

FINANCIAL INCLUSIVENESS IN ISLAMIC BANKING IN PAKISTAN: A COMPARISON OF IDEALS AND PRACTICES

SALMAN AHMED SHAIKH
Universiti Kebangsaan Malaysia

ABSTRACT

This study attempts to document the progress in Islamic banking industry of Pakistan towards fostering an egalitarian and equitable financial intermediation. It evaluates the progress of Islamic banking in enhancing socio-economic mobility, financial inclusiveness and fostering equitable distribution of income. This study uses a set of quantitative indicators to objectively assess the performance of Islamic banks towards fostering a participative, inclusive, cost-effective and real sector oriented financial intermediation. The results highlight that currently, the performance of Islamic banks on these fronts leaves much to be desired. This study highlights that high average cost of financing and limited focus on agriculture and small and medium enterprises requires improvement to achieve the goal of circulation of wealth and equitable distribution of income. It also identifies that various categories of poor people who need finance for their health, education and small business working capital needs cannot be served by Islamic banks by using the available product structures. This study gives a geographical presence of Islamic banks which shows that they are mainly based in big urban cities. It argues that most of the Islamic banking debt-based products are close, but relatively expensive substitutes. The study will help the industry to review its performance in contributing towards financial inclusiveness, social mobility, need fulfillment and equitable income distribution.

Keywords: Islamic banking, Islamic finance, financial inclusion, microfinance.

INTRODUCTION

It is well established in the literature that financial development compliments economic growth. North (1990) and Neal (1990) conclude that regions that developed more sophisticated and well-functioning financial systems were the subsequent leaders in the economic development of their times. Odedokun (1998) also concludes that the growth of financial aggregates in real terms has positive impacts on economic growth of developing countries, irrespective of the level of economic development attained. Levine (2002) using cross-country data argues that financial development is robustly linked with economic growth. Furthermore, Hassan et al. (2011) find a positive relationship between financial development

and economic growth in OIC (Organization of Islamic Cooperation) developing countries.

Figure 1 plots data of 48 OIC member countries for broad money (as a percent of GDP) and annual real GDP in 2016. It can be seen that increase in the monetary assets is positively linked with GDP in a broad cross section of OIC countries.

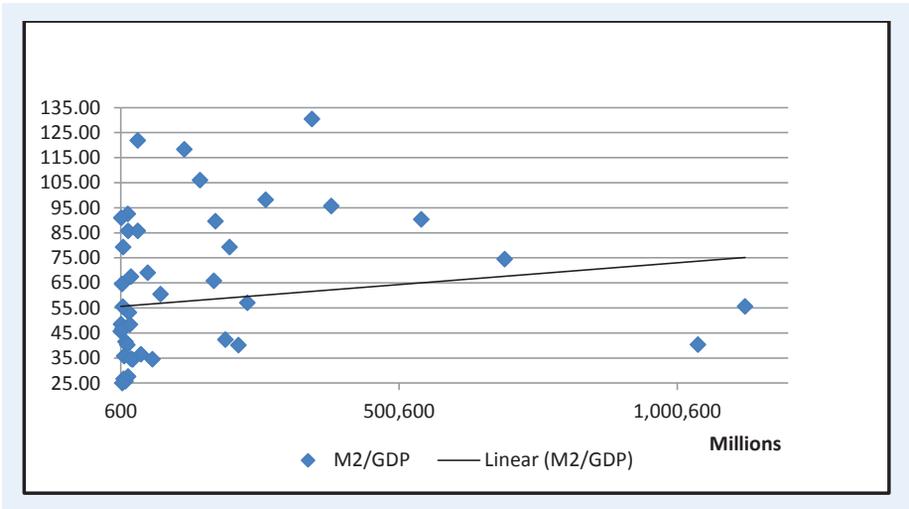


Figure 1: M2 (% of GDP) against GDP (in millions)

Source: World Development Indicators 2016

However, the issue in developing countries is that financial services are not accessible to the masses of poor people. Voluntary exclusion due to faith reasons creates yet another hindrance in the way of financial inclusion in Muslim majority countries. Surveying 65,000 adults from 64 economies, Demirgüç-Kunt et al. (2013) find that Muslims are significantly less likely than non-Muslims to own a formal account or save at a formal financial institution after controlling for other individual and country-level characteristics. For instance, in countries like Afghanistan, Morocco, Iraq, Niger and Djibouti, the percentage of adult population with no bank accounts for religious reasons stands at 33.6 per cent, 26.8 per cent, 25.6 per cent, 23.6 per cent and 22.8 per cent, respectively. Naceur et al. (2015) mention that the share of adults citing religious reasons for not having a bank account is as high as 34 per cent in Afghanistan, 26 per cent to 27 per cent in Iraq and Tunisia, and 23 per cent to 24 per cent in Djibouti and Saudi Arabia. This highlights the need for interest-free banking in these Muslim-majority regions.

Due to the lack of formal financial services in less privileged areas in developing countries, certain non-market institutions fill the gap. Besley (1995) presents

evidence on non-market institutions that have developed in many areas to deal with risk and provide forms of credit. These include credit cooperatives, informal credit and insurance arrangements, rotating savings and co-operative societies.

Providing evidence from India, Rosenzweig & Wolpin (1993) reveal that sales of bullocks increase significantly where weather outcomes are poor, and hence incomes are low and purchases of bullocks increase when rainfall is ample and incomes are above average. It underscores the problems created by lack of financial services in rural settings. Distress sale of a non-divisible asset like bullocks is an inefficient and costly way of coping with income shocks and may have negative effects on productivity since bullocks are an important capital input in the rural agriculture setting. Janzen & Carter (2013) discover that when natural disasters strike in developing countries, households are often forced to choose between preserving assets or consumption. Their results show that insured households are on average 36 per cent points less likely to anticipate drawing down assets, and 25 per cent less likely to anticipate reducing meals upon receipt of a payout.

Using the Indonesian Family Life Survey, Berloff & Modena (2009) suggest that while non-poor farmers smooth consumption relative to income, poor households use labor supply to compensate the income loss and, on average, they save half of this extra income. Constrained households consume less and work more than if they were unconstrained, and these effects are even more pronounced in the face of a negative shock. Non-poor households are more likely to run down assets and to use savings to cope up with negative income shocks, while the asset-poor households are more likely to increase their labor supply to deal with income shocks.

Kazianga & Udry (2006) explore the extent of consumption smoothing between 1981 and 1985 in rural Burkina Faso. The results show that livestock sales, grain storage and inter-household transfers are insufficient in achieving consumption smoothing. Hence, it underscores the importance of formal financial services in rural settings so that households can obtain liquidity without having to sell their assets and incur significant transaction costs. Dubois (2000) establishes that households participating in sharecropping contracts manage to better insure themselves against agricultural income risk. Rosenzweig (2001) establishes that proximity of formal financial institutions increases financial savings and crowds out informal insurance arrangements. Poor financial markets can have significant implications for the real sector and the production methods. Morduch (1995) finds that in certain areas where credit markets are especially poor, households are more likely to choose lower mean, lower variance production methods.

Hence, inclusive finance can assist people to achieve income smoothing, consumption smoothing, higher social mobility and financial stability. But, due to the prohibition of interest, Muslims, in particular, need financial solutions which

are Shariah compliant. To cater to this need, Islamic banking institutions were established in various parts of the world since the 1960s. Since the beginning of the twenty-first century, the Islamic banking industry has achieved uninterrupted growth and now Islamic banking assets constitute a \$2 trillion market. Islamic banking institutions had been established in the Middle East, East Asia, South Asia and Central Asia. The non-Muslim majority countries in Europe and North America are also keen to establish Islamic banking institutions due to their financial and economic merit and for their increased appeal among Muslim population residing in Europe and North America.

Being Islamic institutions, Islamic banks are also expected to help in financial inclusion by providing a faith-compliant set of financial services to include voluntarily excluded households in the financial network. On the other hand, their vision and link with ethical precepts of Islam create an additional expectation for making an egalitarian contribution to the society. Mohieldin et al. (2011) explain that the core principles of Islam lay great emphasis on social justice, inclusion, and sharing of resources between the haves and the have-nots. Laldin & Furqani (2013) explicate three specific ends (*Maqasid*) in Islamic finance, namely wealth circulation, fair and transparent financial practices and justice at the micro- and macro-level. Ahmad (1986) adds reducing poverty and deprivation in *Maqasid al-Shari'ah*. In addition, Chapra (1979) & Chaudhry (1999) incorporate equitable income redistribution and circulation of wealth in *Maqasid-al-Shari'ah*. Furthermore, Iqbal (1997) states that social justice demands that borrowers and lenders share rewards as well as losses in an equitable fashion. Finally, Dusuki & Abozaid (2007) maintain that the objective of the form is to help in ensuring the compliance of the substance to the Shariah and not for itself.

Islamic banking so far has shown resilience, stability and growth during and after the recent financial crisis; however, it also operates within the macroeconomic framework where the banks are debt based financial intermediaries that match savers and investors for intertemporal consumption and investment decisions. In that framework, interest is the price of money capital as well as the prime instrument through which monetary system is managed and regulated by the central bank. Islamic banking is marketed, supported and defended as being participatory, inclusive and egalitarian in its scope, operations and goals.

This paper evaluates the extent to which this vision of Islamic banking matches up with reality. The study will help the industry to review its performance in contributing towards financial inclusiveness, social mobility, need fulfillment and equitable income distribution. Going forward, this paper reviews stylized facts of Islamic banking in Pakistan. Next, it discusses how Islamic banking is assessed by the frontline scholars and practitioners behind Islamic banking and by the pioneer Islamic economists who envision Islamic banking to be truly distinct in philosophy, operations and products. The front seat Islamic banking practitioners hold a more practical and evolutionary view of Islamic banking. While the Islamic economists

hold strictly to the vision of egalitarianism, real sector based participation and inclusiveness as the fundamental distinctive feature of Islamic banking and as a guide to its practical institutional operations. In addition, this study presents empirical evidence from Pakistan to enable a more objective assessment of Islamic banking in Pakistan with regards to cost competitiveness and operational efficiency. Lastly, this study extends the discussion by analyzing the performance of Islamic banking towards facilitating effective and comprehensive financial intermediation, outreach and financial inclusiveness.

The stylized facts about Islamic banking in Pakistan

Ever since the establishment of Pakistan in 1947, there was a great zeal to introduce Islamic institutions in the socio-economic milieu of the country. Nonetheless, political turmoil in the early years did not allow adequate progress in institutional building. Afterwards, given the increased focus in the 1970s around the Muslim world to develop an Islamic financial system for Muslims, the positive effects were also felt in Pakistan. On the regulatory front, the 1973 constitution of Pakistan in Section 38(f) stated that Riba should be eliminated as early as possible.

On the theoretical front, the Pakistan Council of Islamic Ideology in its 1980 report on the elimination of interest from the Pakistan economy clearly defined Riba and suggested that steps should be taken to replace *Riba* based banking with an Islamic alternative. The report stated:

The term riba encompasses interest in all its manifestations irrespective of whether it relates to loans for consumption purposes or for productive purposes, whether the loans are of a personal nature or of a commercial type, whether the borrower is a government, a private individual or a concern, and whether the rate of interest is low or high.

Later on, the Historic Judgment on Interest in 1991 by the Supreme Court of Pakistan settled the debate both in academics as well as in legal sphere. The first phase of Islamic banking in Pakistan during the 1980s under the patronage of ex-President Mr. Zia-ul-Haq was not highly successful. However, with increased participation of Shariah scholars in the policy-making, product design, audit and supervision, the second phase of Islamic banking since 2002 has seen impressive and consistent growth. State Bank of Pakistan has a full-fledged department for Islamic banking and has issued separate regulations for Islamic banking. Now, Islamic banking in Pakistan is an established industry with 11.9 per cent and 13.7 per cent market share achieved in assets and deposits respectively by September 2017. There are 5 full-fledged Islamic banks operating in the country along with 16 conventional banks with a total branch network of 2,368 branches as at September 2017. **Table 1** gives brief details of the key figures in Islamic banking industry in Pakistan.

Table 1:**Stylized facts in Islamic banking industry in Pakistan**

Islamic Banking Industry Progress in Pakistan (as at September 30, 2017)	
Total Assets (in billion Rs.)	2,083
Total Deposits (in billion Rs.)	1,729
Net Financing & Related Assets (in billion Rs.)	1,035
Total Islamic Banking Institutions	21
Total Islamic Banking Branches	2,368

Source: State Bank of Pakistan, Islamic Banking Bulletin

One of the other signs of consolidation includes the central bank's eagerness and commitment to promote Islamic banking. Establishment of centers for excellence in Islamic banking across the major academic circles in Pakistan would ensure adequate and quality supply of human resources to serve this growing industry in the future. **Figure 2** presents the trend in total assets, total deposits and total financing and investments in Islamic banking based on quarterly data for the period 3QCY06-3QCY17. It can be seen that the growth is uninterrupted and more pronounced since 3QCY10.

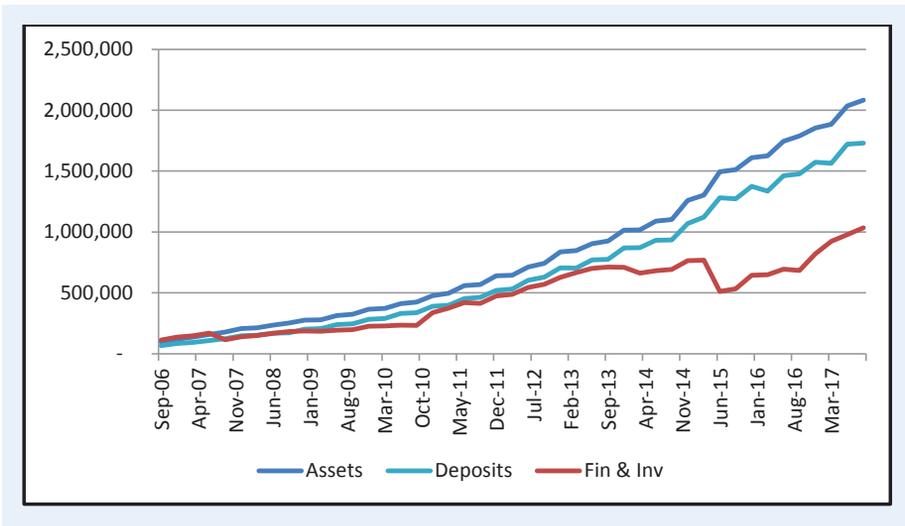


Figure 2: Total assets, total deposits & total financing & investments (mIn PKR) for 2006-2017

Source: State Bank of Pakistan, Islamic Banking Bulletin Various Issues

The basic structure of Islamic banking can be briefly summarized as follows. First, an Islamic bank creates an asset pool which consists of bank's equity and deposits. Deposits include two further classifications, i.e. remunerative deposits and non-remunerative deposits. Remunerative deposits are mobilized using partnership mode *Mudarabah* with bank's shareholders and depositors as partners. Profit sharing ratio is agreed at the start of this partnership. Non-remunerative deposits are mobilized using *Qard* (non-compensatory loan).

This pool of assets is used to provide asset-backed financing. These financing assets are based on different underlying financing contracts, i.e. *Ijarah*, Diminishing *Musharakah*, *Murabahah*, *Salam* and *Istisna*. Islamic bank does not lend money. It provides asset-backed financing in which the asset is owned by the bank. These financing modes can be categorized as lease-based financing or credit sale based financing. The income stream is generated either through profit on credit sale or rental income for the use of the asset.

Currently, Islamic banks use the same interbank benchmark rate, i.e. Karachi Interbank Offered Rate (KIBOR) in Pakistan for pricing assets in credit sale for profit determination and computing necessary amount of rentals to amortize the cost of the asset during the lease period. Income from the sale or lease of the real assets is distributed among the contributors in the asset pool, including bank's shareholders and depositors. To achieve spreads for financial intermediation function, profit sharing is done between the bank and the depositors as per the pre-agreed profit sharing ratio. **Figure 3** shows the profitability in Islamic banking during 2006-2015 in Pakistan as measured by the accounting ratios, Return on Equity (ROE) and Return on Assets (ROA). It can be seen that initially some Islamic banking institutions took time to consolidate and break even, but in later periods, they have registered strong growth with ROE reaching even 18 per cent and sustaining to be in double digits despite the security, energy and fiscal problems in the country.

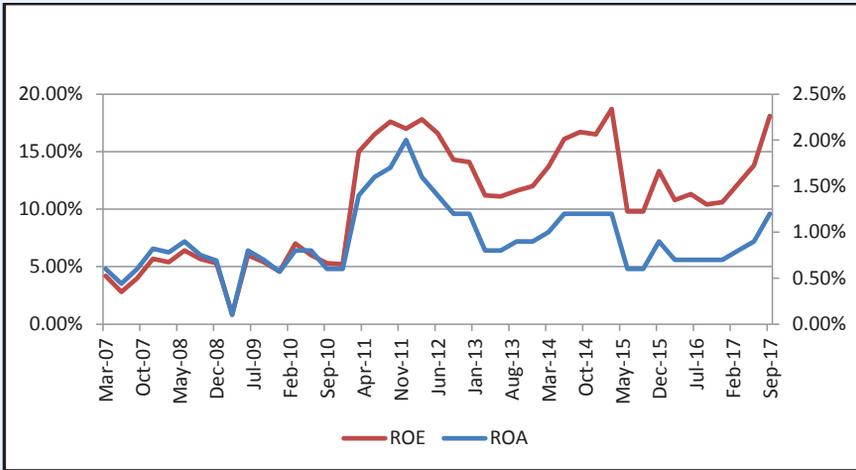


Figure 3: Profitability growth in Islamic banking

Source: Islamic Banking Bulletin, SBP, Various Issues

Asset-backed nature of financing has also helped Islamic banks to contain non-performing loans comparatively better than the conventional banks. Ahmed (2010) highlights that Islamic banking links credit expansion to the growth of the real economy by allowing credit primarily for the purchase of real goods and services which the seller owns and possesses. It also requires the creditor to bear the risk of default by prohibiting the sale of debt, thereby ensuring that he evaluates the risk more carefully. During the credit crunch and low economic growth period (2008-2011), the NPLs rose sharply. But, since 2011, the NPLs are declining and now they remain at 3.5 per cent, which is considerably lower than the 9.2 per cent ratio for the overall banking industry as at September 2017.

Islamic banks as intermediaries: Idealism versus realism

Islamic banks use Shariah compliant contract structures to design and offer financial products. However, they work as commercial financial intermediaries. Pioneer scholars envisioned Islamic banks to be not only Shariah compliant, but also distinctively contributing towards the achievement of equitable income distribution, enhancing social mobility, achieving broad-based financial inclusion and fostering need fulfillment. However, the demands of the industry hamper in achieving these ideals on a priority basis. This has created a wedge between the realists and the idealists. The realists are the executioners of Islamic banking on

the ground and who have to compete alongside conventional banking within same legal, governance and market conditions. Hence, they are obliged to pursue an evolutionary assimilation of Islamic banking to penetrate from ground zero into the mainstream and dominant conventional banking system. Even though, the products are Shariah compliant, but they are structured to compete with the mainstream conventional banking industry. The idealists want a more revolutionary assimilation of Islamic banking to create a distinctive mark on financial landscape right from the beginning. In what follows, this section gives a brief sketch of how the idealists and the realists assess the performance of Islamic banking practice so far.

In the critical evaluation, Asutay (2008) concludes that Islamic banking fails to fulfill the required needs of the (*maqasid*) higher objective of Shariah. Laldin & Furqani (2013) argue that fulfilling minimal Shariah legal compliance in product structuring is insufficient to make progress towards circulation of wealth, transparency and distributive justice. In contemporary discourse about Islamic finance, it is widely noted that the Islamic finance industry remains broadly delinked from the real economy, and thus, the prosperity of the society Ibrahim, Elatrash & Farooq (2014). Due to the overemphasis on the form over substance, Dusuki & Abozaid (2007) argue that Islamic banks are just an exercise in semantics; their functions and operations are no different from conventional banks, except in their use of euphemisms to disguise interest and circumvent the many Shariah prohibitions. Balz (2008) thinks that Islamic finance is experiencing a “formalist deadlock” where the industry is more concerned with formal adherence to Islamic law instead of promoting Islamic ethical values. For instance, *Qard al Hasan* and *Mudarabah* are useful products for ensuring equitable distribution of income, but they are used against the spirit whereby, the Islamic bank becomes the Mudarib and borrower in *Mudarabah* and *Qard al Hasan* contracts respectively in the liability-side operations.

In defense, Khir (2013) explains that mainstream Muslim scholars supporting Islamic finance movement contend that Islam recognizes the legitimacy of the time value of money in Islamic financial transactions such as deferred sale and bilateral rebate. Khan (2014) thinks that critics of practiced Islamic banking do not appreciate how important debt financing is for value creation in an economy and especially for inclusive growth and economic development through making financial services accessible for asset acquisition. Chapra (2007) argues that even if debt financing is predominantly used in Islamic banking practice, asset-backed financing does not allow the debt to exceed the growth of the real economy. He argues that the introduction of such a discipline would ensure greater stability as well as efficiency and equity in the financial system.

On the other hand, Islamic economists holding on to the more egalitarian vision like Siddiqi (2014) argue that the role of debts needs to be drastically reduced and replaced by participatory modes of finance. But, revealing the ground reality, Kayed (2012) observes that the experiences of Islamic banking in various Muslim countries have shown that the profit and loss sharing (PLS) model has been marginalized. Hassan & Bashir (2003) explain that Islamic banks' loan portfolio is heavily biased towards short-term trade financing. Islamic economists like Siddiqi (2007) who expect a lot from Islamic banks than just acting as financial brokers like conventional bank's think that unless Islamic banking gradually moves away from debt like financing, it cannot claim to be a substantive alternative of the conventional banking system.

On the practical difficulties of moving towards PLS modes, Khan (1989) notes that informational asymmetry and higher monitoring costs hinder widespread use of equity contracts. Khan & Bhatti (2006) explain that banks do not find it feasible to enter into the PLS relationship with business people whose majority maintains double sets of accounts for the sake of avoiding exorbitant tax payments. The absence of a just and speedy judicial system also discourages banks from adopting the PLS system. Business people also show high reluctance to enter into the PLS relationship in order to preserve the privacy of their business operations from outside stakeholders.

Other critics of Islamic banking dismiss the notion that the current models and institutional structure can result in any real and meaningful transformation of the way banks function. Choudhury (2012) unequivocally remarks that Islamic banking is a mainstream enterprise, good for the rich shareholders in the narrow pre-conceived notion of avoidance of financial interest, while not understanding the epistemological meaning underlying this principle. Haniffa & Hudaib (2010) argue that *Maqasid al-Shariah* (purposes of the law) have been unduly used to justify the innovation of financial products to compete and converge with conventional banking. Another staunch critic of practiced Islamic finance, El-Gamal (2005) observes that Islamic finance as it exists today is a prohibition-driven industry, which attempts to provide Muslims with permissible analogues of conventional financial services and products that are generally deemed impermissible in Islamic jurisprudence. El Gamal (2007) in another study contends that growth in Islamic finance over the past three decades has been led by rent-seeking Shariah arbitrageurs, whose efforts continue to be focused on synthesizing contemporary financial products and services from classical nominate contracts, without regard to the corporate structure of financial institutions.

Financial inclusion and Islamic banking

The research utilizes various quantitative indicators to focus discussion and evaluate Islamic banking towards enhancing financial inclusion for socio-economic mobility. Before this study proceeds further, it will be pertinent to sketch salient features of an inclusive financial system.

Firstly, an inclusive financial system would cater to the financial needs of a broad-based section of society. Islamic banks in their egalitarian vision of banking are expected to be richer in products and services catering to the bottom 40 percent people of the income distribution and reach them where they are. Secondly, the banks are expected to offer products which could enhance socio-economic mobility. If the products are catered to the top income class only, then the task of socio-economic mobility would not be achieved. Thirdly, the scope of products shall include fulfilling people's financial needs for commercial expansion as well as financial needs of meeting necessary personal expenditures like education and health.

Furthermore, since Islamic banks are expected to be egalitarian in their operations and equitable in their distributional effects, it will be interesting to note how far they contribute towards circulation of wealth, reducing financial costs, use participatory equity-based modes of financing and achieve equitable profit distribution among depositors and the shareholders in contrast with conventional banks. This study uses the following indicators to discuss these issues:

- 1) Branch network in Islamic banking province wise.
- 2) Mapping branch network with income class geography.
- 3) Financing mix of Islamic banks client wise.
- 4) Islamic banking spreads vis-à-vis conventional banking spreads.
- 5) Capital to assets ratio in Islamic banks vis-à-vis conventional banks.
- 6) Mapping target market for major consumer products from stated income requirements.

Looking at the situation on the ground in Pakistan with regards to financial inclusion, it is striking to note that only around 18 per cent of the people in Pakistan hold bank accounts. Furthermore, only 3 per cent of the women in Pakistan have a bank account. On the other hand, financial credit is available to an even meager 3 per cent of the population. **Table 2** reports some results from a World Bank financial inclusion survey from 1,000 respondents in Pakistan. The results show that people mostly borrow from informal sources and for health and education due to limited asset ownership for collateral based loans and lack of consistent formal sector income based employment.

Table 2:

Nature & source of borrowing

Nature of Borrowing	Percent of Respondents With 15+ Years Age
Borrowings in past year	49.75
Borrowed for education or school fees	6.30
Borrowed for health or medical purposes	22.65
Borrowed to start, operate, or expand a farm or business	10.70
Source of Borrowing	Percent of Respondents With 15+ Years Age
Borrowed from a financial institution	1.50
Borrowed from a private informal lender	5.29
Borrowed from a store by buying on credit	25.05
Borrowed from an employer	5.90
Borrowed from family or friends	33.96

Source: World Bank Financial Inclusion Database (FINDEX 2014)

Likewise, the World Bank survey shows that coming up with emergency finance is quite difficult for people on average and especially for relatively poor respondents. In the survey, the respondents were asked as to how easy it is to come up with the possibility of financing 1/20th of GNI per capita within the next month. Strikingly, almost half of the poor and one-third rich respondents state no possibility of financing even this meager amount as shown in **Table 3**.

Table 3:**Emergency finance possibility**

Emergency Finance Possibility (5% of GNI Per Capita Within a Month)	Overall	Poorest 40%	Richest 60%
Not at all possible	37.1	45.2	31.4
Not very possible	12.2	13.4	11.4
Somewhat possible	39.2	35.3	42.0
Very possible	10.8	4.9	14.9

Source: World Bank Financial Inclusion Database (FINDEX 2014)

To change matters, National Financial Inclusion Strategy (NFIS) aims 50 per cent growth in bank accounts by adult population by the year 2020. Recently, the central bank has asked the banks to open bank accounts even with a nominal deposit equivalent to one dollar and without requiring proof of source of income to facilitate easy opening of bank accounts for students, housewives, self-employed technicians, small entrepreneurs and tutors. Sustained growth in branchless banking is required to allow more outreach and to avoid the scale disadvantage in underprivileged areas.

In Pakistan, Naveed & Ali (2012) conclude that as many as 58.7 million people in Pakistan are living in multidimensional poverty with 46 per cent of rural population and 18 per cent of urban households falling below the poverty line. Only 5.5 million people out of 58.7 million poor people are served with microfinance. It shows that only 10 per cent of the potential target market is currently served with microfinance. Islamic banks and conventional banks with Islamic banking branches in urban areas can use their existing branch network to cater to the microfinance needs in urban areas. Documentation, collateral and contract enforcement problems are also less challenging in urban areas as compared to the rural areas.

However, it is striking to note that less than 1 per cent of Islamic financing assets are involved in microfinance. Currently, there is no Islamic microfinance bank in Pakistan at the moment. Other institutions without the scale and liquidity advantage which Islamic banks enjoy had taken initiative to show what can be done with resolve, vision and commitment. Akhuwat, Wasil, Farz Foundation and Naymet are the major institutions offering Islamic microfinance through *Qard al Hasan* and Islamic modes of financing which mostly include *Murabahah*, *Ijarah* and *Salam*. However, it is disappointing to note that despite having huge profits, liquidity and scale advantages, Islamic banks exclude a major part of the population from their product mix. Exclusion of poor and lower middle-class people from the financing products does not contribute to the goal of

inclusiveness and equitable distribution of income. Looking at the geographical spread of Islamic banking branch network, some striking facts appear. Most of the Islamic banking branches are located in big urban cities.

The total number of branches in Punjab, Sindh, KPK and Baluchistan provinces stand at 1,117, 704, 272 and 99 respectively as at September 2017. Punjab and Sindh province together host 77 per cent of total branches in Pakistan. The other two provinces with a higher incidence of poverty and lesser per capita income host only 15 per cent of total Islamic banking branches. Azad Jammu & Kashmir, Gilgit Baltistan, FATA and Federal Capital together host the remaining 8 per cent of total branches in Pakistan. Karachi and Lahore are two major cities of Pakistan. Total branches in these two cities combined constitute 40 per cent of the total branch network. The number of branches in Karachi city alone is almost two times more than the total number of branches in two of the four provinces of Pakistan, i.e. Baluchistan and KPK. Karachi city hosts 81 per cent of the total branches in Sindh province. Lahore city hosts 34 per cent of the total branches in Punjab province. Quetta city hosts 59 per cent of the total branches in Baluchistan province. Peshawar city hosts 23 per cent of the total branches in KPK province. Together, the four provincial capitals of Pakistan host 47 per cent of all the Islamic banking branches. This geographical distribution of branch network goes hand in hand with the income distribution, i.e. there is more presence of Islamic banks in high-income regions.

Table 4 presents the percentage distribution of employed population by average monthly payments. It can be seen that only a quarter of the employed population of Pakistan earns monthly income in excess of Rs 15,000. Around half of these people live in Punjab and one-third in Sindh. It is apparent that branch network is concentrated in high-income areas where people are able to save and earn sufficient income to qualify for financing from banks.

Table 4:

Distribution of employees by average monthly payments (Rs.)

Distribution of Employees by Average Monthly Payments (Rs.)									
Area	Percent Employees with Monthly Income of Rs 15,000 or More – Total			Percent Employees with Monthly Income of Rs 15,000 or More – Urban			Percent Employees with Monthly Income of Rs 15,000 or More – Rural		
	Overall	Male	Female	Overall	Male	Female	Overall	Male	Female
Pakistan	30.43	27.99	2.43	38.38	35.15	3.23	24.03	22.24	1.79
KPK	4.33	3.97	0.36	2.93	2.63	0.30	5.45	5.05	0.41
Punjab	14.64	13.05	1.59	17.74	15.66	2.08	12.15	10.94	1.20
Sindh	9.22	8.85	0.38	15.78	15.06	0.73	3.95	3.86	0.09
Baluchistan	2.23	2.13	0.10	1.92	1.80	0.12	2.48	2.39	0.09

Source: Labor Force Survey 2014-2015

In line with neoclassical economics literature, such as Diamond (1984) who provides a plausible view of the role of intermediary in intertemporal finance, Islamic banks as financial intermediaries can centralize costly monitoring and avoid the duplication of effort of the monitoring of borrowers by small investors. Banks monitor debt (loan) contracts, and issue unmonitored debt (deposit) contracts. Diversification is the financial-engineering technology that makes monitoring of deposit contracts unnecessary when monitoring of loan contracts is necessary. This allows banks to deliver delegated monitoring services.

From the financial economics perspective, the banking model of Islamic banks is similar to that of conventional banks. Capital to total assets ratio is even lower in Islamic banks as compared to the conventional banks, i.e. 6.5 per cent as compared to 7.7 per cent for conventional banks in Pakistan. Most of the funds used in running asset side operations come from depositors. The underlying philosophy and operating framework of fractional reserve banking are in motion at both types of institutions. In the overall deposits, only one-fifth of the deposits are placed in the fixed deposits category in Islamic banking. Current accounts are already interest-free in most cases. In saving accounts, the central bank has directed all banks to pay a fixed rate of return. Islamic banks bypass this requirement through reverse engineering in the calculation of returns by assigning weightage that takes care of time value of money. Hence, due to the regulatory and competitive pressures, it is almost impossible to hope for any transformative change in asset side operations towards meaningful use of equity-based modes of financing.

The deposit funds are mobilized usually from small individual depositors, whereas, these funds are mostly used to provide finance to the upper-class individuals and big corporations. Small depositors are able to open a bank account with their small deposits, but they are unable to obtain any amount of finance for education, healthcare and microfinance. In Islamic banking, deposit mobilization has much less contractual frictions than creating a Shariah compliant financing asset. In providing finance, it is important that finance is provided for the genuine purchase of an asset whose ownership, possession and risk have to be borne by the bank so as to be able to earn any sale premium or rents. While ease of deposit mobilization is a salient plus, it is also a challenge when financing operations have limited product alternatives, contractual frictions and noncompliance risk.

Even then, the dismally inactive financing operations are primarily concentrated in providing finance to the corporate elite, well-to-do-professionals and business executives in the urban localities of Pakistan. In Pakistan, agriculture provides employment to 43 per cent of the people in the labor force. Out of these 43 per cent employed people in agriculture, approximately 41.5 per cent employment is in rural areas and only 1.5 per cent is in urban areas. Looking at sector wise financing mix of Islamic banks as at September 2017, it is revealed that they provide only 0.5 per cent financing to this sector. The banking industry average

for agriculture finance is more than 10 times as much, i.e. 5 per cent as against 0.5 per cent for Islamic banks. This shows that Islamic banks are yet to make significant inroads in the most critical sector upon which almost half of the labor force is directly dependent for their livelihoods.

Banks usually place most funds in financing corporate clientele especially in developing countries. However, if there is anything objectionable about this practice on egalitarian grounds, then Islamic banks are no different than conventional banks in practice. In Pakistan, more than three-fourths of the Islamic banks' financing portfolio is provided to the corporate sector. As against the overall banking industry, Small Medium Enterprise (SME) finance share in Islamic banks' financing portfolio is almost half of that of conventional banks as shown in **Table 5**. Furthermore, as against the overall banking industry, agriculture finance share in Islamic banks' financing portfolio is merely 10 per cent of that of conventional banks. Apart from the corporate sector, the 'individuals' is the only other segment to which Islamic banks provide more financing as compared to conventional banks. Here too, there is no financing product for individuals looking to finance education, health, utility bills and basic food requirements.

Table 5:

Client wise financing portfolio (%) - September 2017

Client Wise Financing Portfolio (%) - September 2017		
	Islamic Banks	Industry
Corporate Sector	71.4	69.3
SMEs	3.1	6.0
Agriculture	0.5	5.0
Consumer Finance	10.8	6.8
Commodity Finance	12.3	11.0
Others	1.9	1.9
Total	100	100

Source: Islamic Banking Bulletin September 2017, SBP

Even then, these financial services are provided less efficiently by Islamic banks than by conventional banks. Islamic banking spreads had been consistently higher than conventional banking spreads. The difference has also remained consistently above 1.5 per cent in the 2010-2014 period.

Lastly, this section presents who qualifies for financing from Islamic banks as an individual. **Table 6** reports the minimum monthly income required to qualify for car and home financing from full-fledged Islamic banks. Per capita income in Pakistan is around Rs 10,000 per month. In **Table 4**, it was seen that only a quarter of employed people in Pakistan earn monthly income in excess of Rs 15,000. The minimum monthly income required for car and home financing is way above the average per capita income and income of most people of Pakistan except the people in the top income quintile.

Table 6:

Distribution of employees by average monthly payments (Rs.)

Banks	Minimum Monthly Income Required			
	Car Finance (Rs.)		Home Finance (Rs.)	
	Salaried	Businessperson	Salaried	Businessperson
Meezan Bank	40,000 ¹²	40,000	40,000	75,000
Bank Islami	40,000	50,000	35,000	50,000
Dubai Islamic Bank	25,000	25,000	40,000	40,000
Al-Baraka Bank	35,000	35,000	Not Offered	Not Offered
Burj Bank	35,000	35,000	65,000	65,000

Source: Official Banks Websites 2017

While it is not surprising to see these numbers since banks usually work like this, but it is inappropriate for Islamic banks to claim any distinction when their proportion of urban branches is greater than rural branches as compared to conventional banks and their debt based financing products result in same cash flows and exclude and include similar kinds of clients as in conventional banks, except that the banking spreads in Islamic banking are as much as 150 basis points higher on average.

On the product side, Islamic banks do not have complete product alternatives for all kinds of conventional finance solutions. According to the World Islamic Banking Competitiveness Report, there are 38 million customers globally with Islamic banks with average product holding of 2.1, which is significantly lower than class leading average of 4.9. This represents untapped cross-selling potential in Islamic banking with existing and growing customer base. While it is indeed appreciable that not all conventional practices are replicated as is by Islamic banks especially in Pakistan, such lacking in solutions and alternatives cannot completely be attributed to this factor alone. Distress financing, educational financing, health financing and microfinance are areas where Islamic product alternatives need to be developed and adequately marketed, so that there will be an increase in the size, penetration and inclusiveness in Islamic banking.

¹² It is computed on lowest cost car for highest possible tenor.

CONCLUSION

This study highlighted the areas for improvement in Islamic banking with regards to inclusiveness and equitable distribution of income. In Pakistan, agriculture provides employment to 43 per cent of the people in the labor force. But, if one looks at the sector-wise financing mix of Islamic banks, they provide only 0.5 per cent financing to this sector. The persistence of higher banking spreads as compared to the overall banking industry also deserves attention. In the geographical footprint, the number of branches in Karachi and Lahore city combined constitutes 40 per cent of the total Islamic banking branch network. The number of branches in Karachi city alone is almost two times more than the total number of branches in two of the four provinces of Pakistan, i.e. Baluchistan and KPK. Taken together, the four provincial capitals of Pakistan host 47 per cent of all branches in Pakistan. Hence, there is still an ample opportunity for expansion and outreach in Islamic banking in small cities and rural areas. In the light of these facts, it is recommended that Islamic banks should give equal priority to agriculture finance, SME finance and in ensuring their presence in less privileged areas of the country. Furthermore, there is an opportunity for Islamic banks to put their focus on agriculture sector on which almost half of the labor force is directly dependent for their livelihoods. Finally, narrowing banking spreads can result in faster growth and assimilation of Islamic finance products and services in the economy.

REFERENCES

- Ahmed, A. (2010). Global financial crisis: An Islamic finance perspective. *International Journal of Islamic and Middle Eastern Finance and Management*, 3(4), 306 – 320.
- Ahmad, K. (1986). Keynote Address. In Z. Ahmed, M. 22. Chapra, M.U., 1985. Towards a Just Monetary System. Iqbal & M.F. Khan, Eds. *Fiscal policy and resource allocation in Islam*. IPS, Islamabad.
- Asutay, M. (2008). Islamic banking and finance: Social failure. New Horizon, 1–4. Retrieved from: SSRN: <https://ssrn.com/abstract=1735674> or <http://dx.doi.org/10.2139/ssrn.1735674>.
- Berloffo, G. & Modena, F. (2009). Income Shocks, Coping Strategies & Consumption Smoothing: An Application to Indonesian Data, Dipartimento Di Economia, Discussion Paper No. 1.
- Balz, K. (2008). Sharia risk? How Islamic finance has transformed Islamic contract law, Islamic Legal Studies Program, Harvard Law School.
- Besley, T. (1995). Nonmarket institutions for credit & risk sharing in low-income countries. *The Journal of Economic Perspectives*, 9(3), 115 – 127.
- Chapra, M. U. (1979). *Objectives of the Islamic economic order*. Leicester, UK: The Islamic Foundation.
- Chapra, M. U. (2007). The case against interest: Is it compelling?. *Thunderbird International Business Review*, 49(2), 161 – 186.
- Chaudhry, M. S. (1999). *Fundamentals of Islamic Economic System*. Burhan Education and Welfare Trust Lahore.
- Choudhury, M. A. (2012). The ‘impossibility’ theorems of Islamic economics. *International Journal of Islamic and Middle Eastern Finance and Management*, 5(3), 179 – 202.
- Council of Islamic Ideology. (1980). Report of the Council of Islamic Ideology on the Elimination of Interest from the Economy, CII, Pakistan.
- Diamond, D.W. (1984). Financial intermediation as delegated monitoring: A simple example. *Review of Economic Studies*, 51(3), 393 – 414.
- Demirgüç-Kunt, Asli, Klapper, L. & Douglas, R. (2013). *Islamic finance and financial inclusion: Measuring use of & demand for formal financial services among Muslim adults*. Policy Research Working Paper No. 6642. Washington, DC: World Bank.
- Dubois, P. (2000). *Consumption insurance with heterogeneous preferences: Can sharecropping help complete markets?*. Econometric Society World Congress 2000 Contributed Papers 1597, Econometric Society.
- Dusuki, A. W. & Abozaid, A. (2007). A Critical appraisal on the challenges of realizing maqasid al-shari’ah in Islamic banking and finance. *IJUM Journal of Economics and Management*, 15(2), 143 – 165.
- El-Gamal, M. A. (2005). Limits and Dangers of Shariah Arbitrage, in S. Nazim Ali (Ed), *Islamic finance: Current legal and regulatory issues*, Cambridge, MA: Islamic Finance Project, Islamic Legal Studies, Harvard Law School, 117 – 131.

- El-Gamal, M. A. (2007). Mutuality as an antidote to rent-seeking shari'ah arbitrage in Islamic finance. *Thunderbird International Business Review*, 49(2), 187 – 202.
- Haniffa, R. & Hudaib, M. (2010). Islamic finance: From sacred intentions to secular goals? *Journal of Islamic Accounting and Business Research*, 1(2), 85 – 91.
- Hassan, M. K. & Bashir, A. H. (2003). Determinants of Islamic Banking Profitability, ERF Paper, 10, 3 – 31.
- Hassan, M. K., Sanchez, B. & Yu, J. S. (2011). Financial development & economic growth in the organization of Islamic conference countries. *Journal of King Abdul Aziz University: Islamic Economics*, 24(1), 145 – 172.
- Ibrahim, A. A., Elatrash, R. J. & Farooq, M. O. (2014). Hoarding versus circulation of wealth from the perspective of maqasid al-shari'ah. *International Journal of Islamic and Middle Eastern Finance and Management*, 7(1), 6 – 21.
- Iqbal, Z. (1997). Islamic financial systems. World Bank Publications, 42 – 43.
- Janzen, S. A. & Carter, M. R. (2013). The impact of micro insurance on consumption smoothing & asset protection: Evidence from a Drought in Kenya, University of California at Davis.
- Kayed, Rasem N. (2012). The entrepreneurial role of profit & loss sharing modes of finance: Theory & practice, *International Journal of Islamic and Middle Eastern Finance and Management*, 5(3), 203 – 228.
- Kazianga, H. & Udry, C. (2006). Consumption smoothing? livestock, insurance & drought in rural Burkina Faso. *Journal of Development Economics*, 79(2), 413 – 446.
- Khan, M. Mansoor & Bhatti, M. Ishaq. (2006). Why interest-free banking and finance movement failed in Pakistan. *Humanomics*, 22(3), 145 – 161.
- Khan, T. (2014). Comment on: Islamic economics: where from, where to? *Journal of King Abdul Aziz University: Islamic Economics*, 27(2), 95 – 103.
- Khan, W. M. (1989). Towards an interest-free Islamic economic system. *Journal of King Abdul Aziz University: Islamic Economics*, 1(1), 3 – 38.
- Khair, M. F. A. (2013). The concept of the time value of money: A shari'ah viewpoint. *International Journal of Islamic Banking & Finance*, 3(2), 1 – 15.
- Laldin, M. A. & Furqani, H. (2013). Developing Islamic finance in the framework of maqasid al-shari'ah: Understanding the ends (maqasid) and the means (wasa'il). *International Journal of Islamic and Middle Eastern Finance and Management*, 6(4), 278 – 289.
- Levine, R. (2002). Bank-based versus market-based financial systems: Which is better?. *Journal of Financial Intermediation*, 11(4), 398 – 428.
- Mohieldin, M., Iqbal, Z., Rostom, A. M. & Fu, X. (2011). *The role of Islamic finance in enhancing financial inclusion in Organization of Islamic Cooperation (OIC) Countries*, Policy Research Working Paper 5920. Washington, DC: World Bank.
- Morduch, J. (1995). Income smoothing & consumption smoothing. *The Journal of Economic Perspectives*, 9(3), 103 – 114.

- Naceur, S. B., Barajas, A. & Massara, A. (2015). Can Islamic banking increase financial inclusion?, IMF Working Paper, WP/15/31.
- Naveed, A. & Ali, N. (2012). *Clustered deprivation: District profile of poverty in Pakistan*. Islamabad: Social Development Policy Institute.
- Neal, L. D. (1990). *The rise of financial capitalism: International capital markets in the age of reason*. Cambridge, UK: Cambridge University Press.
- North, D. (1990). *Institutions, institutional change, and economic performance*. Cambridge, UK: Cambridge University Press.
- Odedokun, M. O. (1998). Financial intermediation & economic growth in developing countries. *Journal of Economic Studies*, 25(3), 203 – 224.
- Rosenzweig, M. R. (2001). Savings behavior in low-income countries. *Oxford Review of Economic Policy*, 17(1), 40 – 54.
- Rosenzweig, M. R. & Wolpin, K. I. (1993). Credit market constraints, consumption smoothing, and the accumulation of durable production assets in low-income countries: Investments in bullocks in India. *Journal of Political Economy*, 101(2), 223 – 244.
- Siddiqi, M. N. (2014). Islamic economics: Where from, where to? *Journal of King Abdul Aziz University: Islamic Economics*, 27(2), 59 – 68.
- Siddiqi, S. A. (2007). *Establishing the need and suggesting a strategy to develop profit and loss Sharing Islamic banking*. Paper presented at the IIU Malaysia Conference on Islamic Banking and Finance, Kuala Lumpur.
- World Bank (2014). Global Financial Inclusion (Global Findex) Database. World Bank Data Division.

Received Date: 9 October 2017
Acceptance Date: 25 April 2018