings account to a conventional account (Figure 5.19), while 11% of Non-Banked respondents would do likewise. Once again, majority of the respondents registered their disagreement to moving their account from an Islamic bank in case of loss.

From the preceding analysis we can conclude that there are similarities between Banked and Non-Banked respondents when it comes to offering interest free loans to the community but there is more of a split for Non-Banked respondents pertaining to whether they would be willing to either pay more for Islamic products or to deposit their money into Islamic accounts as compared to Banked respondents. Majority of Non-Banked respondents are neutral yet there is still over 40% who would be willing to deposit their money into an Islamic account but approximately 36% who would withdraw their money in the event of loss. For Banked respondents, there is less neutrality. Over 50% of respondents would deposit into an Islamic account and would not withdraw in the event of loss.

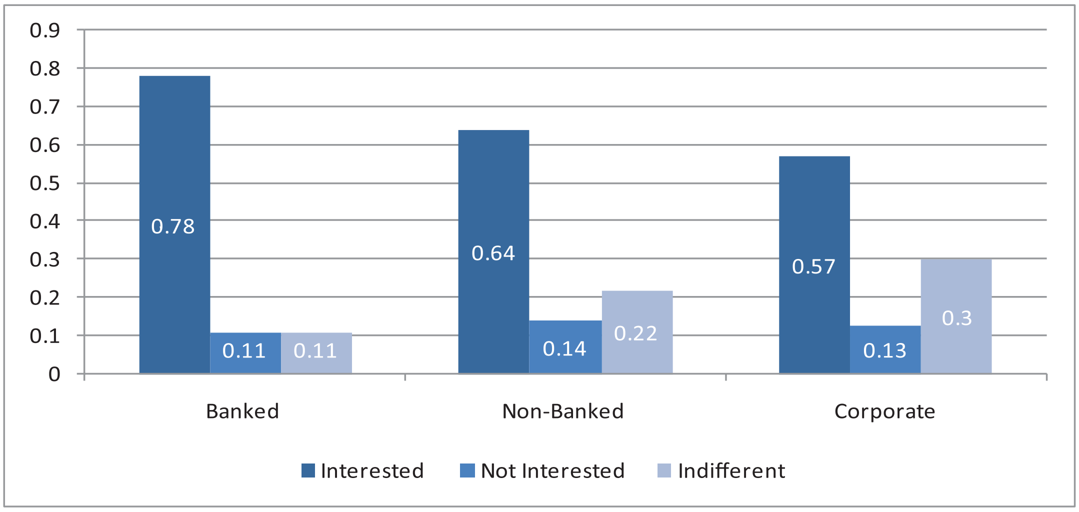


Figure: 5.20: Interest in Islamic Banking

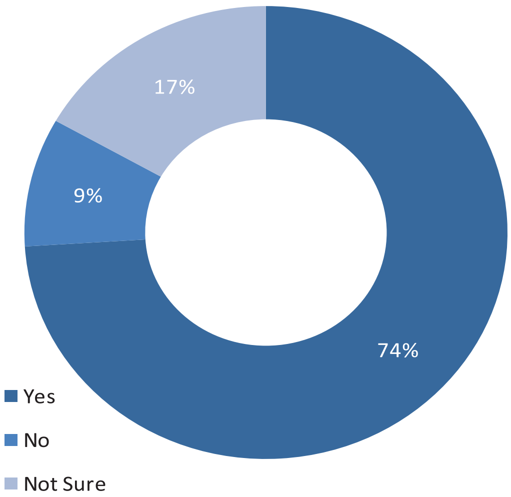


Figure 5.21: Willingness to Switch to Islamic Banking

5.6 Interest in Islamic Banking

The following section looks into the interest in Islamic banking and the products that would meet customer demand (Figure 5.20). We have noted that Banked customers used only a handful of products. Similarly, there was little demand for having a portfolio of products. Demand is limited to current accounts, saving accounts and debit accounts. The same can be seen with Non-Banked. Individuals had very little knowledge of the different types of products available and preferred simple ones.

5.6.1 Willingness to Switch to Islamic Banking

Figure 5.21 shows that overall 74% of Banked were willing to switch to Islamic banking thus showing there is a strong willingness to switch. 26% of Banked would not switch or are unsure.

For those that are interested in Islamic banking, religious satisfaction derived from Islamic banking products and the absence of interest were the two most important reasons for switching to Islamic banking (Table 5.9). Interestingly, profit and loss sharing was the third most important reason for both Banked and Non-Banked while the reputation of the bank and the availability of a range of Shari'a compliant products were relatively less important.

	Banked		Non-Banked	
	Important	Less Important	Important	Less Important
Islamic products/services offer religious satisfaction and comfort	98.41%	1.59%	98.77%	1.23%
Islamic products/services are not based on interest	98.74%	1.26%	99.08%	0.92%
Islamic products offer solutions to most of my personal needs	81.04%	18.96%	76.27%	23.73%
Islamic banks provide better services than conventional banks	72.69%	27.31%	68.09%	31.91%
Islamic banks carry better reputation that conventional banks	66.35%	33.65%	61.38%	38.62%
I value the principle of profit and loss sharing which Islamic banks use for the savings account	84.10%	15.90%	83.46%	16.54%
Shari'a compliant products are readily available	69.37%	30.63%	65.01%	34.99%

Table 5.9: Reasons for Switching to Islamic Banking

However, even if it is not important that the products are not available, the presence of a banking branch is more likely to incur interest and motivate a switch. 69% of Banked interested in Islamic banking stated that there is no Islamic bank in their locality and this is why they have not switched. 65% of Non-Banked explained that there is no Islamic bank in their locality, but 79% felt that they are not banking Islamically because Islamic banks have not approached them. Those that are financially excluded were expecting that banks approach them. We have seen that very few Non-Banked heard of Islamic banking from bank staff suggesting that Islamic banks are not doing enough to publicise Islamic banking to the financially excluded.

Even though both Banked and Non-Banked (retail) respondents believe in the fundamentals of Islamic banking, they were uncertain about current Islamic bank's adherence to Shari'a principles. So even if respondents are willing to switch to Islamic banking services, many considered the

[33] The percentage has been worked out by combining agree and strongly agree options.

current guise of Islamic banking as not coinciding with its ideal form and this could act as an obstacle to switching. This is largely subjective, and considering that a low percentage of respondents had understanding of Islamic banking mechanisms and terminologies, their uncertainty is likely to be based on a lack of knowledge. Greater presence of Islamic banks and more outreach programmes are likely to generate more interest and create more demand.

14% of Banked respondents stated they did not wish to switch. Over 50% of this group stated that the most important reason was that conventional banks offer better solutions. It could be that respondents are simply comfortable with conventional banking services and do not wish to change.

When it comes to Corporates, 57% were interested in Islamic banking. The majority of Corporates interested in Islamic banking stated that attraction to Islamic banking was because of religious factors; however this was not enough to motivate a switch. They are more likely to switch if the services offered by Islamic banks are cheaper (38%) or the quality of services is better than conventional banking (25%). Looking into the reasons for choosing their principle bank, we find that location was the primary factor, followed closely by good financial solutions (Figure 5.22). Hence Islamic banks have to be in a convenient location, offer good financial solutions that are cheaper and are better than similar services offered by conventional banks.

48% of Corporates felt Islamic current accounts were the most relevant to their needs. There was less demand for any other product, with the second most relevant product – trade finance – only gathering 11%. Corporates may not want a distinct range of products, they want to be sure that the bank has the potential to meet its needs if required. This boils down to confidence and relationships rather than having a wide range of products. Islamic banks have to show awareness of corporate needs. Of the 11% that were not interested in Islamic banking, they gave two main reasons: (a) they did not believe that products were truly Islamic; and (b) that they were not cost effective. While the first reason could be considered subjective, the second reason suggests that they undertook some basic research; otherwise it would have been difficult to make that judgement. The religious nature of Islamic banks would not be sufficient to attract Corporates if Islamic products are more expensive.

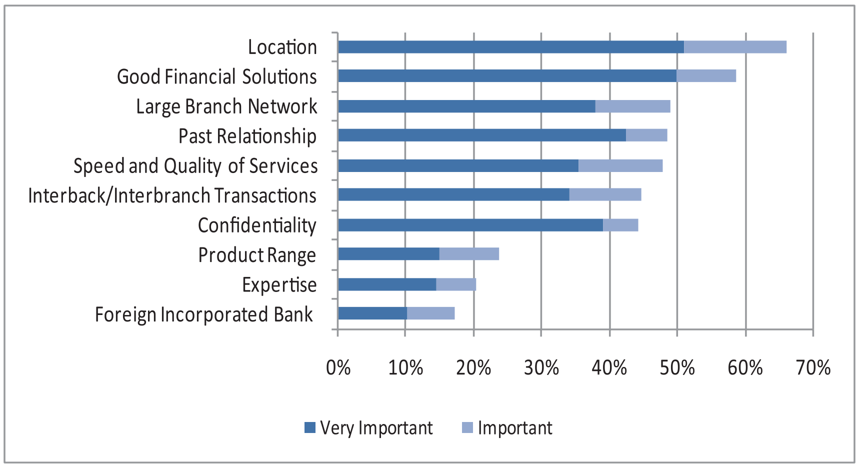


Figure 5.22: Corporate Resons for Choosing Primary Bank

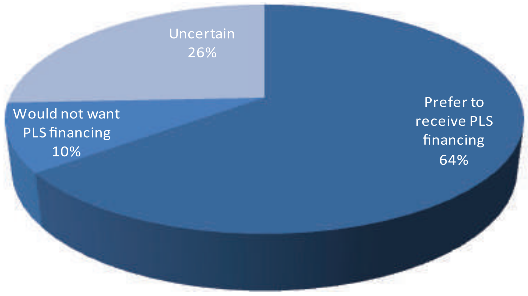


Figure 5.23: Preference for Profit and Loss Products

Religious association, service quality and pricing are not the only aspects that would attract corporate customers. According to Figure 5.23, 64% would prefer to receive financing on a profit and loss basis. Only 10% stated that they are not interested. This is an intriguing result as profit and loss sharing structures are not popular instruments offered by Islamic banks. There is a fear from banks that products will impose too great a risk. However, as this figure shows, the demand is indubitably present. With 26% of respondents claiming uncertainty, it provides an opportunity for Islamic banks to structure products based on participatory modes to attract customers.

From the 10% who said they would not prefer financing through profit and loss sharing, it is likely that most, if not all, Corporates do not have prior experience with profit and loss sharing financing. Thus, the respondents that provided a negative response are likely to have a greater risk aversion to attempting something new. Bank intervention in running of business and access to related information was a cause of discomfort. This was followed by concerns regarding cost and legal documentation.

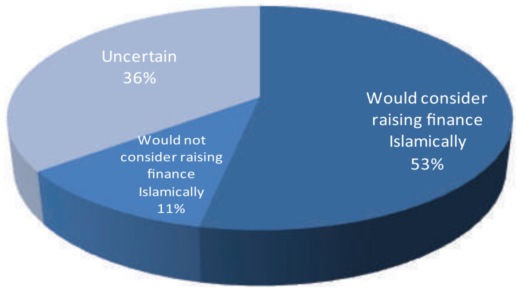


Figure 5.24: Raising Finance Islamically

Interestingly, most of the respondents (53 %) preferred to raise finance though Islamic products (Figure 5.24). 18% respondents expressed desire to use products of Islamic project finance (such as istisna) compared to 33% respondents that agreed with musharaka. For Islamic securities such as sukuk, more respondents were netural, and a greater number would not use securities to raise finance.

11% of Corporates would not consider raising finance on an Islamic basis. For these Corporates, religious reasons do not matter, and factors like quality of services, documentation, pricing of products that will ultimately decide choice. However, this conclusion would be the same for all Corporates who are not switching to Islamic banking. While there is religious sensitivity, it is not strong enough to lead to an overall shift.

5.7. Conclusion

There is overwhelming potential demand for Islamic banking in the country, and if proper awareness is created, significant number of new entrants can be attracted to the industry. The relatively low share of Islamic banking in the country is primarily because of limited outreach and narrow range of Islamic banking products which makes one conclude that demand will be significantly higher, if these issues are addressed.

One clear message that emerges from the data description in this chapter is that awareness of Islamic banking in the country is limited, and the general knowledge of respondents about Islamic banking is rather low. This makes a case for increasing financial literacy in general and the Islamic financial literacy in particular. The banking regulator (the SBP), other concerned parties (i.e., the Islamic banks and conventional banks with Islamic window operations), and stakeholders (particularly the Islamic scholarly community) must take a note of this, to promote Islamic banking in the country.

The attitude of people towards an Islamic banking model is in favour of a full-fledged Islamic bank. Given the preference ordering shown by respondents, it is very clear that the stand alone independent Islamic bank is the preferred choice of those who are interested in Islamic banking. As long as the customers of Islamic banks are convinced that the services they are using are truly Shari'a compliant, they are willing to pay more.

A clear message that comes out of the survey is that a vast majority of people believe in the principle of profit-loss sharing, and hence they are willing to assume risk of losing their money, as long as they can share profit with banks. Another important result coming from the survey is the willingness of majority of the corporate, (more than 50 percent) to access PLS based financing. This is contrary to the perception that there is no demand for such financing among corporate. The following Chapter 6 aims to analyse the information presented in this chapter using more sophisticated data analysing techniques i.e. Factor Analysis to quantify demand for Islamic banking in the country.

CHAPTER 6
Quantification of Demand for Islamic Banking

6.1. Quantifying Demand

What does constitute demand for Islamic banking? While various factors have been identified that affect demand for Islamic banking and finance, little has come out of previous empirical research to suggest what actually constitute the demand. Most of the institutions around the world, which have undertaken market research to assess demand for Islamic banking have relied on simple techniques to study demand for Islamic financial products. Many such studies focused on the prohibition of interest and assumed that the belief in this prohibition on part of the respondents would automatically result into demand for Islamic banking. This is obviously a very simplistic view. Hence, this study applies a more holistic approach to quantifying demand for Islamic banking.

It is not improbable to assume that demand for Islamic banking is primarily a religious phenomenon. This owes to the prohibition of riba (which is commonly known as interest) in the Holy Quran. There are, however, certain Muslims who are not entirely convinced that the interest paid and charged by banks is prohibited in Islam. This is, however, a minority view 94.51% of Banked respondents believed in the prohibition of interest, and 88.41% considered that the contemporary practice of interest in banks is prohibited. The story is not different for Non-Banked respondents rather it is more profound than the banked respondents. The majority of Non-Banked (over 98%) believed in the prohibition of interest and considered the interest charged and given by banks as prohibited (over 93%).

It must be emphasised that the belief in the prohibition of interest is only a *necessary condition* of demand for Islamic banking. The sufficient condition of demand for Islamic banking is that the individual believes that the bank interest is covered by the prohibition of interest and that Islamic banks indeed offer truly Shari'a compliant products. This means that just by looking at the belief on the prohibition of interest held by respondents may be misleading to get implications for demand for Islamic banking in Pakistan. A multitude of other factors must also be considered to have a comprehensive view on the existing and potential demand for Islamic banking. Figure 6.1 provides a sketch of demand for Islamic banking from the dataset at hand. It must be cautioned that the figure only takes into account religious beliefs in approximating demand for Islamic banking in Pakistan.

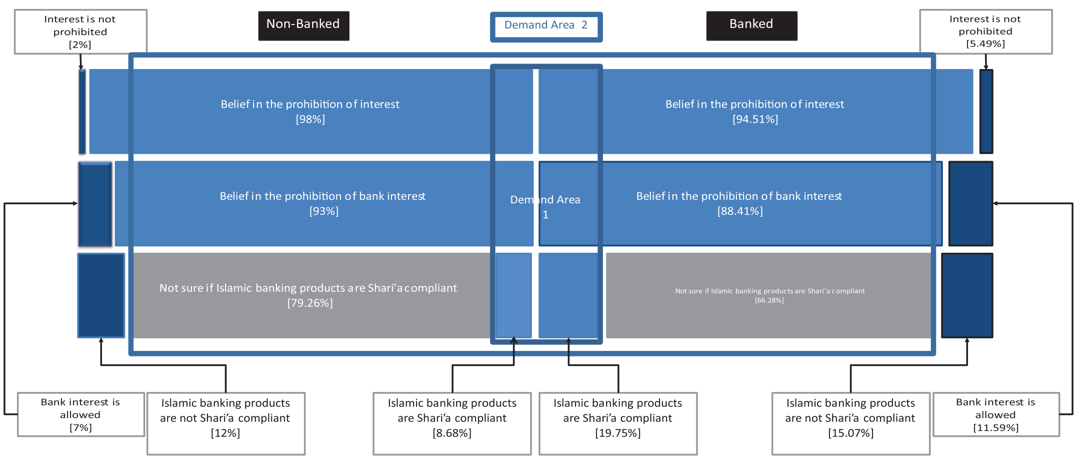


Figure 6.1: A Sketch of Possible Demand for Islamic Banking

[34] All Figures in the chapter should always be expressed, quoted, requoted in totality and should be taken in light of explanation/reasoning given in the text.

This leads us to believe that only those Muslims who believe in the Quranic prohibition of interest and those who consider this to encompass banking interest are sufficiently convinced of Shari'a compliancy of such products will have staunch demand for Islamic banking (demand area 1 in figure 6.1). Those who believe in the prohibition of interest but are not entirely convinced of Shari'a compliancy of operations of Islamic banks and the products offered by them may not have such a strong demand (demand area 2 in figure 6.1).

This is interesting, as many Muslims who believe in the Quranic prohibition of interest and those who believe that paying interest to a bank and/or receiving it from the bank is disallowed in Islam, may still not do business with Islamic banks, if they are not sufficiently convinced that the services offered by Islamic banks are in compliance with Shari'a.

Many advocates of Islamic banking assert that a proportion of religiously motivated Muslims opt out of the banking services if Shari'a compliant financial solutions are not available. This is an argument in favour of a causal relationship between faith and financial exclusion, with the former leading to the latter. If true, this necessarily means a negative relationship between intensity of religiosity and demand for (conventional) banking.

Figure 6.2 classifies demand and lack of demand for Islamic banking into different categories. There are possibly three types of demanders for Islamic banking, with respect to belief in the prohibition of riba.

Type A are the ones who strictly believe in the prohibition of interest and constitute the core part of demand for Islamic banking. These are considered as the "captive" customers of Islamic banking.

Type B are the ones who believe in the prohibition of riba but either do not believe that banking interest is riba or are not entirely convinced of Shari'a compliancy of Islamic banking operations and the products. If a customer of an Islamic bank believes in the prohibition of riba but is not entirely convinced of Shari'a compliancy of Islamic banking but still decides to be a customer with an Islamic bank, we classify them as **B1** demanders. A segment of this group may also include those who think that the products offered by Islamic banks are Shari'a compliant but banking interest is not disallowed either **(B2).** The bottom segment of such a group does not consider bank interest to be disallowed and is not convinced of Shari'a compliancy of Islamic banking products **(B3)**. These customers become customers of Islamic banks not purely for religious reasons but for other factors like convenience, customer services and competitiveness of the products offered by Islamic banks.

Type C are the ones who do not believe in the prohibition of interest at all and incidentally happens to be customers of Islamic banks due to convenience factor or because of competitiveness of Islamic financial products.

Among those who do not have demand for Islamic banking, the most significant are those who think that banking services are not required by them. These people are by and large on the lowest rung of the income spectrum, and may potentially be a good target for microfinance and similar programmes, if offered by Islamic banks. These are termed as **Type X (X1, X2, and X3** in Figure 6.2, depending on their belief in the prohibition). These are certainly those who are financially excluded, either voluntarily or involuntarily.

Among other three types – **Type E, F and G – Type E** is the most interesting, as these people are those who are convinced of the prohibition of interest but still would not like to do business with Islamic banks because they are not sufficiently convinced if Islamic banks are truly Shari'a compliant. Type F and G do not exhibit demand for Islamic banking but for different reasons. Type F are those who have a genuine need for the use of banking services but are most likely to use conventional services because they happen not to believe in the prohibition of riba. Type G, on the other hand happen to believe in the prohibition of riba but do not think that it covers the banking interest.

It must be considered that religious beliefs are not the only factor in determining demand for Islamic banking. There are other factors that may influence the choice of a bank – Islamic or conventional, and preference for one over the other. This chapter attempts to identify such and other factors to determine demand for Islamic banking in Pakistan.

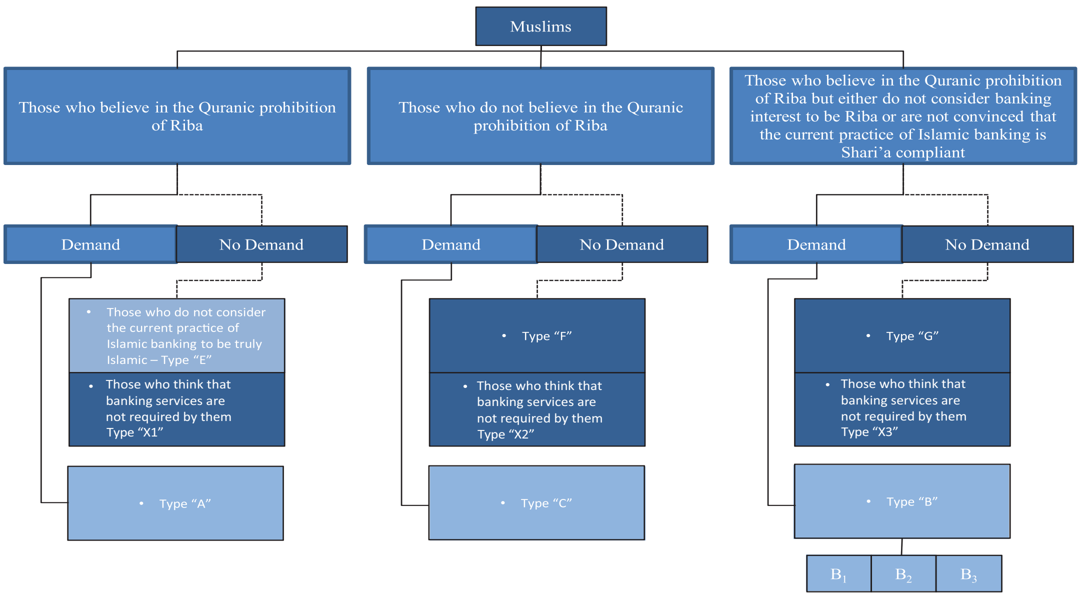


Figure 6.2: Religious Beliefs and Demand for Islamic Banking

6.2. Methodology

The survey comprised of questionnaires (Banked and Non-Banked household and Corporates), aimed at extracting information to be used in quantifying demand for Islamic banking in Pakistan. While the three questionnaires were structured keeping in view different characteristics of the three sampled populations, there are necessarily overlapping questions in the three. This allows us to combine household data on Banked and Non-Banked samples. Business data, however, is used separately, as it is expected that businesses have different needs from households, and hence their demand structure should also be different.

6.2.1. Statistical Techniques

There are different techniques that can be employed to quantify demand for banking services. A univariate anlaysis attempts to study demand in light of correlation between different pairs of variables. While it has its strength in terms of simplicity, its most striking shortcoming is the loss of information that the analyst may have to compromise upon while studying the pair-wise correlations. Chapter 5 provides this kind of analysis to understand the nature of the data set. This chapter, however, employs a multivariate analysis to study demand for Islamic banking. There are three techniques that are deemed appropriate for the kind of dataset we have at hand:

- Principal component analysis
- Factor analysis
- Path Model

These techniques have been discussed in Chapter 3, with their pros and cons. This chapter is based on factor analysis, which is deemed as the most suitable and robust for the dataset at hand. The factor analysis however picked up principal component analysis as the most appropriate way of extracting factors from the information provided. In total, 98 variables (the information on which data was collected through field sur-

Table 6.1: Constituent Factors of Demand for Islamic Banking Amongst Individuals

Factors	Description	Weightage	Variation Explained (%)
X_1	Satisfaction with Islamic banking	19.90%	12.95
X_2	Satisfaction with conventional banking	14.86%	9
X_3	Need for banking services	12.21%	8.46
X_4	Shari'a authenticity and transparency	11.19%	5.59
X_5	Knowledge of Islamic banking products	8.50%	4.36
X_6	Understanding of Islamic banking model	4.86%	4.21
X_7	Staunch patronage of Islamic banking	3.92%	4.17
X_8	Savings by the religiously motivated	3.16%	4.12
X_9	Repute and relevance of Islamic banking products	2.70%	3.02
X_{10}	Basic understanding of Islamic banking	2.24%	2.12
X_{11}	Belief in the prohibition of interest	2.04%	1.55
X_{12}	Outreach of Islamic banks	1.92%	1.41
X_{13}	Need for financing	1.73%	1.33
X_{14}	Displaced commercial risk	1.68%	1.31
X_{15}	Use of the most basic banking services	1.64%	1.31
X_{16}	The relevance of ancillary banking services	1.55%	1.24
X_{17}	Perception of Shari'a authenticity	1.50%	1.14
X_{18}	Past banking experience	1.48%	1.09
X_{19}	Indifference between Islamic and conventional banking	1.47%	1.05
X_{20}	Documentation and procedures	1.45%	1.05

The weights do not add up to 100 primarily because of the rounding up. In actual analysis the exact figures were used.

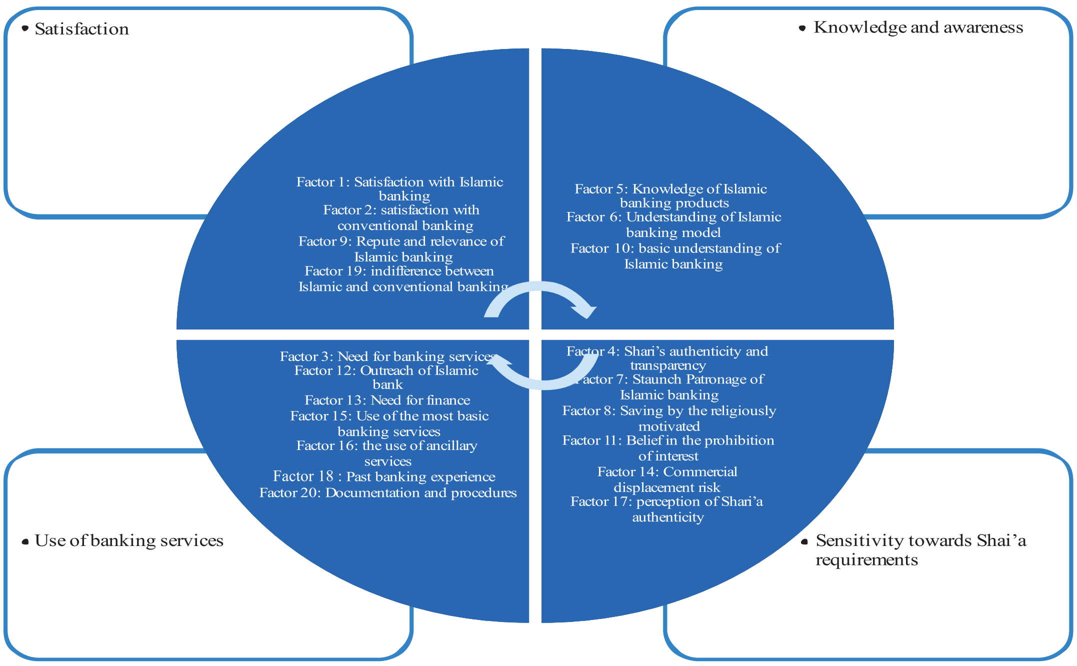


Figure 6.3: Grouping of the Significant Factors Determining Demand for Islamic Banking amongst Household/Individuals

veys) are used to extract the factors that may have an effect on the level of demand for bank

ing amongst the surveyed sample population. The extraction method employed – the principal component analysis – generated 20 significant factors. The factors chosen (given in Table 6.1)[34] explain more than 70% variation in the data set.

These factors fall under the four major categories, i.e., satisfaction; knowledge and awareness, use of banking services, and sensitivity towards Shari'a requirements (see Figure 6.3).

6.2.2. Construction of Demand Index

$$\text{Demand} = \sum_{i=1}^{20} \alpha_i X_i$$

The factor analysis generates the following index:

where a_i are the weights given to different factors X_i.

More specifically, the demand index (DI) can be written as:

$$\begin{aligned} DI = \; & 0.1990X_1 + 0.1486X_2 + 0.1221X_3 + \\ & 0.1119X_4 + 0.0849X_5 + 0.0485X_6 + \\ & 0.0391X_7 + 0.0315X_8 + 0.0270X_9 + \\ & 0.0224X_{10} + 0.0203X_{11} + 0.0191X_{12} + \\ & 0.0172X_{13} + 0.0168X_{14} + 0.0163X_{15} + \\ & 0.0155X_{16} + 0.0149X_{17} + 0.0147X_{18} + \\ & 0.0147X_{19} + 0.0145X_{20} \end{aligned}$$

Where X_i are as defined in Table 6.1.

The data used in the factor analysis has discrete values, ranging from 1 to 6. The order of responses was adjusted to construct a cumulative measure of demand for Islamic banking. For example, Question No. 21 in the questionnaire for Banked respondents (retail) ["Do you consider paying and charging interest to be prohibited in Islam?"] was coded as 1 (Yes), 2 (No) and 3 (Not sure). These codes were adjusted to 1 (No), 2 (Not sure) and 3 (Yes) for factor analysis to ensure that the coefficient of the relevant factor was a positive number. This is the reason that all the X_i above have positive coefficients.

This demand index represents the effect of different factors (religious and non-religious) on the demand for Islamic banking in Pakistan. To calculate more precise demand for Islamic banking, it is important to look into the behaviours of the respondents. Table 6.2 provides minimum and maximum values of the demand index for those who are actually using Islamic banking services and those who are either Non-Banked or are the customers of conventional banks (not using Islamic banking)

Figure 6.4 represents the maximum and minimum values the Demand Index may take. These thresholds are calculated by assigning maximum and minimum values respectively to constituent factors of demand for all respondents. The Demand Index constructed from factor analysis suggests that an overwhelming majority of the respondents exhibit some kind of demand for Islamic banking. Out of the 9,000 valid observations, 8,771 fall in the range 1.83 to 3.61 (the threshold levels of minimum and maximum values of the Demand Index, which is determined by the observations corresponding to the actual users of Islamic banking in the sample). There are only two observations exceeding 3.61, and 227 observations below the lower threshold of 1.83. This means that only 2.52 percent of the respondents do not have demand for Islamic banking at all, with 97.48 percent having some sort of demand for Islamic banking. This is indeed a very strong result, which needs further investigation.

Figure 6.5 classifies demand for Islamic banking. The range of 1 (the minimum value) to 4.64 (the maximum value) is divided into four equal quartiles. The range of values between 1 and 1.91 corresponds to "No Demand". The values exceeding 1.91 and up to 2.82 represent "Pent-up Demand". "Strong Demand" is represented by the values exceeding 2.82 and up to 3.73. Those who have "Staunch Demand" have values exceeding 3.73. Table 6.3 gives the percentages of observations in different categories of demand in the total retail sample.

It must be noted that Figure 6.4 presents the actual range of the demand index for the users of Islamic banking services and of those who are at present financially excluded. Figure 6.5 on the other hand side, classifies the demand into four categories as mentioned above.

	Staunch demand	Strong demand	Pent-up demand	No demand
	(>3.73 – 4.64)	(>2.82 – 3.73)	(>1.91 – 2.82)	(1 – 1.91)
	[Type A]	[Type B_1]	[Types B_2, B_3, C and E]	[Type X]
(Percentage)	*(0)*	*(2.33)*	*(92.50)*	*(5.17)*

Table 6.3: Classification of Demand for Islamic Banking based on the Range

It is interesting to note that there is no evidence of staunch demand (see Box 6.1 for definition) for Islamic banking in Pakistan. This is quite an intuitive result, as even those who are very strongly driven by faith still bank conventionally if they have no access to Islamic banking. This is certainly true that such people however limit the use of banking services to current account and access to other services that are interest-free in nature (e.g., money transfer and making payments).

The pent-up demand needs further decomposition into the four categories created at the start of the chapter, i.e., Types B_2, B_3, C and E. The 92.50% pent-up demand is further divided into these categories in Table 6.4.

Box 6.1: Classification of Demand

Staunch demand is the proportion of demand that is exhibited by those who would like to use only Islamic banking and would prefer to abstain from banking if Islamic banking was not available to them.

Strong demand is exhibited by those who favour Islamic baking over conventional banking services more because of the religious factors and less of the other factors (e.g., convenience, location and service quality etc.).

Weak demand is exhibited by those who favour Islamic banking services equally because of religious and other factors.

Pent-up demand is potential demand for Islamic banking in a situation where Islamic and conventional banking services are equally readily available. This includes weak demand, as defined above.

	Total			Users of Islamic banking			Those who are not using Islamic banking		
	Min.	Max.	Ave.	Min.	Max.	Ave.	Min.	Max.	Ave.
Demand Index	1	4.64	2.82	1.83	3.61	2.72	1.64	3.79	2.72

* Minimum and maximum values are actually theoretical values, calculated by assuming that all constituent variables in the factors included in the Demand Index take the maximum and minimum possible values.

Table 6.2: Range of Demand Index: Total*, Users of Islamic Banking and Non-users of Islamic Banking

[35] See Table A at Chapter end for Factor description

The calculations for B_2 and B_3 are based on the percentages of people who believe in the prohibition of interest, the prohibition of bank interest and their perception whether Islamic banking products are truly Shari'a compliant (given at the start of this chapter). It is based on the simple average (although admittedly a weighted average is preferred but it does not make any significant changes in the number, as Banked and Non-Banked are fairly equally distributed) of the responses drawn from the Banked and Non-Banked samples. For categories C and E, only the normalised percentage responses are used.

	B_2	B_3	C	E
Prohibition of riba/interest	94.51 + 98	94.51 + 98	-	-
Prohibition of bank interest	66.28 + 79.26	15.07 + 12.06	-	-
Shari'a compliancy of Islamic banking	93	93	-	-
Total	431.05	312.64	-	-
Percentage	86.21	62.53	5.49	12.06
Normalised percentage	51.84	37.6	3.13	7.26
Pent-up demand (%)	47.95	34.8	2.9	6.72

Table 6.4: Classification of Pent-up Demand for Islamic Banking

It must, however, be emphasised that a large number of those who exhibit demand for Islamic banking are in fact at present Non-Banked. Furthermore, it appears as if many of the Islamic banking users are influenced by non-religious factors, (e.g. convenience, location, service quality etc) than religion or faith in bank choice. The dominance of B2 and B3 classes of the users of Islamic banking, with 47.95% and 34.8% respectively, indicates this trend. Hence, there is little evidence that faith considerations give rise to financial exclusion. Chapter 5 shows that only 933 respondents included in the sample are actual users of Islamic banks, while our Demand Index suggests that 94.83 respondents exhibit demand for Islamic banking. This means that there must be some Non-Banked respondents who despite having demand for Islamic banking are not using banking services at all. In fact, the factors purely related with religious beliefs explain 17.88% variation in our Demand Index (calculated from Table 6.1).

Figure 6.6 depicts demand for Islamic banking in different groups. As the curve suggests the demand is skewed in favour of strong demand, although it primarily comprises of the pent-up demand. While demand for Islamic banking primarily comes from the religiously motivated (Groups A, B_1 and B_2), it is interesting to note that many others (Groups B^3, C and E) may also bank Islamically, owing to general factors like convenience, customer quality etc. for bank's choice

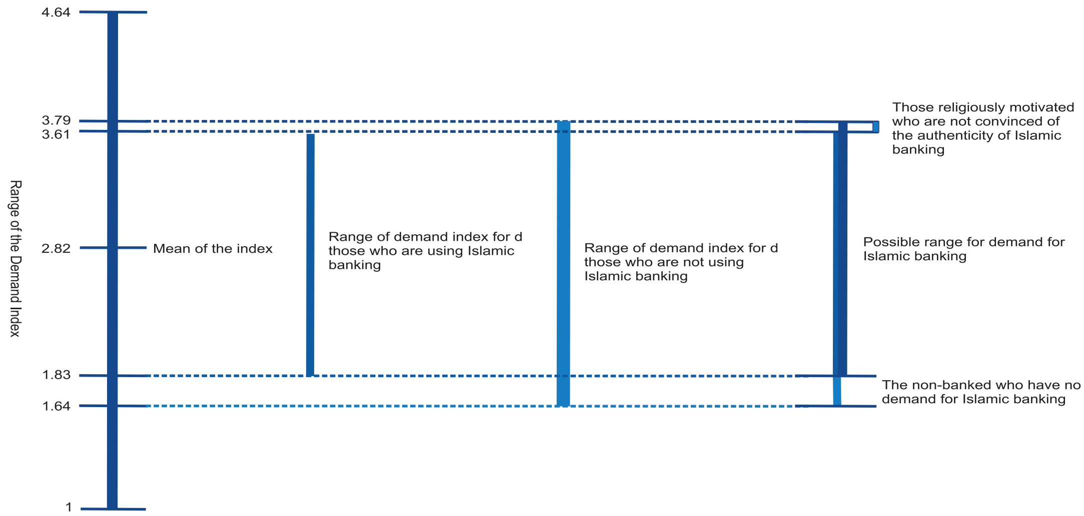


Figure 6.4: The Demand Index Decomposed into "Demand" and "No Demand"

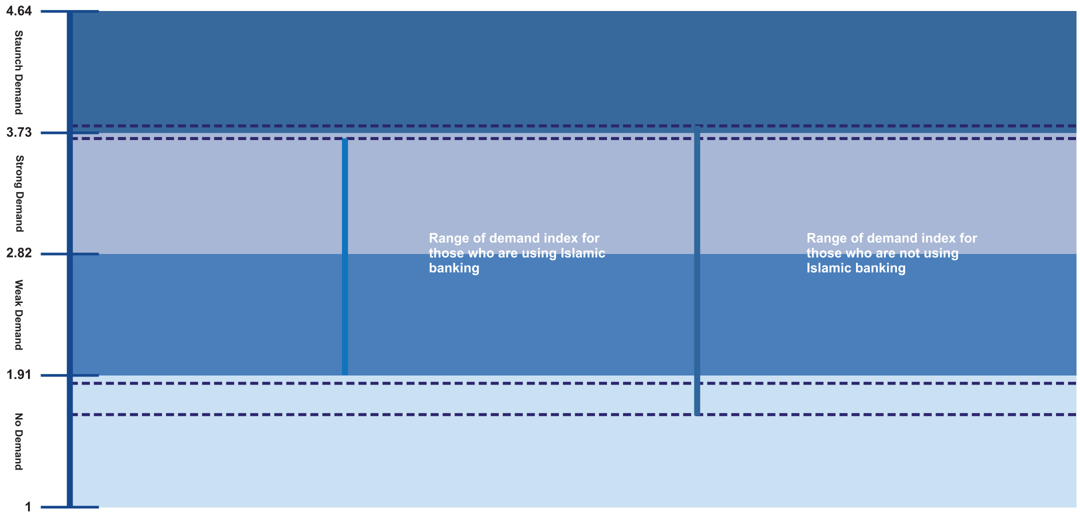


Figure 6.5: Classification of Demand for Islamic Banking into Staunch, Strong, Weak, and No Demand

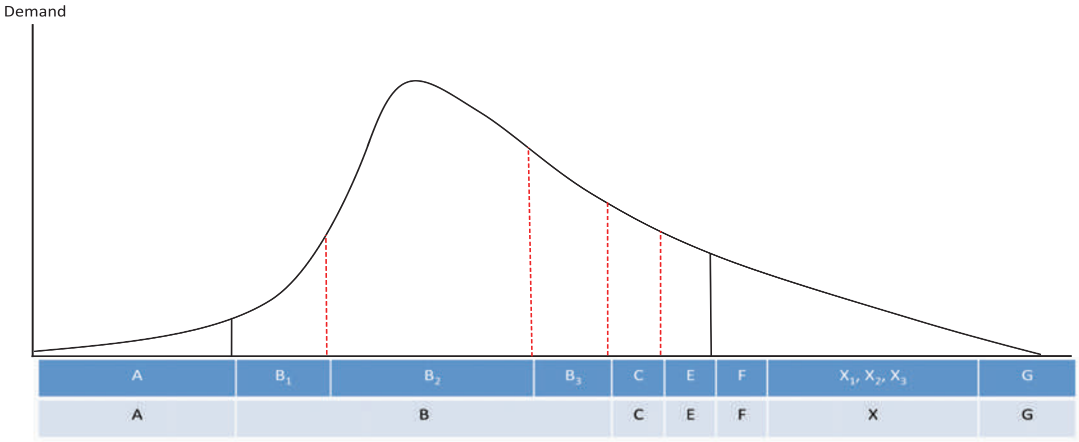


Figure 6.6: Incidence of Demand and Different Types of Demanders

All the factors related with conventional banking (like X_2: satisfaction with conventional banking, X_3: need for banking services, X_{13}: need for finance, X_{15}: use of the most basic banking services, X_{16}: the relevance of ancillary banking products, and X_{18}: past banking experience) contribute to the Demand Index. This means that it is quite likely for an existing user of conventional banking to switch to Islamic banking. It is, therefore, a worthy business for those conventional banks that also offer Islamic banking products to provide the choice between Islamic and conventional to such customers before they switch to fully fledged Islamic banks. This necessarily means that at this early stage of development of Islamic banking in Pakistan, the fear of cannibalisation of conventional business, as faced by conventional banks offering Islamic banking services, is real.

Another constituent of demand is what is known as displaced commercial risk. The data suggests that 62% of Banked respondents will not withdraw money from an Islamic saving account in case it announces a loss. This variable, however, partially explains variation in the relevant factor constituting the demand (X_{14}), which in itself contributes only 1.31% variation in the Demand Index (see Table 6.1).

It is interesting to note that demand for Islamic banking comes from Banked as well as Non-Banked population of the country. Although the factors related with satisfaction with conventional and Islamic banking and prior use of banking services are dominant in determining demand for Islamic banking, the impact of religious beliefs cannot be ruled out. While it is natural to observe that growth in Islamic banking has in its initial stage of development come from within the Banked population, it is primarily because banks targeted only those who are conventionally considered bankable. Given that a very large number of Non-Banked population is interested in Islamic banking, the study has some policy implications for financial exclusion and the possible use of Islamic banking to reduce it.

As in the initial stage of development of Islamic banking, the demand for Islamic banking comes from those who are already banking with conventional banks, many conventional bankers fear cannibalisation of conventional banking by Islamic banking. This realisation may be deemed as one of the factors hampering supply of Islamic banking services by conventional banks, as the shareholders and top management of conventional banks may not find it entirely worthwhile to incur additional costs to develop Islamic banking, if that by and large means helping their conventional clientele to switch from conventional banking to Islamic banking. The conventional banks will develop Islamic banking (through Islamic windows or branches) only if they are threatened by loss of business to the full-fledged Islamic banks.

6.2.3 SKUR Analysis:

In terms of significance of contribution towards demand, all factors as described in Table 6.1 can be summarised in four main categories ; (i) Satisfaction (S), (ii) Knowledge (K), (iii) Use (U) and (iv) Religious Factors (R) (see Figure 6.7).

It is interesting to note that religious beliefs contribute exclusively 23% to demand for Islamic banking, while the most dominating factor remains the level of satisfaction the users of banking services draw from the products and services offered by banks. One-fifth of the demand for Islamic banking is exclusively driven by the already Banked population. This means that 20% of the existing customers of conventional banks will be willing to switch to Islamic banking if the products offered by Islamic banks are a perfect substitute for the conventional banking products. This is in contrast with the responses from the Banked and Non-Banked respondents to the question on switching (Chapter 5), which shows that 74% of the Banked respondents are willing to switch from conventional to Islamic banking. This study reiterates that the simplistic analyses based on market research showing an overwhelming demand for Islamic banking may be misleading. The respondents tend to show their preferences in a general way and it is not necessary that their actual behaviour will follow the revealed preferences, given that the socio-economic reality is complex and it requires a deliberate effort on part of the bank customers to switch from one bank to another[35]. It is also important to consider that the estimated 20% switching will take place only in areas where Islamic banks operate. Given that in the vast majority of the rural areas and small towns, Islamic banking branches are almost non-existent, it may make the switching even more difficult for people wishing to do so.

It is not surprising to note that the most dominant factor determining demand for Islamic banking in Pakistan is customer satisfaction. As 39% of the demand is determined by factors related with customer satisfaction, Islamic banking must be developed purely as a market phenomenon, allowing Islamic banks to compete with conventional banks on a level playing field. This may mean that in order for Islamic banks to compete with their conventional counterparts, they will have to improve their customer services to win business from their rivals.

[36] In a recent survey conducted in UK, it was found that a number of banks customers unhappy with the large high street banks did not switch to small and ethical Islamic banks, despite their willingness to switch. A number of reasons account for the lack of switching, against the revealed preferences of the respondents. It was observed that the most important reasons were inconvenience and the time consuming switching process (Financial Times, July 13, 2012).

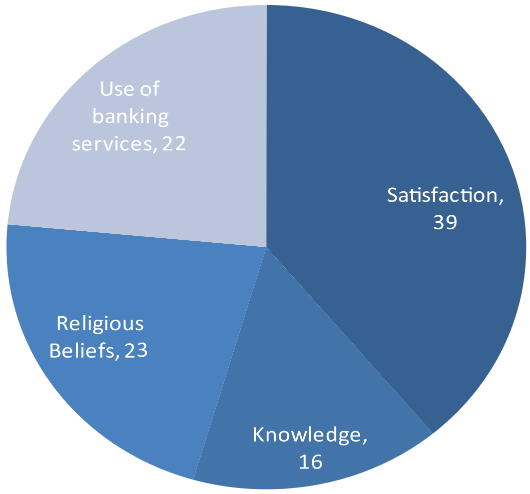


Figure 6.7: Contributions of Different Factors to Demand for Islamic Banking

One of the possible reasons for knowledge playing a limited role in determination of demand for Islamic banking in the country is widespread unawareness of Islamic banking amongst the respondents – both Banked and Non-Banked (see Chapter 5). Knowledge of Islamic banking model, practices and products contribute to only 16% of demand for Islamic banking – the least significant of the most important four determinants of demand. However, religious beliefs and knowledge and awareness of Islamic banking and finance (operations and products) collectively contribute 40% to the demand for Islamic banking.

While switching may help up to 20% of the conventional bank customers to switch to Islamic banking, the real impetus to growth in Islamic banking will come from the Non-Banked population, which has not been tapped by the conventional banks so far.

6.3. Other Factors Affecting Demand for Islamic Banking

After constructing a Demand Index, this study attempts to investigate causal relationship between the demand for Islamic banking in Pakistan and a number of factors like gender, religious sect, income and geographical location. Table 6.6 represents the regression results for demand index (using combined data set of Banked and Non-Banked respondents) on geographical location, religious sect, age, education, and income levels.

It was decided to use dummy variables in the regression results instead of the discrete values that did not have much variation (given the nature of the date collected). A number of variables were used in the initial stage but only six variables were found statistically significant. These variables are:

Location (L):

The four dummy variables represent location of respondents divided into urban planned city (L2), urban katchi abadis (L3), rural within 15 kilometres radius of the tehsil headquarters (L4), and rural outside 15 kilometres radius of the tehsil headquarters, which may be termed as suburban (L5). Urban inner city areas were used as a reference point (L1, which was omitted on statistical grounds).

Gender (G):

Female dummy (G2) was included to use the male respondents as a reference point (G1, omitted).

Sects (S):

The religious sects were represented by five dummies: Sunni deobandi (S2), ahle hadees (S3), shi'a (S4), those who would like to be called sunni only (S5), and those who would like to be called Muslims only (S6). Others were captured by a separate dummy (S7). The reference group in this case was sunni Berelvi (S1, omitted).

Age (A):

There were five age brackets captured by the survey, which were represented by four dummies: age group 31- 40 (A1), age group 41-50 (A2), age group 51- 60 (A3), and age group above 60 (A4). The reference group was 18-30 years of age (A1, omitted).

Education (E):

There were eleven groups identified with respect to educational attainment. Those with primary level education were used as a reference group (E1, omitted). The remaining 10 groups were represented as follows:

Matriculation/O Levels	E2
Intermediate/A Levels	E3
Graduation	E4
Masters – business/banking	E5
Masters – other than business or banking	E6
MPhil/PhD	E7
Dars e Nizami (degree in religious education from a Madrasa)	E8
Vocational education for self employment	E9
Those who did not attend school	E10
Others	E11

Income (I):

The survey collected information on twelve income brackets as given below. Although there was sufficient variation in the data set, the study decided to use dummy variables instead of using income as a continuous variable. This was done so that more useful results with greater explanatory power could be sought. The reference dummy (I0, omitted) was the one with no income. The remaining dummies were defined as below (figures in Pakistan rupees):

Up to 5,000	I1
5,001 – 10,000	I2
10,001 – 15,000	I3
15,001 – 20,000	I4
20,001 – 25,000	I5
25,001 – 35,000	I6
35,001 – 50,000	I7
50,001 – 70,000	I8
70,001 – 90,000	I9
90,001 – 110,000	I10
110,001 – 150,000	I11
More than 150,000	I12

Linear regression

Number of observations = 9000
F(40, 8730) = 75.36
Prob > F = 0.0000
R-squared = 0.2498
Root MSE = .20352

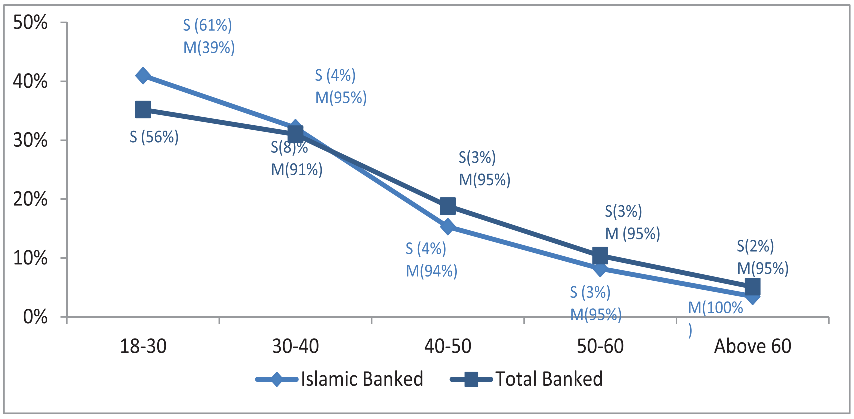
Ind. Var.	Coefficient	Std. Err.	t	P > |t|	[95% Conf. Interval]	
L2	0.012849	0.0069664	1.84	0.065	-0.0008069	0.0265048
L3	0.0467236	0.0067126	6.96	0	0.0335653	0.059882
L4	-0.0239836	0.0097554	-2.46	0.014	-0.0431066	-0.0048607
L5	0.0107835	0.0062235	1.73	0.083	-0.0014162	0.0229831
G2	-0.0969635	0.0067556	-14.35	0	-0.1102061	-0.083721
S2	0.0186761	0.0085764	2.18	0.029	0.0018644	0.0354879
S3	-0.0002481	0.0127958	-0.02	0.985	-0.0253309	0.0248346
S4	-0.0656023	0.0103645	-6.33	0	-0.0859192	-0.0452854
S5	-0.0177947	0.0067373	-2.64	0.008	-0.0310014	-0.0045879
S6	0.0082571	0.0073165	1.13	0.259	-0.0060849	0.0225991
S7	0.0140629	0.0235364	0.6	0.55	-0.032074	0.0601999
A2	0.0262005	0.0054272	4.83	0	0.0155618	0.0368391
A3	0.0372507	0.0066294	5.62	0	0.0242554	0.050246
A4	0.0442122	0.0084828	5.21	0	0.0275839	0.0608404
A5	0.0306537	0.0110799	2.77	0.006	0.0089345	0.052373
E2	0.0419775	0.0087564	4.79	0	0.0248128	0.0591422
E3	0.0772785	0.0084491	9.15	0	0.0607163	0.0938407
E4	0.1068029	0.0075914	14.07	0	0.091922	0.1216839
E5	0.1378776	0.008362	16.49	0	0.1214861	0.1542692
E6	0.1666277	0.0087922	18.95	0	0.149393	0.1838624
E7	0.2567094	0.0180239	14.24	0	0.2213783	0.2920404
E8	0.1642881	0.0107043	15.35	0	0.1433051	0.1852711
E9	0.1468196	0.0218041	6.73	0	0.1040784	0.1895607
E10	0.2037708	0.04605	4.42	0	0.1135019	0.2940397
E11	0.1382876	0.0367182	3.77	0	0.0663112	0.210264
I1	0.06344	0.0103444	6.13	0	0.0431625	0.0837176
I2	0.1147603	0.0088746	12.93	0	0.097364	0.1321565
I3	0.1411675	0.0089963	15.69	0	0.1235327	0.1588023
I4	0.1408124	0.0097219	14.48	0	0.1217553	0.1598695
I5	0.1699943	0.0107093	15.87	0	0.1490017	0.190987
I6	0.1398115	0.0108005	12.94	0	0.11864	0.160983
I7	0.1616655	0.0110342	14.65	0	0.1400359	0.1832952
I8	0.1569118	0.0138177	11.36	0	0.129826	0.1839977
I9	0.1981768	0.0213224	9.29	0	0.1563799	0.2399736
I10	0.1667504	0.020584	8.1	0	0.1264009	0.2070998
I11	0.1689029	0.0206639	8.17	0	0.1283968	0.209409
I12	0.1948962	0.0166187	11.73	0	0.1623197	0.2274727
Constant	2.113776	0.0117458	179.96	0	2.090751	2.1368

Table 6.5: Regression Results

The regression results (given in Table 6.5) show that there is no much effect of the location on the variation in demand for Islamic banking, as all the five locations show no significant variation. This should be interesting for those who believe that the real demand for Islamic banking is in the urban areas, as the results suggest that demand is evenly distributed between urban, rural and suburban areas[36].

There is some small difference of incidence of demand for Islamic baking between men and women, as the former tend to exhibit almost 10% more demand for Islamic banking than the latter. Similarly, religious sects do not show significant variation in demand for Islamic banking.

It is also clear from the results above that demand is evenly distributed amongst different age groups. The results given in Table 6.5 are helpful, as simple observation of the data otherwise may very well be misleading. This point can be illustrated with the help of the Figure 6.8.



*S= Single M=Married.

Figure 6.8: Age and Incidence of Demand for Islamic Banking

Figure 6.8 suggests that demand for Islamic banking decreases with the increase in age (as revealed by the raw data). It also shows that demand for conventional banking amongst the older population outstrips the demand for Islamic banking. However, regression analysis suggests that demand for Islamic banking is almost evenly distributed amongst all age groups, with very small variations, between about 2% to 4.5% more from the baseline age bracket of 18-30 years.

[37] If there were 1,000 customers of Islamic banking in the inner cities, the analysis suggests the planned areas of the cities (like Clifton in Karachi, Gulberg in Lahore and Satellite Town in Rawalpindi) will have 1,013 Islamic customers. Slightly more, 1,047, will fall in the urban katchi abadis (or unplanned urban growth areas). Suburban areas would have 976 Islamic customers, and rural areas 1,010.

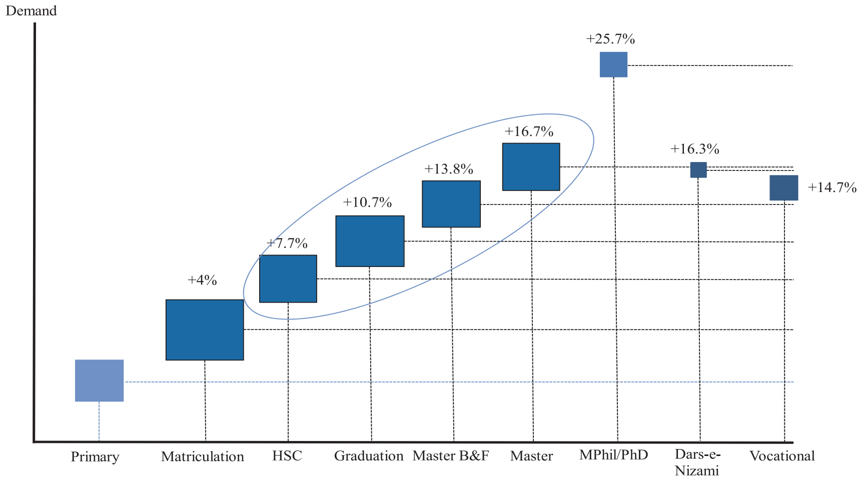


Figure 6.9: Educational Attainment and Demand for Islamic Banking

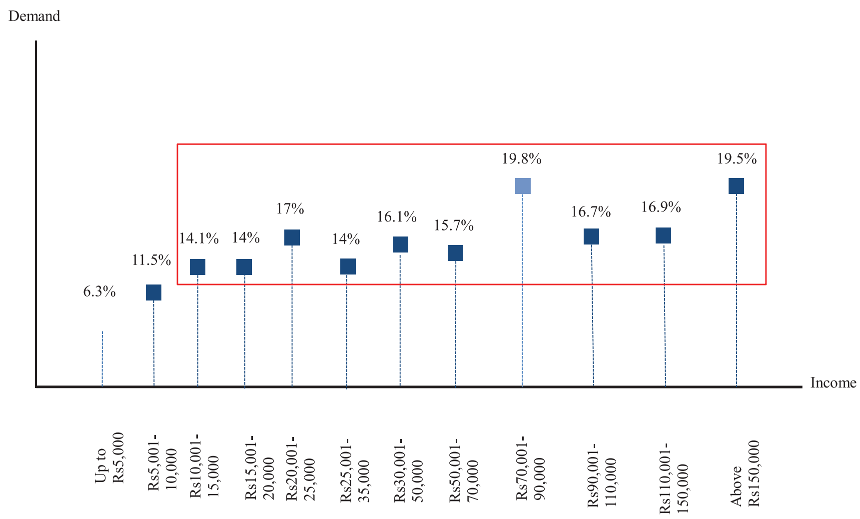


Figure 6.10: Relationship between Income and Incidence of Demand for Islamic Banking

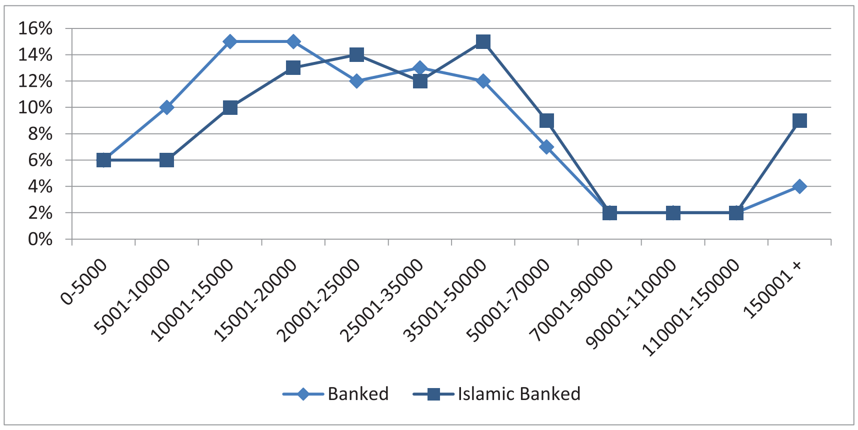


Figure 6.11: Income Levels of the Respondents

It is, however, interesting to observe that demand exhibits a clear upward trend with the increase in education level. Someone with an MPhil or PhD exhibits 25% more demand than someone with basic education (to primary school level). Hence, there is clear indications that demand for Islamic banking is more amongst relatively highly educated. It is curious to note that a graduate of an Islamic school shows almost 10% less demand as compared with an MPhil or PhD degree. Figure 6.9 compares educational attainment with demand for Islamic banking.

Figure 6.9 shows the increase in demand for Islamic banking in Pakistan with reference to increase in educational level. Although MPhil/PhD holders represent the highest demand for Islamic banking, the real opportunity for expansion lies in the education brackets between those with a higher secondary school certificate and a postgraduate qualification. This is represented by the sizes of the boxes, which roughly represent the proportion of respondents in the survey falling in these categories.

Figure 6.10 depicts the relationship between income levels and the level of demand for Islamic banking (based on the regression results given in Table 6.6). It is clear that demand for Islamic banking increases with the increase in income levels but it tends to saturate (and hence fluctuates between 14% to 20% above the baseline case) in the region marked as red. This leads one to conclude that those banks that are targeting different group levels should focus on those groups that have monthly incomes no less than Rs10,000. This includes almost all the income groups except the very poor or on the lowest income levels. Perhaps this is why most Islamic banks around the world tend to focus on the middle-income groups and the newly emerging mass affluent class of bank customers. This trend is no different from the conventional banks that focus on the same groups. This means that both conventional and Islamic banks are targeting the same groups of people. Hence, there seems to be severe competition between the two rival groups, especially in countries where Islamic banking is assuming increasing significance and importance.

It is important, however, to suggest that there is a window of opportunity for Islamic banks to target the lowest income brackets and develop micro savings and microfinance products (see next chapter for further details).

These results are consistent with the raw evidence from the dataset (given in Figure 6.11), which suggests that those in the lower income brackets are more likely to prefer conventional products over Islamic. This is perhaps due to the fact that the lower income groups have relatively simpler banking needs, i.e., just a current account or need for accepting remittances from overseas. On the other hand, people in higher income brackets tend to have other banking needs, especially in terms of access to financing products that have obvious Shari'a issues involved. While a Shari'a sensitive individual may very well be indifferent between holding a current account with a conventional or an Islamic bank, the choice does not remain simple when it comes to borrowing on an interest basis or having access to a Shari'a compliant personal finance facility.

6.4. Quantification of Demand for Business Sector in Pakistan

As in the case of retail analysis, the same method of extracting factors i.e. principal component analysis was used to construct the following Demand Index for Businesses (DIB).

$$DIB = 0.2927Y_1 + 0.1429Y_2 + 0.1364Y_3 + 0.0906Y_4 + 0.0465Y_5 + 0.0391Y_6 + 0.0348Y_7 + 0.0316Y_8 + 0.0312Y_9 + 0.0242Y_{10} + 0.0224Y_{11} + 0.0210Y_{12} + 0.0177Y_{13} + 0.0168Y_{14} + 0.0158Y_{15} + 0.0156Y_{16} + 0.0151Y_{17} + 0.0012Y_{18} + 0.0012Y_{19} + 0.0012Y_{20} + 0.0011Y_{21}$$

The above independent variables are defined in Table 6.6 below.

Factors	Description	Weightage	Variation Explained (%)
Y_1	Use of various banking services (see the list in Table 6.6a)	29.28	24.36
Y_2	Satisfaction with specific conventional banking services (see Table 6.6a)	14.29	12.38
Y_3	Satisfaction with specific Islamic banking services (see Table 6.6a)	13.65	10.91
Y_4	Characteristics of Islamic banking products	9.06	6.59
Y_5	Knowledge and understanding of Islamic banking	4.65	3.66
Y_6	General awareness about Islamic banking	3.91	3.48
Y_7	Specific factors considered in choosing a bank	3.48	2.84
Y_8	Satisfaction with specific Islamic banking services (see Table 6.6a)	3.17	2.63
Y_9	Satisfaction with specific conventional banking services (see Table 6.6a)	3.13	2.8
Y_{10}	Satisfaction with specific conventional banking services (see Table 6.6a)	2.42	2.37
Y_{11}	Specific factors considered in choosing a bank (see Table 6.6a)	2.24	1.76
Y_{12}	Satisfaction with specific Islamic banking services (see Table 6.6a)	2.11	1.63
Y_{13}	Satisfaction with specific Islamic banking services (see Table 6.6a)	1.78	1.73
Y_{14}	Inadequacy or unsuitability of Islamic banking	1.68	1.54
Y_{15}	Knowledge and understanding of specific Islamic banking products (see Table 6.6a)	1.58	1.42
Y_{16}	Belief in the prohibition of interest	1.57	1.44
Y_{17}	Interest in Islamic banking	1.51	0.14
Y_{18}	Satisfaction with specific conventional banking services (see Table 6.6a)	0.12	0.11
Y_{19}	Satisfaction with specific conventional banking services (see Table 6.6a)	0.12	0.11
Y_{20}	Inadequacy and unsuitability of Islamic banking	0.12	0.07
Y_{21}	Shari'a authenticity of Islamic banking products	0.11	0.08

Table 6.6: Constituent Factors of Demand for Islamic Banking by Businesses

Table 6.7 provides minimum and maximum values of DIB for those businesses who are actually using Islamic banking services (either have a bank account with an Islamic bank or with an Islamic branch of a conventional bank) and those who are the users of conventional banking services.

Given that there is not much difference between the DIB values for the users (68 in total) and non-users of Islamic banking services (932 in number), the classification method used in case of the retail side data is even more adequate for the corporate. Consistent with the previously used classification method based on the quartiles, the range is divided into four groups to decide on the nature of demand for Islamic banking among businesses.

	Total			Users of Islamic banking			Those who are not using Islamic banking		
	Min.	Max.	Ave.	Min.	Max.	Ave.	Min.	Max.	Ave.
DIB	1.23	1.79	1.44	1.25	1.68	1.44	1.23	1.77	1.43

Table 6.7: Range of DIB: Total, Users of Islamic Banking and Users of Conventional Banking

	Staunch demand	Strong demand	Pent-up demand	No demand
	(1.65 – 1.79)	(1.51 – 1.64)	(1.37 – 1.50)	(1.23 – 1.36)
(Percentage)	*(1.9)*	*(21.5)*	*(49.6)*	*(27.0)*

Table 6.8: Classification of Demand for Islamic Banking Amongst Businesses

The range of 1.23 - 1.79 is divided into four quartiles: 1.23 - 1.36 (to correspond to "no demand" area); 1.37 - 1.50 (to correspond to "pent-up demand"); 1.51 - 1.64 ("strong demand"); and 1.65 - 1.79 ("staunch demand"). Table 6.8 presents the results.

23.4% businesses in Pakistan exhibit serious demand (staunch and strong demand) for Islamic banking. This is a significantly higher figure as compared to the retail results that suggest that only 2.33% of the households in Pakistan possess serious demand for Islamic banking products. While pent-up demand is nearly 50%, it is also important to keep in mind that 27% of the businesses in the country do not exhibit demand for Islamic banking.

6.4.1 Factors Affecting Demand for Islamic Banking among Businesses; SKURO Analysis

The contribution of various factors to demand can be summarised in five main categories (SKURO); (i) Satisfaction (S) (ii) Knowledge (iii) Use (iv) Religious beliefs and (v) others (Figure 6.12). Satisfaction with banking services (both conventional and Islamic) features dominantly in the DIB, a feature consistent with the demand analysis for the retail. There are nine factors in total related with satisfaction, explaining in total 40.79 percent variation in the demand. Prior use of banking services explains about 29.28 percent variation in demand for Islamic banking amongst businesses in Pakistan. Knowledge of Islamic banking products and general awareness about Islamic banking explains only 10.14 percent variation in the demand. Religious beliefs also play a significant role, comprising 14.05 percent of the variation in demand for Islamic banking. General factors affecting bank choice explain another 5.72 percent variation in demand for Islamic banking (see Table 6.6)[37].

Businesses have more knowledge of Islamic banking products therefore they will make more informed choices, meaning that they will be in a better position to determine whether to procure Islamic products, while retail consumers will make more visceral choices. Furthermore, banking needs of businesses are better defined and varied as compared to retail. Hence, they tend be more definite in their demand preferences.

Not unsurprisingly, this figure; the factor analysis (being a multivariate technique) has produced results that differ from univariate analysis. For example, in Chapter 5, the corporate respondents gave the religiosity of the owners as the main reason for choice of an Islamic bank, which is only captured by the third most important group of factors in the given figure.

[38] See Table A at Chapter end for Factor description

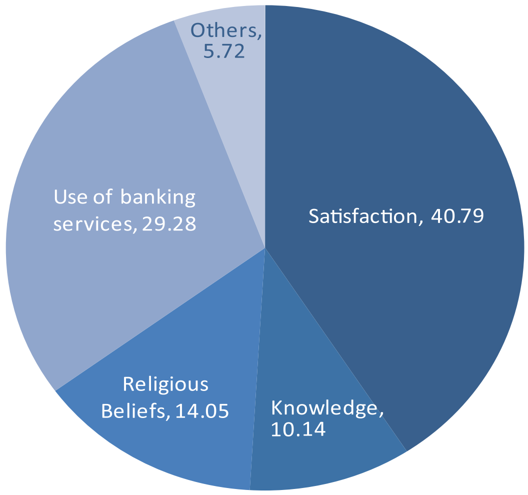


Figure 6.12: Contributions of Different Factors to Demand for Islamic Banking Amongst Businesses

6.5. A Geographical Note on Incidence of Demand

Figures 6.13 and 6.14 provide geographical maps of incidence of demand in the surveyed areas for the retail and corporate samples, respectively.

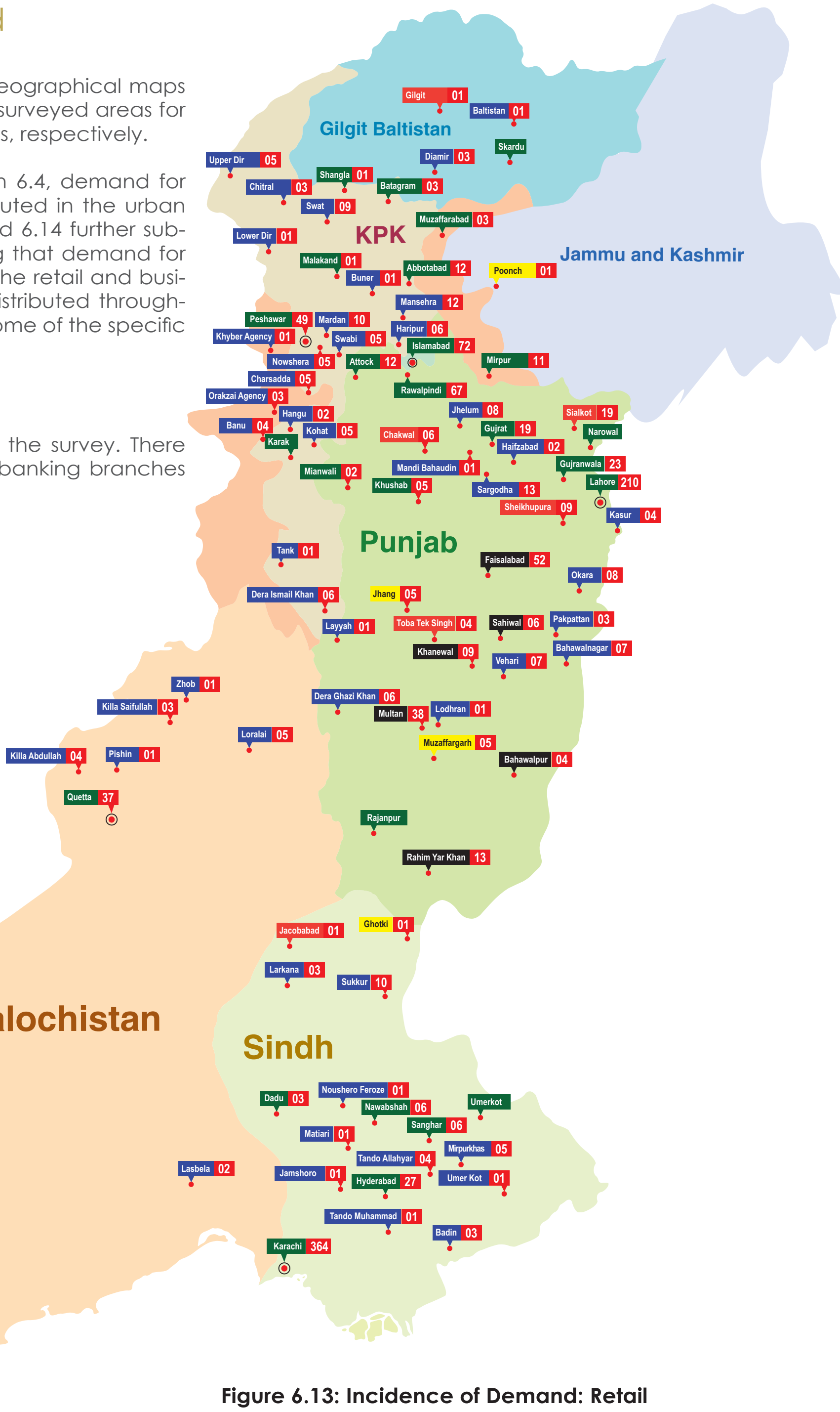
As mentioned above in Section 6.4, demand for Islamic banking is evenly distributed in the urban and rural areas. Figures 6.13 and 6.14 further substantiate this finding by showing that demand for Islamic banking amongst both the retail and business customers is also evenly distributed throughout the country. Following are some of the specific observations:

Retail:

1. 41 districts were covered by the survey. There were 37 districts where Islamic banking branches of both the full-fledged Islamic banks and conventional banks operate. There were four districts in the sample, where no Islamic banking branches are currently operating.

2. In all the districts covered by the survey, respondents showed demand for Islamic banking overwhelmingly. However, there were 26 out of 41 districts where more than 95% of the respondents exhibited demand for Islamic banking (represented by dark green boxes on the map in Figure 6.13).

3. While demand for Islamic banking is strong in KPK, northern Punjab and southern Sindh, there is an obvious relative fall in demand in the southern Punjab and northern Sindh, as in most of the surveyed districts in these areas relatively less percentage of people showed demand for Islamic banking. In fact, in 7 out of 12 districts surveyed in this area less than 90% of the respondents showed demand for Islamic banking, as opposed to over 90% in almost all of the other districts surveyed.



Retail

Percentages

- <85
- 86-90
- 91-95
- 96-100
- Not included in the survey

Figure 6.13: Incidence of Demand: Retail

Corporate:

1. Demand for Islamic banking amongst businesses is even more evenly distributed amongst all the districts included in the survey. There is no conclusive evidence that the demand for Islamic banking by businesses located in large and industrial cities is more intense than the businesses located elsewhere.

2. As discussed earlier, overall demand for Islamic banking is less as compared to the demand by the retail customers.

While revealed demand for Islamic banking amongst households and corporates can adequately be explained with the help of equations, this report recommends that another general measure of demand, what we call here as effective demand must also be considered.

The effective demand from households and Corporates is calculated as follows:

$$ED = \left[(N_3 - A)\alpha_1 + (N_2 - B)\alpha_2\right] + \left[(N_3 - C)\alpha_2\right] \text{.............Equation 5}$$

Where

$$A = \frac{N_2}{N_1+N_2} x100,\ B = \frac{N_1}{N_1+N_2} x100,\ C = N_2$$

a_1 = the switching factor as determined by our analysis in demand index (a1 equals 0.20 for household data and 0.28 for the corporate)

a_2 = the inclination to switch as revealed by the respondents in the surveys (a^2 equals 0.74 for the household and 0.30 for the corporate)

N_1 = Number of observations in the "staunch" demand category

N_2 = Number of observations in the "strong" demand category

N_3 = Number of observations in the "pent-up" demand category

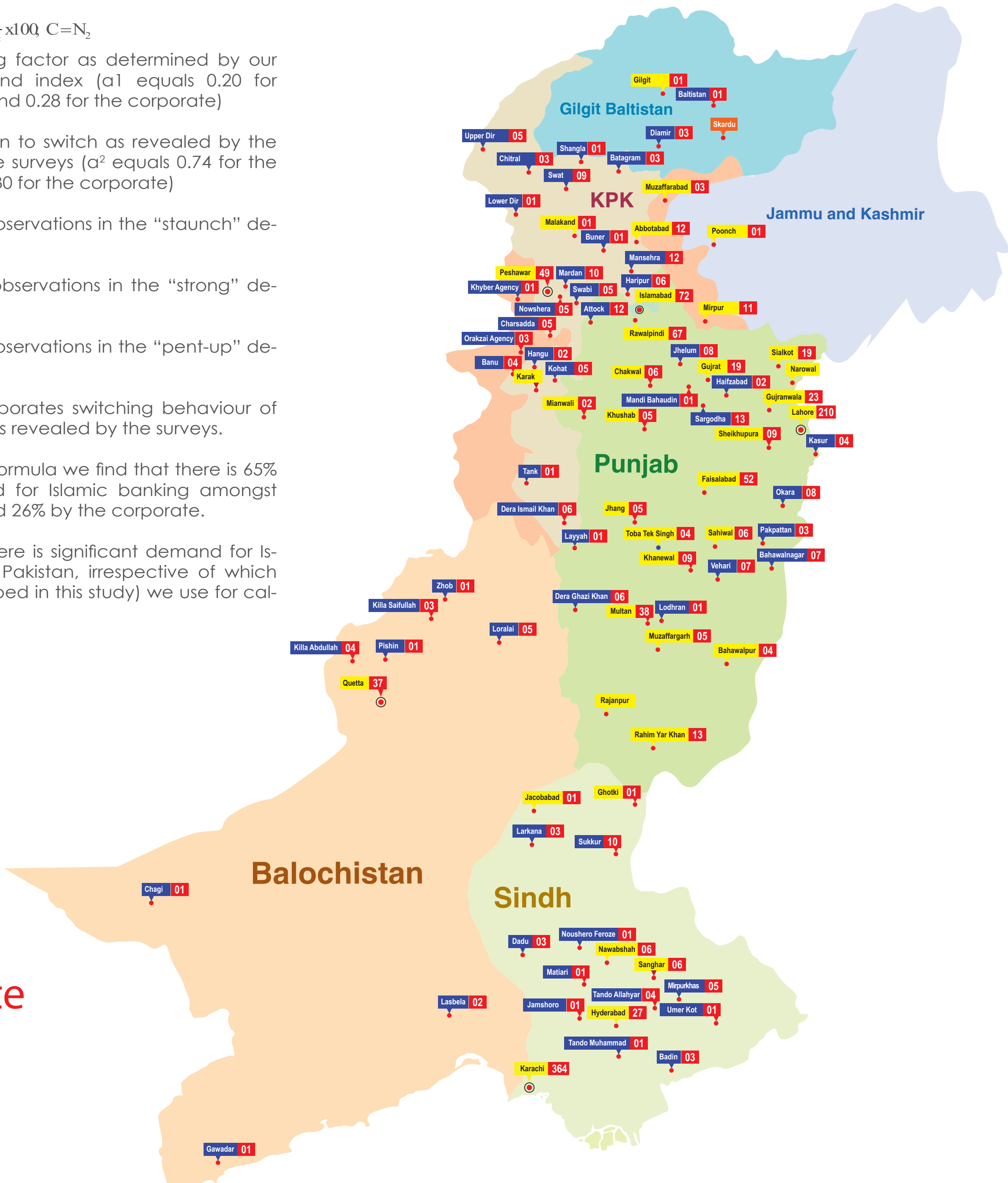
This formula incorporates switching behaviour of the respondents as revealed by the surveys.

Using the above formula we find that there is 65% effective demand for Islamic banking amongst the household and 26% by the corporate.

This shows that there is significant demand for Islamic banking in Pakistan, irrespective of which formulae (developed in this study) we use for calculations.

6.7. Summary

This chapter clearly demonstrates that there is significant demand for Islamic banking amongst retail and business in Pakistan. It follows from the analysis that while overall demand for Islamic banking amongst the retail is higher than the businesses (nearly 95% for households and about 73% for businesses), the effective demand for Islamic banking amongst businesses and individuals also remains consistent (26% for businesses as opposed to 65% for individuals). Given that most of the untapped demand for Islamic banking is in the districts where Islamic banking branches are already operating, there is a need to develop outreach programmes to bring potential Islamic customers into Islamic banking net. This applies both to the retail and corporate customers.



Corporate

Percentages

- <85
- 86-90
- 91-95
- 96-100
- Not included in the survey

Figure 6.14: Incidence of Demand: The Corporate

Factors	Variables
X_1	General satisfaction with Islamic banking, religious satisfaction, interest free nature of Islamic banking, coverage of Islamic banking products to personal and business needs, service quality, the use of profit loss sharing, pricing of Islamic banking products, advice and guidance of Shari'a scholars, convenience of location, customer relationship, working hours, branch décor and comfort, staff cooperation and help
X_2	Lack of local presence of Islamic banking branches, no belief in Islamic banking, usefulness of conventional banking products, satisfaction with conventional banks and their products, availability of conventional banking products, inability to switch to Islamic banking, similarity between Islamic and conventional products, documentation of Islamic banking products
X_3	Fixed deposits, foreign currency accounts, investment accounts, monthly income schemes, certificates of investment and term finance certificates, personal and household equipment finance, credit cards, children education accounts, agriculture finance, remittance/cash transfer facilities, export/import finance, bankatakaful, bank guarantee, lockers, internet banking
X_4	Shari'a vetting of products and Shari'a audit, simplicity of products, customer services quality, efficiency of Islamic products delivery, Shari'a compliance of legal documentation, transparency and information disclosure
X_5	Ijara, Murabaha, Salam, Istisna' and diminishing Musharaka
X_6	Understanding of Islamic banking model, deposits and other products, understanding of Shari'a compliance mechanism
X_7	Interest free loans, willingness to bear loss on deposits and Shari'a premium
X_8	Interest in Islamic banking, saving accounts, willingness to switch to Islamic banking, religious satisfaction, and the interest free nature of Islamic banking
X_9	Comprehensiveness of Islamic banking products, service quality, reputation, principle of profit loss sharing, availability of Islamic financial products
X_{10}	Awareness of Islamic banks and its products Qard Hasana, Mudaraba, Musharaka
X_{11}	Prohibition of interest and bank interest
X_{12}	Working capital financing, non-availability of Islamic banking locally, Limitation of outreach of Islamic banking
X_{13}	Home finance, and auto finance
X_{14}	Pricing of Islamic banking products, withdrawal of funds in case an Islamic bank underperforms
X_{15}	Current account
X_{16}	ATM/debit card,
X_{17}	Shari'a compliancy of Islamic banking products
X_{18}	Length of time with an Islamic bank
X_{19}	Reputation of Islamic banking
X_{20}	Complexity of documentation

Table A: Composition of Factors: Retail Sample

Factors	Variables
Y_1	Basic banking products like current account and cash management account, and assets side products like working capital finance, trade finance, projects finance, corporate overdraft facility
Y_2	Financing products like foreign exchange loan, pre and post shipment export financing, import financing, LMM financing, project finance, bridge finance, treasury products, receivable financing, financing against liquid securities, syndication /c consortium financing, mutual funds, investment products, real estate finance, commodity financing, SBP export refinance, bank guarantee, note issuance facility, offshore banking, securitisation, underwriting and other facilities like tele-banking
Y_3	Project finance, real estate finance, investment products, bridge finance, pre and post shipment export financing, Islamic export refinance scheme, export bills for collection, Mudaraba finance, Musharaka finance, diminishing Musharaka, Islamic investment funds, syndication financing, securitisation, offshore banking
Y_8	Ijara, Murabaha, Salam, Istisna' and diminishing Musharaka
Y_9	Trade finance, corporate overdraft, import financing, underwriting and internet banking
Y_{10}	Foreign currency account, cash management account, running finance / overdraft, balance transfer facility, working capital finance, corporate credit card, and internet banking
Y_{12}	Letter of credit / letter of guarantee, standby letter of credit, and bank guarantee
Y_{13}	Cash management account, Ijara, and remittance / cash transfer
Y_{15}	Working capital finance based on Mudaraba, Salam or Istisna', Murabaha finance and tele banking
Y_{18}	Letter of credit / letter of guarantee, standby letter of credit, bank guarantee, and remittance / fund transfer facility
Y_{19}	Saving account, daily product account
All other factors are single variable factors	

Table B: Composition of Factors Corporate Sample

Chapter 7
Supply Side Analysis

7.1. Introduction

After a comprehensive demand analysis in the previous two chapters, this chapter focuses on the supply side of Islamic banking in Pakistan. The analysis herein is based on 100 interviews with senior and middle level managers (including Shari'a advisers) of 5 full-fledged Islamic banks and 11 conventional banks with Islamic banking windows, covering almost 89% of all the banks engaged in Islamic banking. Interviews have an added advantage of capturing individual opinions. These interviews solicited information regarding the knowledge and attitude of Islamic banking professionals and also explored current practices and issues confronted by the industry. As in the demand side surveys, supply side interviews covered the following:

Knowledge: Insight into respondents' understanding of the industry and their motivation for being in the industry.

Attitude: Personal beliefs and interest in Islamic banking. Questions also assessed respondents' opinions on the current paradigm of Islamic banking compared to conventional banking, and whether banks can be involved in trade based modes of financing.

Practices: Interviews also focused on respondents' views on problems and challenges faced as an Islamic banker, and their views on participatory modes of financing, agriculture and small and medium enterprises (SME) financing, expectations regarding growth of the industry in Pakistan, potential demand areas and the type of products demanded by customers.

7.2. Knowledge

7.2.1. Awareness of the Prohibition of Interest

The commitment to, and hence expertise in, Islamic banking is determined by a number of factors, but the most crucial is comprehension of its philosophy and paradigm. It is expected that an employee of an Islamic bank, with limited interest in, and knowledge of Islamic banking, may have an adverse effect on the business, especially by dampening the enthusiasm of many potential customers of Islamic banking if they happen to interact with such an employee. This section reviews respondents' reasons for choosing to be in the Islamic banking industry, opinions on riba and Maqasid al Shari'a.

The decision to join an Islamic bank is very much a religious decision, as most of the respondents stated religious satisfaction as their primary reason for starting or switching their career to Islamic banking It might very well be the case that many people do not enter into banking operations because of their belief in the prohibition of interest, but the present survey did not capture that segment of the labour market because it was beyond its scope. However, from the response of the interviewees one may conclude that there is some anecdotal evidence that the prohibition of riba does give rise to some sort of voluntary exclusion by professional from the banking industry.

80% of the respondents stated that religious motivation was a primary reason behind their decision to join Islamic banking. The remaining 20% stated that working in an Islamic bank or an Islamic banking window was purely a professional move. For those who are motivated by religion, Islamic banking is different, and a halal way of earning income. One respondent stated:

"*I worked at a conventional bank for about 15 years. Following my pilgrimage [to Makkah] it jarred on my nerves that I earned my income from an interest based source that was considered haram. I finally decided not to work in a conventional bank any longer and was introduced to Islamic banking. I am convinced that it is very different to conventional banking and now I am confident that the salary I receive is halal.*" [Quotation 1]

A number of interviewees expressed similar sentiments. Almost all of the senior managers interviewed remarked that they started their career with conventional banks because there were limited opportunities in Islamic banking industry. Many knew of the prohibition of riba but chose to remain with a conventional bank for the time. With the growing presence of Islamic banks after 2002, they were able to switch. As explained by one respondent:

"*It was my desire to be an Islamic banker or part of an Islamic financial institution. When I joined the sector [banking] there was no Islamic bank operating so I had to give up my dream. But in 2003, when my bank started Islamic banking, I was lucky to be chosen for the initial project, and since then I have carried on.*" [Quotation 2]

20% of the respondents were though aware of the prohibition of riba but joined Islamic banking for professional development. These included individuals who believed Islamic banking was a growing industry, and being part of it would help their own career progression. Others regarded working in an Islamic bank as a challenge; they wanted to see if they could propel the bank forward since it is relatively a new industry.

7.2.2. Islamic Banking as a Business or a Means to Achieve the Higher Objectives of Shari'a[38]

There was little awareness of Maqasid al Shari'a (the higher objectives of Shari'a) amongst the interviewed senior management of Islamic banking institutions. Most of the respondents, however, mentioned that Islamic banking is not just an interest-free banking model. Because of the lack of understanding or awareness of Maqasid al Shari'a, most of the interviewees (56%) were not sure if the current practice of Islamic banking is in line with the Maqasid al Shari'a. 19% regarded Islamic banking as not in conformity with the Maqasid al Shari'a. 26% stated that Islamic banking fulfilled the higher objectives of Shari'a but only partially. There were only 9% of the respondents who believed that Islamic banking achieved the higher objectives of Shari'a (Figure 7.1).

Because of the lack of awareness and understanding of Maqasid al Shari'a, many interviewees did not differentiate between Shari'a compliancy and Maqasid al Shari'a. Others who were aware of Maqasid al Shari'a referred to Imam Ghazali's classification. Most of these respondents who were aware of Maqasid al Shari'a come from full-fledged Islamic banks. Some associated Maqasid with the strict legal interpretation and criticized more liberal opinions originating from other jurisdictions. For them Maqasid al-Shari'a meant offering a conservative view to Islamic banking products. Two representative responses are given below:

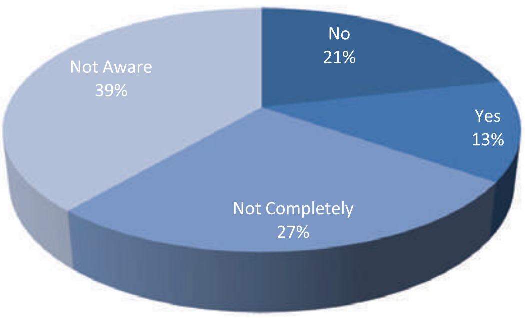


Figure 7.1: Does the current practice of Islamic banking meet the Maqasid al Shari'a?

Those who do not understand Maqasid al Shari'a

"I think Islamic banks are following the Maqasid alShari'a. All Islamic banks have their own Shari'a boards or Shari'a advisors, and hence everything is going according to Shari'a." [Quotation 3]

Those who do understand Maqasid al Shari'a

"The banking we do should not only be Shari'a compliant, it should also be compliant with the Maqasid al Shari'a and safeguard the five things mentioned by Imam Ghazali: life, religion, lineage, wealth and intellect." [Quotation 4]

7.3 Attitudes and Perceptions

7.3.1 Islamic Banking- A Banking System beyond Interest Free

Although most of the respondents were not aware of Maqasid al Shari'a, or were not sure, most of the respondents nevertheless viewed Islamic banking being more than an interest free banking model. While 34% interviewees were of the view that Islamic banking was just about being an interest-free model of banking, the remaining 64% held additional views on Islamic banking. In fact, most viewed Islamic banking as a faith-based phenomenon; something consistent with the demand analysis and the earlier suggestion in the supply side analysis (a major reason for employees of Islamic banks is religious affinity.)

39% of the respondents perceive Islamic banking not merely an interest-free system but rather a faith based practice with prohibition of interest as one of the elements laid out by the religion Islam (Figure 7.2). Islamic banking, in addition to being interest free, observes other religious proscriptions of gambling, alcohol, pork and other unethical goods and services. There were 15% who used the term ethical banking to describe additional features of Islamic banking.

"*Elimination of riba is a major factor, however, ethical values are part of Shari'a that aims for equitable distribution of wealth. The ultimate objective of Islamic banking is to have fair and just society.*" [Quotation 5]

5% believe that the Islamic banking industry is an alternative to the conventional banking system, and can also satisfy the religious sensitive population. However, they viewed Islamic banking as career option even for individuals who do not believe in the underlying faith sensitive fundamentals.

4% believed that Islamic banking is a lot more about building relationships with clients than merely being interest free. 3% believed that Islamic banking practices are all about the trading, where Islamic banks need to be trading houses rather than lending houses.

"*Islamic banking is more than just banking. It creates a stronger relationship between the bank and the customer because of variety of roles the Islamic bank play – partner, whole seller, trader, lessee, etc.*" [Quotation 6]

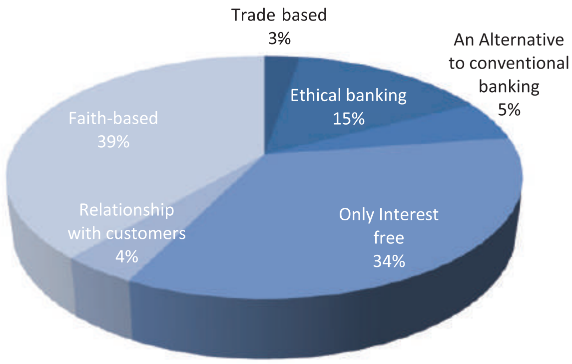


Figure 7.2: What is Islamic banking beyond being interest free?

7.3.2. Difference Between Shari'a-based and Shari'a-compliant Products

Despite the popular debate on Shari'a- compliant and Shari'a-based products, the interviewees, in general (73 %) were unaware of the distinction between the two (Figure 7.3). 28% of the respondents opined that there is a difference between Shari'a compliant and Shari'a based products; however their explanations varied. Some respondents regarded Shari'a compliance as meaning anything that is not against Shari'a. A few stated that Shari'a-based was a philosophical conceptualization. The Islamic economic system has its own values and objectives, i.e. fair distribution of wealth, poverty alleviation and other social responsibility objectives. Respondents emphasized that if these objectives were reflected in a product or contract it becomes Shari'a-based.

[39] Maqasid al Shari'a, or the higher objectives of Shari'a have different dimensions but the most commonly understood interpretation is that of Imam Ghazali who defined Maqasid al Shari'a in terms of protection and preservation of belief, life, property, intellect and lineage. The response from some of the interviewees confirmed this understanding.

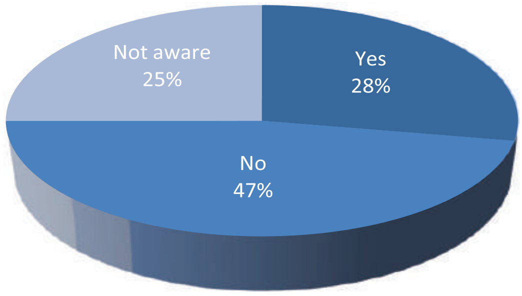


Figure 7.3: Do you differentiate between Shari'a based products and Shari'a compliant products?

About 47% believed that there is no difference between Shari'a-compliant and Shari'a-based products, and these terms should not be used as they confuse people who are new to this industry. Banks should focus on the real issue, which is offering complete Shari'a compliant solutions to clients.

25% were not sure about the distinction but believed that it was the job of their Shari'a advisor to proclaim a product as Shari'a-compliant or Shari'a-based. Majority of the Shari'a advisors, who were interviewed, however, opined that there was no distinction between a Shari'a-compliant and a Shari'a-based product.

"*A product is either Shari'a compliant or not; if a product is Shari'a compliant, it is also Shari'a based,*" [Quotation 7]

7.3.3. Universal Banking versus Commercial Banking

Universal banking is defined as a banking system in which banks provide a wide variety of financial services, including both commercial and investment banking services. About 90% of the total respondents answered that Islamic banks should follow the universal banking model. They also maintained that the prevailing banking system in Pakistan was working fairly well and in the best interest of Islamic banking. One respondent explained:

"*It suits us to be a commercial bank rather than focusing on investment banking. It is unlikely that investment banking will be a predominant part of our banking*." [Quotation 8]

A respondent highlighting the benefit of universal banking model mentioned:

"*I think universal banking model is the best for the growth of Islamic banking. There is more scope for us in universal banking*." [Quotation 9]

This view is perhaps based on the opinion of some of the industry analysts that universal banking suits Islamic banking better, as it allows banks to get involved in a multitude of activities – both commercial and investment banking. Given that Islamic banking is more trade-oriented, the universal banking model suits it better.

58% of respondents believed that Islamic banks should be involved in trade wherein they should actually buy and sell commodities, and not merely use agency arrangements with clients in order to transfer the function of trading in commodities. A few respondents suggested employing the Kuwait Finance House model in Pakistan. It was also suggested that Islamic banks should take both the risk of commodity and price. One respondent stated:

"*Islamic banks should move gradually towards real trade. We should develop expertise for that and we could do it for certain products such as cars and real estate. I think that will give Islamic banking an added uniqueness.*" [Quotation 10]

On the other hand, approximately 42% respondents believed that Islamic banks should not be involved in physical trade where they actually deal in real commodities. They should do what they do best, which is banking. In justifying this opinion, several respondents felt that Islamic banks do not have any expertise in trading real assets, and if banks were to diversify, it would add a lot of risk to their balance sheet. They felt that the current agency structure does not create any problems as contracts are disclosed and are in line with Shari'a. Therefore, there is no need to be involved in real trade of goods.

This opinion seems to be based on the existing level of expertise amongst bankers in general and Islamic bankers in particular. There is a need to develop trade oriented expertise amongst the management of Islamic banking institutions. The inclusion of real sector specialist in Islamic banks will certainly enhance the scope of Islamic banking and improve their perception. There is, in particular, a need to employ SME financing experts in Islamic banks, who have hands-on experience of running and managing SMEs. A great number of SMEs need management expertise to expand their operations but face difficulty in procuring such assistance because it is expensive to have access to management consulting services. Islamic banks can fill this vacuum by employing SME experts who should be able to get involved in the business of the SMEs they attempt to finance. This will not only increase profitability of Islamic banks but will also immensely benefit the SME sector to grow.

A related question is about the use of profit loss sharing (PLS) modes in Islamic banking. Most Islamic banks shy away from offering PLS-based financing to businesses primarily because they do not have the required resources to monitor and supervise operations and financials of the businesses. This is despite an overwhelming appetite by businesses to procure financing on the basis of PLS (see Chapter 5, Figure 5.23).

Given that about 64% respondents on the demand side would prefer to receive financing on PLS basis (Chapter 5, Figure 5.23) and 80% of the managers of Islamic banks think that there is a need to provide financing based on the PLS, what are the reasons that Islamic banks have shied away from providing PLS-based financing?

Most respondents believed that Islamic banks should use products based on profit and loss (80%). Some suggested that Islamic banks should allocate a certain percentage of their deposits for profit and loss based products. 20% of the respondents highlighted profound challenges for adopting profit and loss model; it is very difficult for Islamic banks to go for profit and loss sharing financing in the country because the legal system does not support such contracts. Given the overall economic condition of the country it is very difficult for banks to function based on such contracts. According to a Senior Manager of an Islamic bank:

"*Musharaka is not the only product Islamic banking has; there are other products as well. However, Mushakara is the last thing a bank would offer due to moral hazard and issues like high tax payments such products attract.*" [Quotation 11]

Other respondents expressed that people would not like to share their financial information with banks, making it very difficult for a bank to assess their viability in a profit and loss partnership.

Of the 20% respondents who believed Islamic banks should not offer profit and loss based products, reasoned that information about business of an individual or a corporate is crucial to effectiveness of such contracts. If a client does not dis close financial information, it would create mistrust between the client and the bank. Some of the respondents said that a large proportion of SMEs in Pakistan are not properly documented. Many small businesses do not have a bank account and the business activity is done in the name of the owner i.e. personal accounts are being used for businesses. Lack of proper records of such businesses makes customer assessment, particularly credit history extremely difficult and hence banks are unable to extend financing, even on the basis of interest. Few of the respondents stated that they would be happy to work on profit and loss basis on the liability side but not on the asset side of the bank's balance sheet.

Banks apparently face difficulties in having PLS based transactions with large corporate as one respondent mentioned

"In Musharaka based products you are sharing a larger portion of the profit, but generally big businesses feel happy to give away small amounts as interest, profit or taxes and don't allow banks to interfere in their policies and tax matters." [Quotation 12]

Several respondents argued that the promotion of such products is dependent on improvement in the legal and regulatory environment, transparency and more disclosure on part of the client. Moreover, as mentioned earlier, inclusion of a sector specialist in the management of Islamic banks will certainly help in promoting PLS based financing. Islamic banks are presently manned by bankers having no experience and insights of various rural sector businesses; this may be acceptable rather desirable in conventional banks but not in Islamic banks whose business is either assets based or PLS based which the bankers alone could not manage. In this regard, there is a need for training staff to become effective supervisors of the financed businesses.

7.4. Practices

This section focuses on practices of Islamic banks while presenting responses of practitioners with particular reference to issues and challenges confronted by the industry.

Respondents in general were convinced about the value proposition of Islamic banking. In particular, they revealed that working in an Islamic banking institution would involve distinct roles and responsibilities. In a country like Pakistan where dual banking system is adopted the personnel involved in Islamic banking face some real challenges.

7.4.1 Challenges of Working in a Dual System

87% of respondents answered this question with 62% expressing that the current dual banking system prevailing in the country poses its own challenges. Several respondents felt that customer brand loyalty makes it difficult for Islamic banks to draw in customers who have got history with conventional banks and according to them Islamic banks have to offer more competitively priced products to attract such clientele. Legal system was also viewed as a challenge for the industry as the same legal principles, statutes and cases are used to adjudicate both conventional and Islamic banking. The conventional side is firmly embedded in the system and there are more facilities to help them sustain themselves compared to Islamic banking institutions. For instance, on the liquidity management side, tools are far more advanced for conventional banking, which means that Islamic banks lose out.

38% of the respondents felt that working in the dual banking system did not pose any real challenges. Most of these respondents felt that irrespective of the dual banking system, there is a strong growth potential due to the unique value proposition of Islamic banking. Firstly, the majority of the population is Muslim, which would make it easier to sell Islamic banking products. Secondly, there is a large untapped market in the country that even the conventional sector has yet to provide services to. Respondents felt that this significant group would procure Islamic products and services that are in line with their beliefs and values, if offered to them. They felt that Islamic banks should tap into rural areas and try and attract investment from those areas where even conventional banking has not reached.

However, almost all respondents stated that a real challenge of being in a dual banking system was the need to continuously educate the public about Islamic banking. This is in line with the demand analysis that suggests that a very significant proportion of the general public are unable to see a difference between Islamic and conventional banking. Although there is an overwhelming belief held by the general public in favour of the prohibition of interest, not all of them are sufficiently convinced of the Shari'a compliancy of Islamic banking products.

In particular, there is an impression that Islamic windows are treated with suspicion. This realization is significantly real in the wake of the preference of the banking consumers in favour of a full-fledged Islamic bank. Perhaps this is why many supply-side respondents also suggested that the system should evolve in such a way that it eventually favours full-fledged Islamic banks instead of Islamic banking windows. Many respondents from Islamic windows in conventional banks revealed their difficulty in convincing public of the complete segregation of their Islamic operations from the conventional side of the business. Although some conventional banks have succeeded in setting their Islamic banking operations, however, it is a continuous challenge that they face when procuring new Islamic business. One head of Islamic banking with a conventional bank summarized the challenge in the following words:

"There are lots of challenges: first of all it is very difficult for us to make people understand that though we are part of the conventional setup, we are operating as a separate entity. We have our own set of accounts, assets and liabilities. We are a bank within a bank and that needs a lot of clarification from our end. Also, it takes a lot of our time and effort to make our management understand the reason for launching a new product, and by the time it is launched, that product has already been introduced by a full-fledged [Islamic] bank." [Quotation 13]

This is an interesting observation. While in general Islamic banks complain of tough competition from conventional banks, the conventional banks offering Islamic banking also face different challenges in this regard. The most important challenge is to convince the top management of the parent bank that Islamic banking products offered by them will not cannibalize their own conventional business. This is the main hindrance to further development of Islamic banking in the country.

Some of those in Islamic windows of conventional banks felt that the strategic agenda of the parent bank has always been to keep their Islamic windows at a certain size. 71% of respondents of Islamic windows stated that they were not allowed to target the conventional bank's customers as it brings direct competition with the parent company. If a customer of the parent conventional bank requests Islamic banking only then can the Islamic window cater to the customer's needs. A senior personnel of an Islamic window of a conventional bank stated:

"There is a problem. We have to get clearance for this. Let us suppose a customer is willing to work with us, and they want to have an Islamic mode of financing. In order to have them we have to get the clearance from the parent bank to offer the service." [Quotation 14]

If a customer is closing his account with the parent company and is expected to approach competitor banks, the Islamic banking division will then be allowed to approach the customer directly with the view that it might help retain the client.

It is very clear that both the full-fledged Islamic banks and the Islamic banking windows have their own sets of challenges of working in a dual banking system. While the concerns of full-fledged Islamic banks are easier to understand, the question arises why conventional banks are not fully convinced of the growth potential of Islamic banking. Some possible explanations are given in the following:

1. As no authentic information is available on the true potential of Islamic banking, conventional banks have yet to convince themselves that there is a real demand for Islamic banking in the country. Most of these banks believe that Islamic banking is primarily driven by supply and that the majority of those who are at present demanding Islamic banking is because they have access to Islamic banking products. The demand, according to them, is not strong enough to force their customers and clients to switch from conventional to Islamic banking.

2. Setting up Islamic banking operations and expanding and maintaining them require substantial costs. Somehow, shareholders and managers of conventional banks still believe that costs of setting up and expanding their Islamic operations are significantly higher than the expected benefits, at least in the short run.

3. The well-established banking families in the country have yet to be convinced by the real proposition of Islamic banking. There is an inherent resistance to Islamic banking and hence they are reluctant to expand their Islamic banking operations. Islamic banking has so far been introduced and expanded with the help of foreign capital. This is why those banks that have foreign partial ownerships are more into Islamic banking than those that are principally owned and controlled by local families and groups and government.

7.4.2. Efficiency of the Current Islamic Banking System

50% respondents were of the view that the current paradigm of Islamic banking is more efficient than conventional banking because it is directly related to real assets and economic activity (Figure 7.4).

41% believed that the current Islamic banking system is not as efficient as conventional banking, primarily because Islamic banking is relatively new. The Islamic banking industry in Pakistan lacks liquidity management instruments and a legal framework. There is a need to offer innovative Islamic banking products, so that more people are attracted towards it. Cumbersome documentation, detailed Shari'a review and audits are among factors that raise cost of doing business thereby portraying Islamic banking as a relatively less efficient system.

9% of respondents stated that efficiency is comparatively the same in both Islamic and conventional banks.

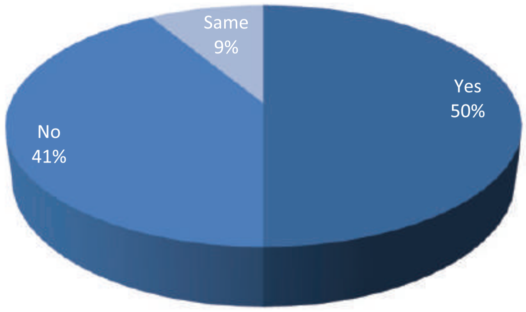


Figure 7.4: Do you think that the current paradigm of Islamic banking is more efficient than conventional banking?

7.4.3. Roles and Responsibilities of Working in an Islamic Banking Institution

One should expect that the roles and responsibilities of the personnel involved in Islamic banking not to be significantly different from those who are working in conventional banking institutions. The Islamic banking personnel, however, opined that despite obvious similarities between the two; in essence the two roles are very different. 78% of the respondents believed that roles though appear similar (e.g. a risk manager performs similar duties irrespective as to whether it is conventional or Islamic) but they are very different (Figure 7.5). For example, a head of an Islamic banking institution stated:

"We should be convinced, committed and dedicated to perform the job in the right manner, as we are involved in Islamic banking. We need not only look at the economic viability of each transaction but also ensure Shari'a compliance on each step. People have a lot of expectations from us (especially being head of Islamic finance) since it's not just banking but has a religious element embedded in it" [Quotation 15]

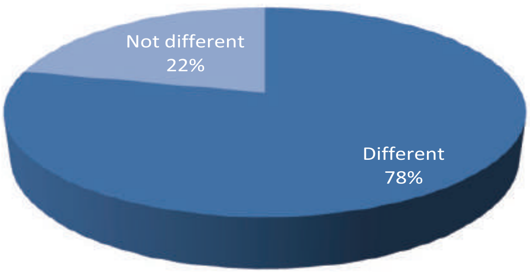


Figure 7.5: Is your role different from the corresponding role in a conventional bank?

It is obvious that while technical aspects of an Islamic banking job appear the same, the Islamic banking personnel have to show added due diligence on the matters related with Shari'a compliancy. They also have to meet the expectations of their clients, ensuring that their product offerings and operations not only remain Shari'a compliant but are also perceived to be so. In this respect, ensuring Shari'a compliance is the most important function. After all, Islamic banking is primarily a religious phenomenon and ensuring that all its aspects remain in compliance with Shari'a is a real challenge.

A large number of respondents believed that challenges do not pertain to the execution of expected duties rather the challenges are related to the overall Islamic banking and finance industry. Switching to Islamic banking is after all a paradigm shift and the potential customers of Islamic banking must be sufficiently convinced that the products they are being sold are truly Shari'a- compli ant.

The respondents highlighted that, first of all, it is very difficult to change perceptions of people who are using conventional banking. Many potential customers have questions that remain unanswered by the branch staff of an Islamic bank. Unfortunately, these potential customers leave with the conclusion that Islamic banking is not really Islamic and there is not much difference between the two.

It is difficult for Islamic banks to attract clients compared to conventional since they not only have to market the viability of the product but also have to convince the client about its value proposition and adherence to Shari'a.

In addition, people do not like switching because of hassle involved in moving an account; and if they are not sufficiently convinced of the value proposition of Islamic banking, they would see little reason to go through the trouble of switching. One senior staff member of an Islamic bank aptly remarked:

"It is easy to make a Shari'a compliant product but the bigger challenge comes in the implementation of that product at a branch level. When a customer sees an Islamic bank their expectations from the bank are very high in terms of ethical standards and shari'a compliance." [Quotation16]

According to one respondent a significant challenge for an Islamic bank is the Shari'a approval process (which is not applicable in conventional banking) and makes the product approval time lengthy and costly.

"The main challenge is that the turnover time increases since you have to ensure regulatory compliance, then comes the Shari'a filter which is quite demanding since you have to visit the customer and make a phone call to the supplier to see whether he has delivered the goods or not. Moreover, your cost increases since the Shari'a team travels all around the country, and for certain transactions they have to verify each and every step." [Quotation 17]

7.4.4. Building Human Resources

Human resource is important for any industry and Islamic banking is no exception. Considering human resource as one of the most critical elements towards the growth of industry, respondents indicated multiple factors that are considered while hiring. 49% of the respondents considered professionalism as the most important factor when hiring new staff (Figure 7.6). Of this 49% respondents 72% mentioned commitment to the industry and eagerness to learn Islamic banking as among important factors. Another 28% mentioned honesty, integrity and previous work experience as a banker as imperative for recruitment.

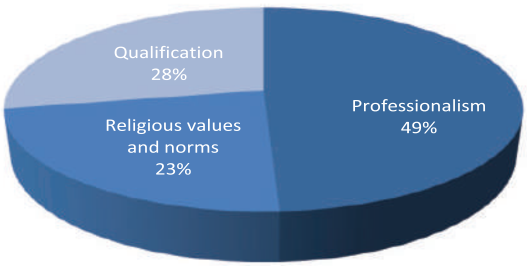


Figure 7.6: If you are involved in hiring staff, what characteristics are you looking for in addition to qualifications?

28% of the respondents stated that it is important for the professional to have an academic qualification in Islamic banking and finance either in the form of a degree or completing professional courses. For an individual in a Shari'a department, the bank expects the professional to have a relevant academic qualification, command of the Arabic language and some experience of going through legal documents.

23% of the respondents expressed that they look for candidates' religious sensitivity:

"If given the choice between someone who is willing to practice Islamic banking with a religious zeal and a true spirit, or someone who is an opportunist coming into Islamic banking because it's a new line and he will have a better growth opportunity, then I prefer to have on board the person with religious zeal." [Quotation 18]

It is an interesting finding. While professionalism remains the most important factor, a qualification in Islamic banking and finance is also considered very important. It is, however, important to mention that there are not many academic institutions in Pakistan that offer specialized degree programmes in Islamic banking and finance. Given this, the supply of adequately qualified personnel for Islamic banking institutions remains a major challenge.

7.4.5. Shari'a Assurance Process

In Pakistan the Shari'a assurance process for Islamic banking institutions involves:

1. A Shari'a advisor appointed by individual Islamic banking institutions to ensure that their product offerings remain in compliance with Shari'a.

2. Shari'a audits of the individual Islamic banking institutions conducted by SBP.

Majority of respondents saw Shari'a advisors' role of critical importance within their institution. In Islamic banking institutions in Pakistan, the Shari'a advisor is actively involved in the product development process and determines the overall Shari'a strategy for the institution:

"Our Shari'a advisor is involved in reviewing the transaction, auditing products and even giving opinion on other activities like HR policies." [Quotation 19]

Few respondents stated their preference for a Shari'a board instead of a single Shari'a advisor as they felt it is always good to have multiple opinions. Another respondent while highlighting the importance of the role for Shari'a advisor stated that:

"The role of the Shari'a advisor is very important, not only to advise on what contract - Musharaka or Ijarah - to be used but also in structuring a transaction since every customer is different from the other, and hence the demands are different. I think there should be a team working under the Shari'a advisor for structuring. Having a Shari'a board is definitely better than having a Shari'a advisor and if they sit together they can add more expertise as they might see things differently." [Quotation 20]

Another respondent added:

"The role of Shari'a board or Shari'a advisor is the most important in an Islamic bank, as they are involved in every stage of product development, its implementation, execution and distribution." [Quotation 21]

Overwhelming majority of respondents were satisfied with their Shari'a advisor; 96% of the respondents stated that they were satisfied with the services provided by their Shari'a advisor and the other 4% preferred to have a Shari'a board at the bank instead of having just a Shari'a advisor. One senior

Islamic banker commented:

"I am very much satisfied with the services provided by the Shari'a advisor. Whenever there is a problem we go directly to him and discuss the matter. If he feels that something is not being carried out in accordance to Shari'a, he promptly rectifies the problem. He is very cooperative, and is keen to promote Islamic banking industry in the country." [Quotation 22]

Interestingly, while recognizing the importance of Shari'a scholars some respondents expressed the need for finance related training for them so that they can have better understanding of modern financial needs and practices. While this is the view of a minority, it is an important suggestion. It is important that Shari'a advisors at Islamic banking institutions are encouraged and supported to pursue banking and finance related qualifications as part of their continuous professional development.

7.4.6. Risks in Islamic Banking

Like conventional banks, Islamic banks face a multitude of risks but there are some risks that are unique to Islamic banks. The most important of these is Shari'a compliance risk. Another important risk unique to Islamic banking is displaced commercial risk, however, no respondent mentioned this as a credible risk during the interviews.

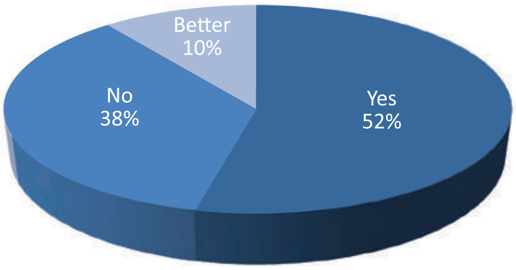


Figure 7.7: Is risk mitigation more challenging for Islamic finance institutions?

Figure 7.7 shows that a majority of Islamic banking respondents (52%) reported that risk mitigation in an Islamic bank is more challenging than conventional banks. They were of the view that there is a need to develop different risk management tools as the nature of risk in an Islamic bank is not the same as in a conventional bank. There are a number of risks that are unique to Islamic banking products. For example, a Murabaha-based transaction will involve the usual credit risk, but Islamic banks may also face commodity risk in addition to the added operational risk that may emanate from the complicated nature of Murabaha as compared to a conventional interest-based loan. For those Islamic banking institutions that do not impose default penalty (there was at least one bank that practices non-inclusion of default penalty in the documentation of Murabaha transactions), there is an added credit risk involved. One respondent noted:

"In Islamic banking, risk mitigation techniques are more challenging as there are certain unique risks we are faced with. These include Shari'a risk and ownership risk, which are not present on conventional side. Islamic banks need different structures and techniques to mitigate these risks as the product nature is different. Shari'a compliancy is also a reputational risk for an Islamic bank." [Quotation 23]

Respondents who believed that risk mitigation is more challenging in Islamic banks also discussed the risks associated with products. In Ijara, in the case of natural disasters like earthquake and fire, the liability lies with the Islamic bank whereas for the conventional bank the obligation stays with the client.

38% believed that while Islamic banks have unique risks, managing them does not pose a significant challenge. They use similar techniques to mitigate risks as conventional banks. Nevertheless, these respondents felt that Islamic banks should analyze how new and innovative risk management techniques can be used to mitigate the inherent risks in Islamic banking.

10% believed that Islamic banks are in a better position to mitigate risk than conventional banks as all transactions are asset backed. This is true only when Islamic banking institutions structure their products in such a way that their exposure to the underlying assets is real and sustainable during the course of financing. One respondent stated:

"It is a common perception that Islamic banking is more risky, but market research suggests the other way. It is true that we are taking more risk in certain transactions but we can track and know the utilization of our funds which makes us less risky." [Quotation 24]

In terms of client default, penalty charges received from the client becomes part of the income of a conventional bank while for Islamic banks these charges have to be donated to the charity fund. A number of respondents were of the view that an alternative for the Islamic bank in case of default ensuring protection from losses is required. They felt that Shari'a scholars need to look into the current practices of tackling default and see if an improved process can be implemented that allows Islamic banks to recover their losses partially if not completely.

7.5 Growth Potential of Islamic Banking

7.5.1 Growth Engine

There is no doubt the Islamic banking industry in Pakistan provides an exemplary story of growth. Since the inception of the dual banking system in 2002, the share of Islamic banking in the total banking sector has grown from less than 1 percent to about 9.6 percent. The majority of respondents (60%) stated that growth of Islamic banking is a demand driven phenomenon (Figure 7.8). Very few saw the growth of industry as a purely supply side phenomenon. 33 % of respondents believed that both supply and demand forces together drive the growth of Islamic banking.

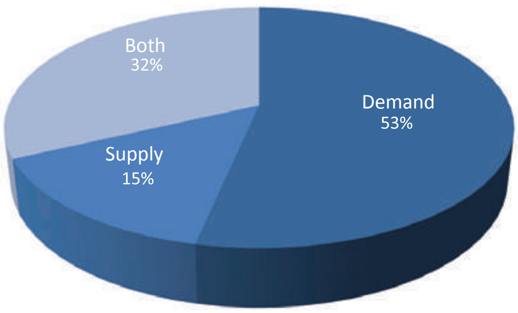


Figure 7.8: What is the main engine behind the growth of the industry? Is this a supply or demand driven phenomenon?

Because growth in Islamic banking is perceived to be demand driven, Islamic banking institutions have not pursued very aggressive business generation campaigns. Though demand will certainly play an important role, supply side players would have to play a more active role to win additional business. This will certainly make it a demand-supply phenomenon, as suggested by 33% of the respondents.

In response to potential areas for further growth in Islamic banking, respondents felt that untapped markets for Islamic banks are rural markets, SMEs and agriculture. 34% of respondents believed that the rural population is largely untapped both by Islamic and conventional banks, and this provides Islamic banks with a huge opportunity to benefit from (Figure 7.9). However, for future growth, the industry needs to diversify its outreach. There is widespread realization amongst the Islamic bankers that the rural population should be tapped, which by and large remains financially excluded. If Islamic banks can develop an outreach programme to cover this untapped market, the share of Islamic banking in total banking in Pakistan will witness an exponential growth. 32% respondents believed that there is a strong appetite for financing SMEs and agriculture, which has so far been ignored.

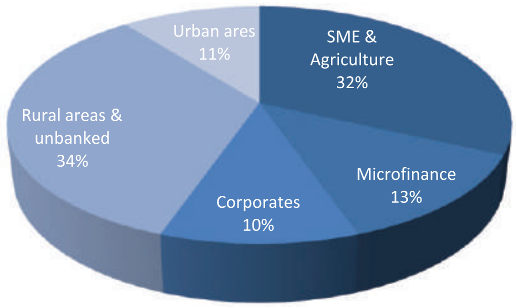


Figure 7.9: Which markets hold the most potential for Islamic banks?

While discussing the reasons for limited exposure in these mentioned sectors, 24% believed Islamic banks have not been able to finance SME's and agriculture because the industry is relatively new and has not reached a reasonable size (Figure 7.10). One of the respondents expressed his view as follows:

"I think it is just the case that Islamic banking industry has just started to grow and there are many areas it has to penetrate into, which will happen in time." [Quotation 25]

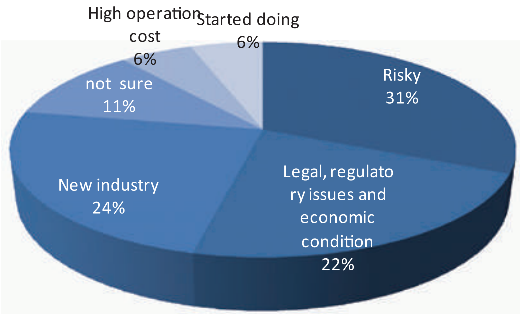


Figure 7.10: Why have Islamic banks not actively done financing in areas like SME and Agriculture?

The third most important area of growth as perceived by the industry practitioners is microfinance. Urban areas and corporate financing are seen as the least important from a growth perspective. However, 31% believed that it is very risky to be involved in such sectors (microfinance) because of due diligence concerns. Assessing the credibility and the capability to use funds efficiently for an organization requires assessment of previous financial history. For these respondents, SMEs and agricultural businesses lack sufficient documentary evidence. They added that the SME sector is not an organized sector and companies are not willing to share their company accounts with banks. About 11% of the respondents were unsure as to the reasons behind not financing SMEs and agriculture, but they strongly supported the idea. One respondent stated:

"I don't know why Islamic banks don't finance SMEs and agriculture. I think if the Islamic banks finance SMEs and agriculture it will provide real support to the community." [Quotation 26].

13% respondents expressed that Islamic banks need to put more effort into developing Islamic microfinance in order to help impoverished and bring them into the finalcial system.

About 11% of the respondents perceived the demand for Islamic banking services will primarily come from urban areas as inhabitants are likely to be more educated and aware of Islamic banking (Figure 7.9). It is expected that cities like Lahore, Karachi and Islamabad will see more growth compared to rest of the country. One respondent suggested banks to market heavily using different types of media (television, radio, internet etc) so that the people can gain an exposure to the Islamic banking both in urban and rural areas.

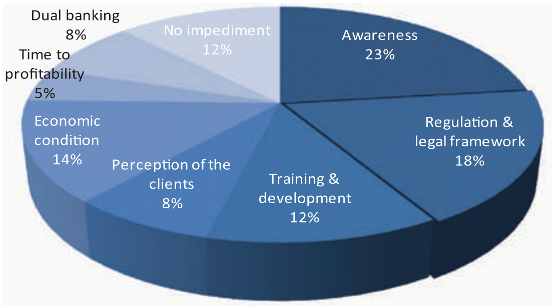


Figure 7.11: What is the major impediment to development of Islamic banking in Pakistan?

Given this realization amongst the industry practitioners, why has Islamic banking yet to reach to these sectors. Given the relatively small size of the industry, there is a need to push the industry by helping them innovate and come up with new products conducive for financing of SMEs,agriculture and microfinance sectors. Given the success of conventional microfinance in the country, it is expected that Islamic microfinance will be a bigger success, as a major proportion of the pent-up demand for Islamic banking remains to be served.

7.5.2. Impediments to the Development of Islamic Banking in Pakistan

For Islamic banking in Pakistan to continue its growth, the majority of respondents felt that there were a number of impediments that could hinder its growth. 88% of respondents shared their views on the impediments, while the remaining 12% thought that there were no impediments to the growth of Islamic banking in the country (Figure 7.11).

23% felt that people in the country do not have necessary awareness of the Islamic banking products and services. This observation is consistent with the demand side analysis. While Islamic banking has grown significantly in the recent past, a vast majority of people is not aware of even simple products offered by Islamic banking institutions. Also, there is a need to improve the public image of the products in terms of their Shari'a authenticity. These respondents proposed programmes to inform and educate potential customers about the industry. Several respondents pushed for more cooperation between Islamic banks and a need for creating market campaigns focusing on expanding their outreach. One respondent commented:

"Lack of awareness is the main impediment to the growth. All Islamic banks need to combine their efforts and launch an awareness campaign in the public for Islamic banking and finance." [Quotation 27]

8% of the respondents stated that negative perceptions are an impediment to the growth of Islamic banking in the country. 12% expressed that employees at Islamic banks do not have the desired understanding and training in Islamic banking to answer questions of current and potential customers. This is more of a problem for an Islamic window where staff may due to lack of knowledge are unable to answer queries of customers. Consequently, respondents suggested that effective training for the bank staff would improve their understanding and help them in dealing with their customers. 14% of the respondents believed that the overall economic condition of the country can hinder the growth of Islamic banking.

7.5.3. Future Prospects of the Industry

There is widespread optimism regarding the future of Islamic banking in Pakistan. 90% of the respondents believed that Islamic banking has a bright future in Pakistan. One respondent predicted that one of the five full-fledged Islamic banks would be among the top ten banks in next 5 years. While highlighting the importance of awareness, he added:

"By creating awareness I can see a great future for the Islamic banking industry in Pakistan and even if we keep growing with the speed we are growing now, we will be better off as the growth rate of the Islamic banking is more than the conventional banks in the country."[Quotation 28]

One of the respondents highlighted the need for innovative products and services:

"Islamic banks need to come up with innovative products that give a better risk/return profile than of conventional counterparts."[Quotation 29]

In addition, a number of respondents were of the view that Islamic banking branches have greater potential to attract deposits than the conventional banking branches.

" If a new Islamic banking branch and conventional branch is opened in a rural area, the Islamic banking branch will collect more deposit income in three months than a conventional banking branch will collect in one year." [Quotation 30]

The remaining 10% either felt that current practices needed to be changed for it to be successful, or that the economic condition of the country will not allow progress as foreign investments are drying up in the country. The first group stated that the current practices of Islamic banking are not truly in line with best practices. If the industry is to have a significant impact on the overall banking industry, products should be based on true profit and loss sharing.

While awareness, development of human resources for the industry, improvement in Shari'a authenticity and all other suggestions are important, perhaps the most important is the new product development. At present, there are very few products of Islamic banks available to have an effective outreach to the rural areas, and to finance SMEs and offer microfinance programmes. The new products developed for the Islamic banking industry can be used as a policy tool to decrease financial exclusion and to provide financing to the sectors deemed important for the economic development of the country.

7.6. Summary and Conclusion

There are a number of issues that the chapter highlights but the following are of great importance:

1. Islamic banking is a religious phenomenon when it comes to choosing a career in banking. This is consistent with the demand side of Islamic banking. However, it is not clear if shareholders of Islamic banks are also primarily motivated by religion.

2. Islamic banking is a business phenomenon, driven by profit motive. Given this, Islamic banks compete with conventional banks in winning business. This competitive trend has resulted in product offerings on both sides of the balance sheet, which have more or less the same characteristics and economic profiles.

3. While the future of Islamic banking is bright in Pakistan, there are some serious impediments to growth. Addressing the issues related with these impediments will help the industry grow further.

4. There are three major areas where Islamic banking can grow relatively easily: rural areas, SME and agriculture financing, and microfinance services. In order for Islamic banks to target these areas, they must develop some innovative products. This may require either investing more into research and development (R&D) by themselves or seeking external support.

The main findings of this chapter remain in line with the demand analysis of the previous chapters.

Chapter 8
Policy Implications

8.1. Introduction

Given that there is an overwhelming demand for Islamic banking in Pakistan, as suggested by the demand side analysis (Chapters 5-6) and insights collected during the supply side interviews (Chapter 7), the government and its related institutions, particularly the SBP being banking regulator, cannot miss these developments in either the Islamic banking sector in the country or broader international trends in the industry. This survey is the first comprehensive study on Islamic banking in Pakistan and has indeed been successful in quantifying demand for Islamic banking in the country – both for retail and corporate customers, and in identifying gaps in demand-supply equation. While overall demand for Islamic banking happens to be more amongst retail than the corporate, the latter have greater staunch and strong demand than the former. The retail happens to show more pent-up demand (92.5% as opposed to 49.5% in case of the former). In case of effective demand (as defined at the end of Chapter 6), retail sector remains consistent in showing greater demand than the corporate.

Figure 8.1 is a general snapshot of the supply-demand gap in the Islamic banking sector in Pakistan. As the figure suggests, there is a huge supply-demand gap and all the stakeholders must take concrete steps to fill this gap. This challenge is discussed in the next section along with some other challenges.

8.2. Challenges

There are a number of challenges that this study identifies, which have policy implications. These challenges are being discussed in this section along with recommendations.

8.2.1. Size of the Industry

It is evident from Figure 8.1 that at its current size, the Islamic banking sector cannot meet the effective demand from households and businesses in the country. SBP must devise a policy to increase the size of the industry to meet the growing demand for Islamic banking products. This can be done by: widening the scope of Islamic banking by way of helping the industry to develop more products for retail as well as business sectors;

1. deepening the penetration of Islamic banking through extending its branch network beyond big cities into rural areas; and

2. aggrandizing the size of incumbent Islamic banks by requiring them to increase their capital basis.

It is recommended that conventional banks with larger Islamic banking operations must be incentivised to convert their conventional operations into full-fledged Islamic banks or at least consider setting up independent Islamic bank subsidiaries. This recommendation is consistent with the obser

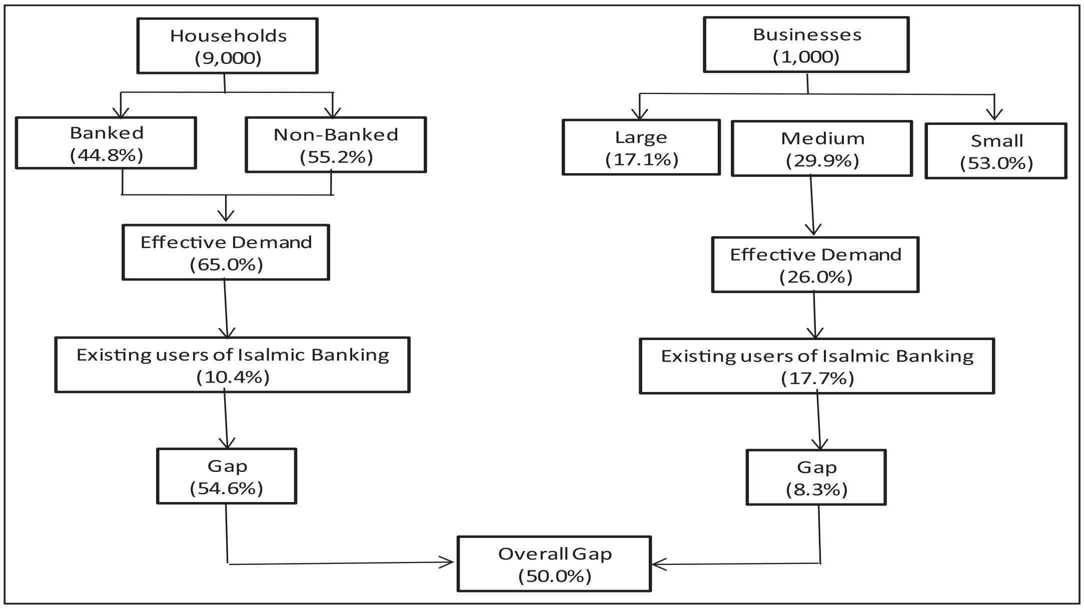


Figure 8.1: Supply-Demand Gap in Islamic Banking

vation that the preferred model of Islamic banking in the country is a full-fledged Islamic bank as opposed to Islamic branches or windows of conventional banks.

8.2.2. Lack of Awareness

Lack of general awareness about Islamic banking should be a major concern for stakeholders of the Islamic banking industry. The vast majority of respondents do not understand Islamic banking model, the nature of deposits, nature of contracts and Shari'a compliance mechanism. The knowledge about Islamic contracts and terminology was almost non-existent. This is an area for concern, as this may have a drag effect on the decision of Banked population, already banking with a conventional bank, to switch to Islamic banking, despite them having demand for Islamic banking. Therefore, educating the masses with basic Islamic terminology and the way Islamic banking products work remains an important challenge for the Islamic banking industry. Without a robust awareness campaign about Islamic banking, the task of promoting Islamic banking will at best be difficult.

8.2.3. The Nature of Demand

It is very clear from the analysis that a major proportion of demand for Islamic banking in Pakistan is in the form of "pent-up" demand (92.5% for households and 49.6% for the corporate). The incidence of "staunch" and "strong" demand" is very low in the household segment, although it is better in the case of corporate. A real challenge for banks involved in Islamic banking is how to convert this pent-up demand into business for Islamic banking. This necessarily involves pushing the demand curve leftwards or stretching it upwards to ensure that more people enter into strong and/or staunch demand areas (see Figure 8.2 below). For those who are interested in decreasing financial exclusion, this would necessarily mean focusing on that segment of pent up demand, that at present is out of the banking net but exhibit demand for Islamic banking. For such retail and business customers, Islamic banking can be used as a tool for promoting financial inclusion in the country.

8.2.4. Product Development and Innovation

One way of coping with the large effective demand for Islamic banking is to develop a comprehensive range of Islamic financial products. There are three areas that may require special focus:

1.Microfinance;
2.SME financing; and
3.Financing for agriculture

In addition to these products for the businesses, there is a need to develop long-term savings and investment products for retail customers.

8.3. Solutions and Recommendations

8.3.1. The Role of Shari'a Scholars

It is recommended that the role of Shari'a scholars is enhanced and made more public in promoting Islamic banking and finance. So far, a very limited number of Shari'a scholars are involved in Islamic banking. It is important that scholars are trained in Islamic banking, so that they will be able to offer concrete perspectives on the issues related to the field. In this context, while some existing institutions are playing an important role, it is also recommended that other institutions (like universities and madrassas) should be used to train imams and ulma in Islamic banking. The Shari'a Academy at International Islamic University Islamabad has a long record of training judges and senior officials in the judiciary on matters related to Islamic law. It is recommended that a similar institution should be developed and used to increase awareness and knowledge of Islamic banking amongst imams and ulma.

The role of the ulma in promoting Islamic banking and finance cannot be over-exaggerated, as the majority of those who are doing Islamic banking feel that it is a Shari'a board that makes a bank Islamic (see Figure 8.3).

8.3.2. Islamic Financial Literacy Campaign

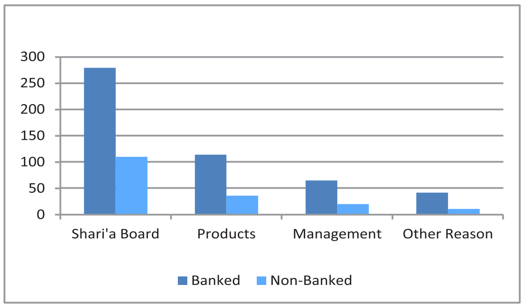


Figure 8.3: What Makes a Bank Islamic?

There is widespread ignorance about Islamic banking in the country. Every third person one may encounter on the road may not have either heard of Islamic banking or does not understand it, if he/she heard about it from elsewhere (see Chapter 5 for further details). This requires an aggressive public awareness campaign on matters related to Islamic banking. It is recommended that an organised industry wide Islamic finance campaign on print, electronic and digital media must be run by the stakeholders. As an increasing number and proportion of youth is now using social media, it will have more relevance and value if social media is used for creating awareness about Islamic banking.

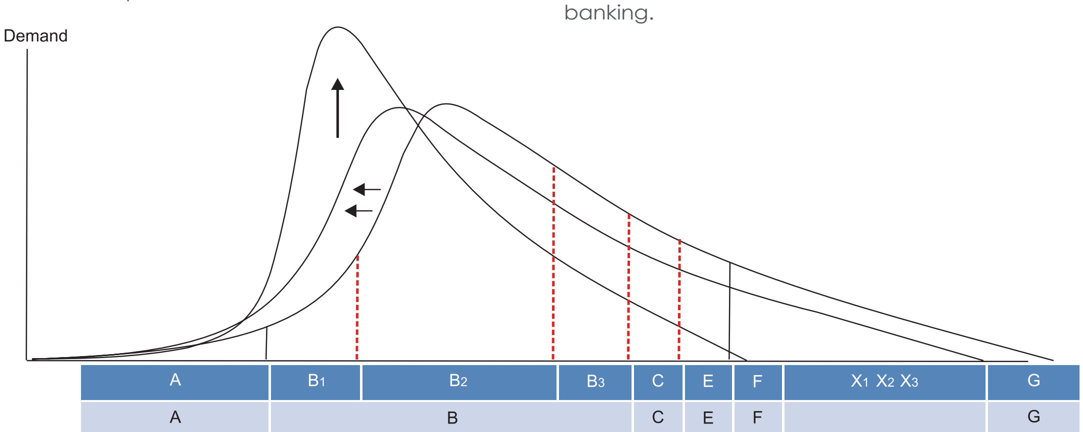


Figure 8.2: Shifting Demand from "Pent-up" to "Strong" and "Staunch"

8.3.3. The Islamic Banking Model

While the dual banking system prevails in Pakistan at present, the question arises: how should this model evolve? There are two possible sub-models:

1.Islamic banks and conventional banks operating independent of each other, with no interaction between them or only limited interaction (e.g., for treasury management) based on Shari'a compliant contracts and activities; and

2.Islamic banks and conventional banks both offering Islamic banking products; the latter allowed to offer Islamic products either through dedicated separate Islamic branches or Islamic windows, provided that they maintain the required segregation between Islamic and conventional operations.

In Pakistan, sub-model 2 is at present being followed. However, this study based on the preference ordering of the respondents, suggests that sub-model 1 should be adopted. 42% of the Non-Banked respondents and 36% of the Banked respondents prefer conventional banks to offer Islamic banking by way of creating a separate, fully independent company. Another 30% of the Non-Banked and 32% of the Banked respondents would like to see conventional banks transforming themselves into full-fledged Islamic banks. The preference is similar when we consider the response of the surveyed corporate.

8.3.4. Future Product Development

As discussed earlier, about 57% of Corporates would prefer to receive financing on a profit- loss sharing. This has serious implications for product development. There is clear preference by Corporates to get involved in profit-loss sharing. However, the reasons of those who would not like profit-loss sharing, or are not sure about it, are primarily: (1) they do not have prior experience of dealing in profit-loss sharing, (2) they do not feel comfortable sharing a lot of information with banks, and (3) they fear bank intervention in the running of their business. It is, therefore, important that a system of profit-loss sharing is devised that takes into account these concerns of Corporates in the country.

In our supply side analysis, top management of Islamic banks revealed their willingness to expand into SME and agriculture financing, as long as there is a robust legal framework to support them in managing risks specific to these sector. Currently, there are very few products to support agriculture and SME financing, and there is a need to initiate a specific programme for product development in areas like SME, agriculture and microfinance. Islamic banks could also be encouraged to establish agri marketing companies, large corporate firms and live stock firms through independent subsidiaries either individually or in collaboration with other IBIs. This would not only result into much needed improvement in agriculture sector but would also provide an attractive Shari'a permissible investment avenue to IBIs. Similar interventions could be made for SMEs, micro enterprises and low cost housing.

Given that the State Bank of Pakistan has impressive expertise in microfinance and the country boasts of having the best regulatory framework for microfinance, this expertise can be used to develop Islamic microfinance and SME products. In this respect, it is recommended that a product development programme should be devised to help Islamic banks to structure innovative Islamic products to cater to the financing needs of agriculture, SMEs and the financially excluded.

8.4. Concluding Remarks

This comprehensive survey on Islamic banking in Pakistan clearly indicates that there is an overwhelming demand for Islamic banking in the country. Given the supply-demand gaps, and gaps in products offering, there is huge potential for further development of Islamic banking in Pakistan. As a very large segment of demand for Islamic banking is yet to be met, and a significant proportion of demand lies amongst those who are still financially excluded, greenfield growth in Islamic banking has a huge scope. Although at present, conventional banks are afraid of cannibalisation of their conventional business if they start offering Islamic banking products. However, they must be mindful of the premise that significant unmet demand for Islamic banking resides outside the formal banking net.

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