CHAPTER 23
The Pakistan model

23.1 Introduction

Islamic finance has witnessed rapid expansion over the years and can now truly be considered a global industry both in terms geographical spread and assets class coverage. The IFSB, estimates assets of the Islamic financial industry to reach USD 1,600 billion along with revenues of approximately USD 120 billion by 2012. Currently the Middle East and Asia are the largest Islamic financial markets while the United Kingdom, Australia, China, France, Germany, Hong Kong, Italy, Korea, Luxembourg, and Singapore are among the list of non-Muslim countries providing Islamic finance services. Islamic financial institutions have gone through major transformation, while proactively responding to market demands. Given that 22 % of the world population is Muslim, even a 1 % contribution by IFIs towards global financial assets and deposits depicts a significantly untapped market.

Pakistan remains at the forefront in promoting Islamic finance. Efforts in this regard can be traced back to the mid 60s, when the Banking Companies Ordinance (BCO, 1962) was amended to allow non-interest based transactions. Following this, in 1973, Article 38(F) of the constitution of Pakistan directed the elimination of riba from the country's economic system. However, initial attempts of establishing Islamic finance as an alternative to the conventional system did not meet success. A landmark event in the evolution of Islamic finance in the country was achieved in 1980's when banks were directed not to accept interest bearing deposits and the Modaraba Companies & Modaraba (Floatation & Control) Ordinance 1980, and Modaraba Companies and Modaraba Rules (1981) were promulgated. Financial institutions were instructed to conduct their business in line with Shari'a principles. Despite being way ahead of other countries introducing Islamic finance reforms at that time, this model could not meet its objectives. This was primarily due to lack of planning for smooth transition, limitations of the proposed system to adjust to market dynamics, and apprehensions in its implementation on part of majority of the stakeholders.

In the beginning of the 1990s, the Federal Shari'a Court classified banking transactions non-Islamic and an appeal was filed before the Shari'a Appellate Bench (SAB) of Supreme Court of Pakistan (SCP). The SAB, in response to this appeal, not only directed to transform the whole system to a purely Islamic system by 30th June 2002,[1] but also prescribed detailed guidelines for the transformation. This time round, there was a greater sense of maturity on part of all the stakeholders. The government and the central bank, the State Bank of Pakistan (SBP), have remained committed ever since the court's decision to introduce Islamic finance reforms based on strong Shari'a and market fundamentals. This process has also been supported by the progress made in Islamic finance internationally, providing local stakeholders an opportunity to learn from global experiences and ensuring a dynamic regulatory framework that facilitates market development.

At present, the Islamic finance industry consists of banking and non banking institutions. The banking sector contains full-fledged Islamic banks, stand alone Islamic branches of conventional banks; while non banking institutions include mudaraba companies, mutual funds and takaful companies etc. The (SBP) regulates the banking sector, while the non banking sector is regulated by the Security & Exchange Commission of Pakistan (SECP).

23.2 Banking institutions

In line with the SAB of the Supreme Court of Pakistan's instructions to transform the banking system into an

[1] First deadline was June 2001 that got extended to June 2002.

Islamic banking mode, SBP introduced an exclusive Islamic banking policy first time in 2001. The prime focus of the policy was to develop the Islamic banking market in parallel with the conventional banking industry. Today there is a dedicated Islamic banking department at the SBP facilitating and monitoring 5 full fledged Islamic banks (IBs) and 13 conventional banks with Islamic branches with a total network of around 700 branches across the country. Having a dedicated department for the Islamic banking industry reflects the commitment of the central bank to not only ensure Shari'a-compliance by IFIs, but to also facilitate development of the industry.

Regulatory Framework

The central bank has formulated the regulatory infrastructure for the Islamic banking industry on the basis of existing regulatory framework for conventional banks, while accommodating the unique characteristics of Islamic banking institutions (IBIs).

23.2.1 Establishment of Islamic banking institutions:

The SBP adopted a three pronged strategy to develop the Islamic banking market at a higher pace to enhance the breadth of the overall financial industry. According to this strategy, banks were allowed to offer Islamic financial services under the following three structures:

• Full fledged Islamic banks

On 1st December, 2001, State Bank of Pakistan issued detailed Criteria (Part-I strategy) for setting up of Scheduled Islamic Commercial banks based on Shari'a principles in the private sector. The criterion indicated obligatory features such as

- the proposed bank needs to be a public limited company listed on stock exchange having 50 % shares for general public offering

- minimum paid up capital of Rs. 1000 million

- minimum Capital Adequacy ratio (CAR) of 8 % on the basis of risk weighted assets

- sponsor directors should not be less than seven while at least 15 % paid up capital should be subscribed personally by them

- the bank needs to commence operations within six months of grant of permission and all financial transactions are required to be in accordance with the injunctions of the Shari'a

• Islamic banking subsidiaries

As Part-II of the strategy a new clause was inserted in sub-section (1) of section 23 of the Banking Companies Ordinance 1962 in November 2002 to allow the scheduled commercial banks to open subsidiaries for Shari'a-compliance operations. The detailed criterion for opening up of subsidiaries mentioned the similar criterion of paid up capital and CAR as required for full fledged Islamic banks. However, there is an additional condition of having CAMEL ratings of 1, 2 and 3 during the last three on site inspections. Islamic banking subsidiaries are allowed 49 % shares for public offering compared to 50 % share in case full fledged Islamic banks

• Stand-alone Islamic banking branches (IBBs)

Guidelines for opening IBBs by existing commercial banks were formulated as Part-III of the strategy. The eligibility criterion for this mode mainly focused on the financial strength of the bank as is evident by capital base (net capital free of actual and potential losses), adequacy of its capital structure, record of earning capabilities, future earning prospects of the bank, managerial capabilities, bank's liquidity position, track record of the bank's adherence to prudential regulations, credit discipline, quality of customer services etc. Stand alone IBBs have got the similar criterion of CAMEL ratings as for Islamic banking subsidiaries, along with the condition that there should not be any major adverse inspection findings against the bank. Banks need to identify experienced and trained key staff to handle the IBBs' operations. Moreover, all conventional banks having Islamic banking license for IBBs should maintain a minimum Islamic banking fund of Rs 50 million as seed capital, and should also maintain a Capital Adequacy Ratio (CAR), prescribed by the SBP for banking system.

• Statutory liquidity and cash reserve requirement

For Cash Reserve Requirement (CRR), the Islamic Banking Department (IBD) maintains a separate current account with the State Bank where commercial banks are required to maintain 5 % of demand liabilities. However for Statutory Liquidity Requirement (SLR) due to the lack of Shari'a- compliant approved securities, the banks can maintain 40 % of their SLR in the form of cash. Therefore on a weekly basis, Islamic banks have to maintain almost 9 % of demand liabilities while 8 % on daily basis in the current account with the central bank.

23.2.2 Instructions & guidelines for Shari'a-compliance

a) Shari'a board

As an advisory body for the banking sector on procedures, laws and regulations pertaining to Islamic banking, a national-level Shari'a body 'Shari'a board' was established at SBP. The Shari'a board members consist of Islamic scholars, bankers, accountants, lawyers and experts of other relevant fields. The composition of SBP's Shari'a board has been formulated in a way that it can guide on almost all aspects of Islamic finance regulation.

The board has a minimum of five members; at least two members are Shari'a scholars, a Chartered accountant, a lawyer, a member representing banking system and director of the Islamic Banking Department (IBD), SBP. The board is chaired by the Shari'a scholar while the IBD director, is secretary to the board.

In order to promote Shari'a-compliance in the Islamic banking industry, the central bank has issued detailed Shari'a-compliance instructions and guidelines in addition to other prudential regulations, guidelines that are to be followed by the Islamic banking institutions, unless specifically mentioned otherwise. These instructions contain guidelines on areas like appointment, removal and working of Shari'a advisors; conflict resolution in Shari'a rulings; Shari'a-compliant modes; use of charity fund, introduction of new products and services, internal Shari'a audit, investment in shares, etc.

• Shari'a advisor

Apart from having a Shari'a board at SBP, each Islamic bank is required to appoint a Shari'a advisor before commencing its operations. The primary responsibility of a Shari'a advisor is to ensure the Shari'a-compliance of the products and procedures of banking. In this regard, one significant duty of the advisor is to submit a report on the basis of periodic review of the banks' operations. These periodic reviews should have a particular focus on ensuring Shari'a-compliance and adherence to SBP regulations.

Since, the Shari'a advisor plays a central role in ensuring compliance of Islamic principles, SBP has issued a detailed 'Fit and Proper' criterion for his/her eligibility. This criterion lays out contemporary educational qualifications as well as experience and exposure requirements for becoming a Shari'a advisor. According to the SBP criterion, a person can work as Shari'a advisor only for one bank. Moreover, the Shari'a advisor is responsible for arranging and conducting Shari'a training programmes for staff and offering advice on any matter referred to him by the Board of Directors (BOD)/management.

• Conflict resolution in Shari'a rulings

In case of a conflict between the Shari'a advisor of an Islamic bank and the SBP's Inspection staff or between other SBP departments or management of any IBI and their Shari'a advisor which remains unresolved at bank level, the case can be sent to the SBP Shari'a board. However IBIs can also use this option for issues related to Shari'a-compliance.

• Shari'a advisors forum (SAF)

Considering the sensitive nature of Shari'a-compliance, SBP has provided an option of a Shari'a advisor forum. In case of an Islamic banking issue of mutual/collective interests, meetings of Shari'a advisors for discussion and possible resolution can be called that can then form a sub-committee to submit its research based findings to the SBP for final resolution. The matter can also be discussed at the Shari'a board of SBP when the need arises.

• Establishment & use of charity fund

Islamic banking institutions have been directed to establish a charity fund; and the source of revenue for the fund is income of non-Shari'a-compliant sources or penalties and late payment charges received from clients in default or overdue cases. The charity fund amount is supposed to be utilized for social welfare purposes.

• Introduction of new products and services

While the central bank has provided some essential elements to be followed to develop products, banks in this regard have also been given flexibility subject to conditions like:

• It has to be based on AAOIFI Shari'a standards if SBP has not provided any guidelines

• Vetting by Shari'a advisor

• IBIs are required to prepare a full set of documents including agreements, process flows, checklists and manuals pertaining to the deposit, the investment and financing products

23.2.3 Essentials & model agreements of Islamic modes of financing

The central bank has adopted AAOIFI Shari'a standards subject to certain clarifications and amendments to provide essential elements to be followed as minimum requirement for Shari'a-compliance while developing certain products. The central bank has provided essentials for 1) mudaraba 2) musharaka 3) diminishing musharaka 4) ijara 5) murabaha 6) musawamah 7) salam and 8) istisna. Moreover, the central bank has also developed model agreements including Murabaha Facility Agreement, Musawamah Facility Agreement, Lease Agreement, Salam Agreement, Musharaka Investment Agreement, Istisna Agreement, Agreement for Interest free Loan, Mudaraba Financing Agreement and Syndication mudaraba Agreement. However, banks have been given flexibility as discussed above to introduce their own products subject to certain conditions.

23.2.4 Shari'a standards

In order to bring standardization, harmony and to put the local industry at par with the international industry, the central bank is reviewing and customising AAOIFI Shari'a standards in a gradual manner. Up until now, the AAOIFI's Shari'a Standards No.3 (Default in Payment by a Debtor), No.8 (Murabaha to the Purchase Order), No.9 (Ijara & Ijara Muntahia Bittamleek) and No.13 (Mudaraba) have been tailored to be adopted by IBIs in Pakistan. Moreover, to ensure the compliance of these regulations, it has been decided that failure to comply with them may invoke penal action under the provisions of Banking Companies Ordinance, 1962.

23.2.5 Risk management

Being the supervisor and regulator of the financial sector, risk management is one of the key concerns of the central bank. Following the same strategy of standardizing of Shari'a standards, the central bank has provided detailed guidelines of risk management on the basis of guidelines offered by IFSB. These guidelines can be used as a basis to establish an effective risk management system. There are fifteen principles of risk management that are applicable to six categories of risks viz: credit risk, market risk, liquidity risk, operational risk, equity investment risk and rate of return risk.

To make risk management more effective and uniform for conventional and Islamic banking institutions, the central bank has introduced measures like:

• Institutional risk assessment framework (IRAF)

SBP has developed detailed Shari'a-compliance questionnaires drawn from the overall Shari'a-compliance framework of institutional risk assessment framework (IRAF). IRAF is an offsite self assessment of risk on inputs relating to four areas, namely compliance with standards, codes & guidelines supervisory & regulatory information; financial performance & condition and market information & intelligence.

• Shari'a-compliance inspection

As a regulator, the major concern of the central bank is to monitor and ensure financial sector stability. Therefore off site monitoring and inspection of banking institutions is of great significance. Shari'a-compliance of the Islamic banking institutions cannot be judged by following procedures of conventional banks. Therefore SBP has developed a Shari'a inspection manual with the help of leading consultants. SBP staff has also been trained by these consultants. SBP inspectors review Islamic financial arrangements, general banking services and operations, financial statements and accounting records of Islamic banking institutions to ensure that all transactions and operations are being carried out in accordance with Shari'a principles, in their substance and form.

• Development of enforcement framework

Along with the development of a Shari'a inspection regime SBP has also developed an enforcement framework for Shari'a-compliance in Islamic banking institutions.

23.2.6 Other initiatives

a. Islamic microfinance business

As in the case of Islamic banking industry, SBP has accepted the responsibility of developing a micro finance industry in the country. Realizing the burgeoning demand, SBP has allowed provisioning of Islamic microfinance and has also formulated guidelines for Islamic microfinance products and services. These guidelines provide an explicit framework for extension of various modes of services conditional to institutional arrangements, responsibility of institutions of raising awareness about Islamic finance products and processes and also of provision of detailed contacts for potential clients.

b. Islamic finance for agriculture

The regulatory infrastructure of banking sector has also set out guidelines for Shari'a based agriculture financing. This includes Shari'a based modes of financing for working capital and term financing.

c. Islamic export refinance scheme (IERS)

The central bank has extended to Islamic banking institutions, a musharaka based export refinance facility for traders. For this purpose, the central bank has identified a limit of 1.5 times of IBs equity in the first year of their operation of IERS. This limit for subsequent years will be fixed subject to IBs' financial performance. In case of Islamic branches of conventional banks, the overall limit of the bank for the scheme does not change. However, conventional banks can get the approval of up to a maximum of 10 % of their limit for their Islamic branches. Guidelines also provide detailed criterion for profit and loss sharing between the central bank and the bank offering IERS services through the establishment of takaful fund.

23.3 Non-banking financial institutions (NBFIs)

In 2002, the supervisory and regulatory role of non-banking financial institutions was transferred from the SBP to SECP. Islamic NBFIs in Pakistan constitute of 27 mudaraba companies, 15 mutual funds and five takaful companies.

Regulatory Infrastructure

23.3.1 Mudaraba companies

Mudaraba is a two tier structure that is established for specific or multi purposes, and can also be perpetual or floated for a specified period. Leasing is the most common business mudarabas undertake.

Mudaraba companies, one of the prime initiatives of Islamisation in the country during the 80's, have got the highest business share among Islamic NBFIs. Their regulatory framework "Modarba Companies and Modarba Ordinance 1980' was introduced at the time of their promulgation in 1980's followed by Modarba Companies and Modarba Rules 1981 and Prudential Regulations for Mudarabas by Securities & Exchange Commission of Pakistan.

SECP has provided detailed regulations for mudarabas including;

• mudarabas have been directed to create and build up a reserve having an amount of at least 10 % after tax profit till the reserve fund becomes equal to paid up capital. Thereafter an amount of at least 5 % after tax amount should be credited to the reserve

• the commission has introduced a limit on liabilities; seven times of equity of mudaraba for the first two years of operation that can then be enhanced to ten times in subsequent years. Moreover, limit on per party exposure - 20 % of the equity of the mudaraba - has also been put in place.

• to ensure sustainability, mudaraba companies have been directed to follow certain conditions including

- ensuring that the current asset to liability ratio of the borrower does not fall below 1:1

- total borrowing of the borrower does not exceed ten times of the capital and reserves (free of losses) of the borrower

- Fresh/additional accommodation in the form of long term facilities should be provided on the basis of debt equity ratio not exceeding 60:40:

• mudarabas are directed to give due weightage to the credit report of Credit Information Bureau of (SBP) about the borrower and his group, before extending finance facility and a defaulter will not be financed in any case.

• detailed directions about assets' classification and provisioning have been provided in prudential regulations for both; working capital and term advance. On the basis of difference in overdue periods, assets have been classified in four categories along with their relative provisioning; Overdue (No provisioning), Substandard (20 % provisioning), Doubtful (50 % provisioning) and Loss (100 % provisioning).

• the 'fit and proper' criterion has also been introduced for the appointment of key executives of mudarabas. The criterion indicates financial soundness, integrity and track record, competence and capability of person etc, as significant indicators for selection.

• to ensure healthy financial performance of mudaraba companies, not only regular off site surveillance and onsite inspection have been made obligatory, but also various enforcement actions including directions, warnings, issuance of show cause notices and orders have also been initiated.

23.3.2 Takaful companies

SECP has provided detailed rules; Takaful Rules 2005, as regulatory framework for the operation of takaful companies (Islamic insurance) in the country. These rules require that

• takaful operators may underwrite all and any kind of business subject to approval of SECP

• takaful operators need to appoint a Shari'a board to ensure that all products and procedures followed by them are Shari'a-compliant.

• conventional insurance operators cannot carry out the business of takaful.

• principal operational models for insurance risk management and investment component need to be based on wakala and mudaraba.

• these rules provide quite detailed and explanatory guidelines regarding payment of losses, sharing of surplus, investment, product design, book keeping, record maintenance, re-takaful etc.

23.3.3 Islamic capital market

SECP is also responsible for regulating the Islamic capital market. Up until now, two musharaka based, five ijara based domestic and one international sukuks[2] term finance certificates have been introduced. However, the pace of growth in this sector is slow despite the critical nature of this area, particularly for liquidity management.

23.3.4 Taxation issue

To deal with taxation of the Islamic financial industry, a committee at the Institute of Chartered Accountant of Pakistan (ICAP) has been established to devise accounting standards for Islamic modes of financing. Due to the unique nature of the Islamic financial industry, a comprehensive feedback involving all stakeholders was required, for which the central bank has played the key role. On the basis of accounting treatment defined by ICAP, effective tax treatments are framed and sent to the concerned government departments for finalization. For the banking industry, Finance Bill 2007 has announced equal tax treatment for both conventional and Islamic banks.

23.4 Conclusion

Though, the Islamic finance sector in Pakistan has a history of around five decades, it was only in 2001 that things turned around and the Islamic finance industry's evolution process witnessed a rather successful transformation. It stands today as a serious alternative to the conventional finance sector. All stakeholders need to ensure now is that the reputational damage caused by the weak implementation during the 1980's does not happen again as it would seriously hamper Islamic finance's future in the country. The central bank has played a key role in facilitating the ascension of the domestic Islamic finance industry, so that it reaches a point of recognition both at the local and international level.

Despite achieving 6 % of banking portfolio, Islamic finance institutions are confronted with some key challenges that have slowed their pace of growth to some extent. Issues faced by the overall industry including banking and non-banking institutions are broadly related to finance and governance. The industry has not been able to grow at the expected pace, primarily due to lack of skilled human resources, limited development on the product innovation front, and absence of investment avenues especially in the short term. While SBP has been conducting a number of Islamic finance training programs, market players need to step up their own efforts to compliment the central bank's efforts in order to increase availability of specialized human resources. On the product development front, the SBP has been collaborating with both international and local institutions to introduce regulations that are aligned with Islamic principles and facilitate market development. However, regulations should be formulated in close collaboration with international agencies.

Due to the prudence of the financial system, the country did not face any serious external shocks caused by the recent global financial crises. Regulators in the country, particularly the central bank, have already introduced effective risk mitigation regulations, however the liquid management infrastructure for Islamic financial institutions needs to be developed further. Islamic finance has established itself as an alternative to the conventional finance system. Islamic finance in Pakistan now needs to demonstrate a higher level of resilience and partner closely with international players to meet market expectations in the future.

[2] Government of Pakistan has floated five issues of its international sukuk