
ECONOMIC ANALYSIS OF ISLAMIC BANKING IN PAKISTAN

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ABSTRACT

Islamic banking has achieved substantial growth in Pakistan and all over the world in the last two decades or so. Despite the financial and economic crisis of 2007-2010, the Islamic banking industry has witnessed exemplary and uninterrupted growth. In Pakistan, it has achieved market share of almost nine percent in the banking industry. There is vast literature available on explaining the features and mechanics of Islamic banking; however, limited attention has been paid on the thorough analysis of Islamic banking architecture from finance, economics, and development point of view. Though, there exists substantial body of literature explaining the negative effects of interest based institutions in Capitalism. But, little has been written on conducting a meaningful and objective economic analysis of Islamic banking practices. This paper attempts to touch upon an overlooked area which is a thorough and objective analysis of Islamic banking with its economic merits and shortcomings.

Keywords: Islamic banking, Islamic finance, financial institutions, consumer financing, corporate finance

INTRODUCTION

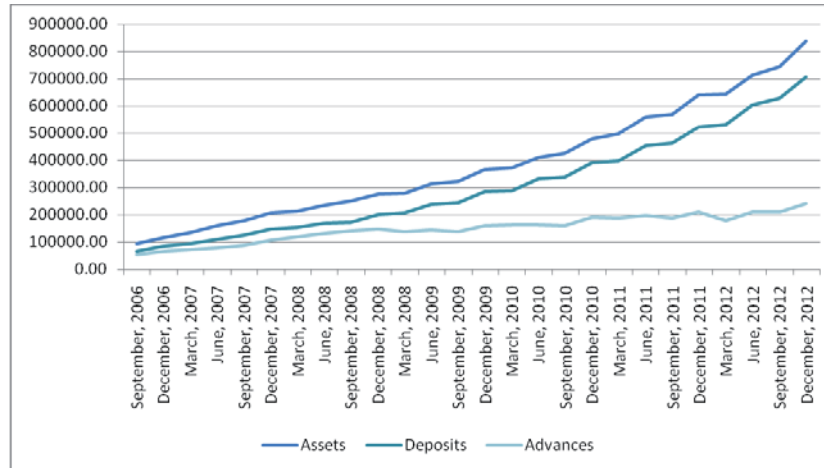
Islamic economic principles have prominently been applied in financial industry especially in banking. During the last decade and half, the Islamic financial industry has seen tremendous growth even when the conventional financial institutions went into a deep crisis.

According to some, this growth owes to some unique features inherent in Islamic financial products. Adel (2010) explained the economic merits of Islamic banking by pointing out that credit expansion through Islamic banking is linked to the growth of the real economy by allowing credit primarily for the purchase of real goods and services. 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.

Chapra (2007) highlighting the benefits of asset backed financing by Islamic banks stated that asset-based debt should further help by not allowing the debt to exceed the growth of the real economy. The introduction of such a discipline carries the potential of helping realize not only greater stability, but also greater efficiency and equity in the financial system.

In Pakistan, the second phase of Islamic banking started in 2002. The first phase during the 1980s under the patronage of Zia-ul-Haq was not successful. However, with increased participation of Shari'ah scholars in the policy making, product design, audit and supervision, the second phase has seen impressive and consistent growth. Now, Islamic banking in Pakistan is an established industry with 9percent market share achieved in just over a decade. There are five full fledged Islamic banks and eighteen other commercial banks that operate Islamic banking windows alongside conventional banking in Pakistan. Figure 1 shows the growth in assets, deposits and advances in Islamic banking industry in Pakistan for the period 2006-2012. The exponential and uninterrupted growth is evident from this graph.

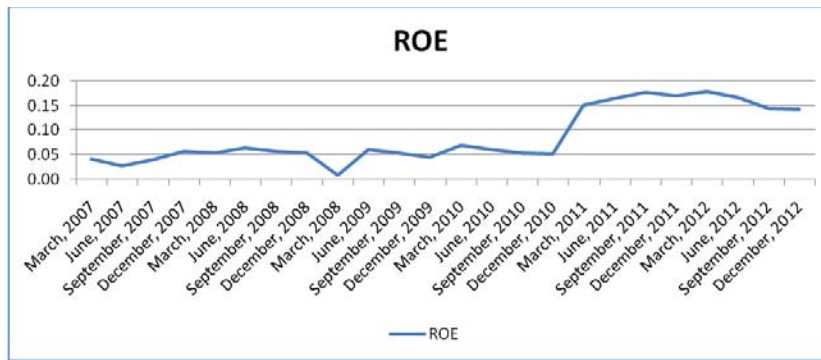
Figure 1: Growth in Islamic Banking Assets, Deposits and Advances



Source: Islamic Banking Bulletin, 2011

Figure 2 shows the profitability in Islamic banking during the period 2006-2012 in Pakistan as measured by the accounting ratio, Return on Equity (ROE). It can be seen that initially some banks took time to consolidate and break even, but in later periods, they have registered strong growth with ROE reaching even 18 percent and sustaining to be in double digits despite the security, energy and fiscal crisis in the country.

Figure 2: Profitability Growth in Islamic Banking



Source: Islamic Banking Bulletin, 2011

A lot of literature is available on the explanation and contract mechanics of Islamic banking. In this paper, we attempt to touch upon an overlooked area which is a thorough and objective analysis of Islamic banking with its economic merits and demerits. For statistical data, we use financial statistics taken from State Bank of Pakistan’s statistical bulletin and financial statements of banks. Most statistics unless specified pertain to the period 2006-2012.

The paper is structured as follows. Section 2 explains the problem with interest based financial intermediation. Section 3 describes the essential features of commonly used Islamic contracts and modes of financing. Section 4 presents the economic analysis of Islamic banking and modes of financing by explaining the merits. Section 5 presents the economic analysis of Islamic banking and modes of financing by outlining the shortcomings.

ANALYSIS OF INTEREST AS PRICE OF CAPITAL

Mainstream economics define physical capital stock as things that are ‘produced means of production’. In a market economy, physical capital stocks are either traded or rented. But when it comes to the price of capital, the user cost of capital is used given by Jorgenson (1963).

$$UC = Pk (r + d)$$

where

UC is user cost of capital

Pk is purchase price of capital stock

r is real rate of interest

d is the depreciation rate

In the intertemporal transfer of money in the loanable funds market, interest is legally regarded as the price of capital. However, it does not answer the philosophical and deep question as to what is the right price of money, especially when it is not backed by anything that has intrinsic value of its own.

The contemporary view takes interest based financial intermediation as a given and as an exogenous variable to the mathematical economics analysis. Given the existence of interest based financial intermediation, real interest is used as the price of use of physical capital stock using opportunity cost concept.

It can be explained through a basic example. If RM1,000 earn 10percent rate of interest in bank account, RM1,000 invested in machinery should yield at least 10percent for justification of efficient allocation of resources. But, the legal, moral and philosophical base of 'interest based financial intermediation' still needs justification.

From the economic standpoint, there are following problems in interest based financial intermediation and its subsequent effects on goods markets and resource markets with regards to how much physical capital stock must be bought by the firms to maximize their expected value of total profits:

- It ignores the negative externality imposed through inflation on people. Interest paid is added in cost and through transfer pricing, it is paid by households eventually.
- It discourages investment in socially optimal profitable projects, but which are not favored because of relative cost comparison from real interest rate in the market.
- It compels firms to engage in aggressive advertising and promoting consumerism to meet interest cost. Selling small number of units will not allow benefit from leveraging and meeting interest cost.

Hence, firms have no choice than to promote as much sales as possible and obtain more financing to increase the size of firm.

- If sales do not increase, it may lead to business cycle fluctuations with unplanned increase in inventories.
- With increased pressure to service debt, the environmental degradation and human resource exploitation may become common.
- It results in skewed distribution of income and wealth with guaranteed return to capitalists and uncertain return to real sector entrepreneurs who are burdened to provide incessant increase to capitalists.
- It supports only the wealthy entrepreneurs who are able to afford interest payments right from the start from their entrepreneurial pursuits and who already own capital that can be used as collateral. This will affect the kinds of entrepreneurial investments they make and hence allocation of resources.
- With barriers to entry due to restricted availability of funds for investment in real sector, the real sector could result in increased market concentration in large scale businesses.
- It may result in other negative externalities, for example increased income inequality, poverty and below full employment use of real scarce resources resulting by artificially making capital scarce.
- Increased printing of fiat money by borrowing on interest will jeopardize the welfare of future generations. With no afterlife accountability, no policy maker or institution can incorporate infinite horizon and accountability to future generations. This creates the problem of moral hazard.

ISLAMIC BANKING IN PRACTICE

In this section, we give an overview of major asset and liability side generic products and contracts used in Pakistan's Islamic banking industry. This overview is based on product offerings by Islamic banks

including Meezan Bank Limited, Bank Islami, Dubai Islamic Bank, Bank Al-Barakah, Burj Islamic Bank and other commercial banks that operate Islamic banking windows.

ASSETS: FINANCING AND ADVANCES

For a bank, assets among other things include the financing and advances made by the bank for profit. Some of the important and often used financing products of Islamic banks are discussed below:

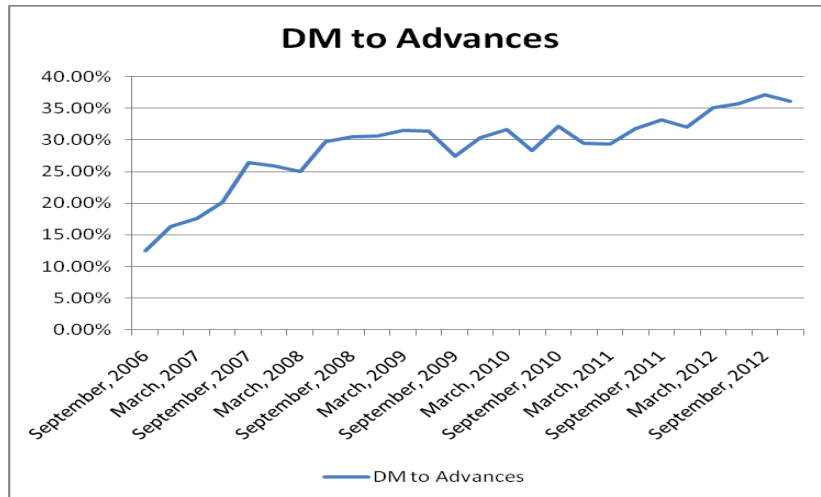
DIMINISHING MUSHARAKAH

Diminishing Musharakah is one of the major modes of financing used in Islamic banking. It is usually used to finance fixed assets for long term consumer and corporate financing. It is also one of the major structures used in offering house financing products by Islamic banks.

In Diminishing Musharakah, the customer approaches the bank for joint purchase of an asset/property. Designated valuation agencies are consulted for the valuation of the asset/property. The seller of the property is paid by the bank and the bank and the customer enter into a Musharakah Agreement.

It is referred to as 'Diminishing Musharakah' because of the arrangement by which the ownership stake of the tenant increases and that of the bank decreases with the passage of time. The rent decreases as the ownership stake of the tenant increases.

The share of the bank in asset/property is divided into units. These units are purchased by the customer periodically. When he has purchased all units, he becomes the sole owner of the asset/property. Figure 3 gives share of Diminishing Musharakah in total financing mix of Islamic banking institutions in Pakistan over the period 2006-2012.

Figure 3: DM to Total Advances (%)

Source: Islamic Banking Bulletin, 2011

MURABAHA

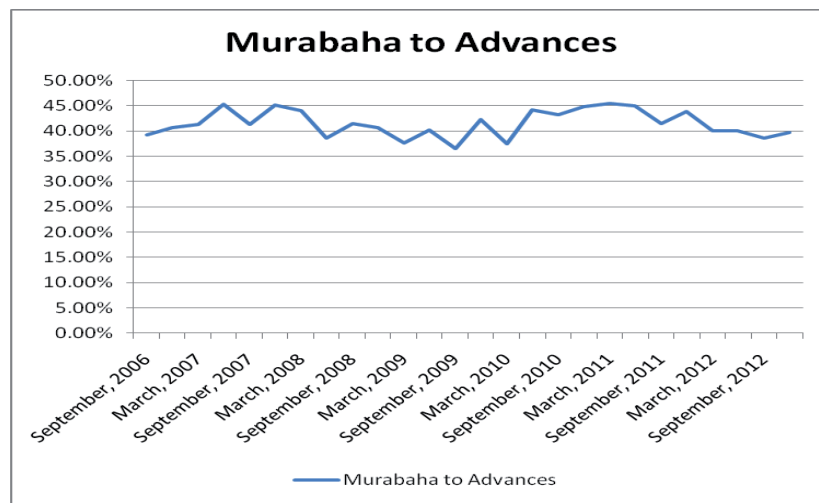
Murabaha is a deferred payment sale. Murabaha is used in working capital financing, SME financing and trade financing for short term period. If a customer wants to buy an asset for which it does not have the capacity to pay immediately, then Murabaha contract could be used to provide short term financing.

The process flow of Murabaha is as follows:

- Islamic bank and the client sign a Murabaha finance agreement and an agency agreement. According to the agency agreement, the customer purchases goods from the supplier on bank's behalf. The customer undertakes to purchase the asset from the bank. It is a one-sided promise and undertaking. The bank pays the supplier and obtains title and physical/constructive possession of the asset. The customer signs a declaration that he has purchased the goods on bank's behalf and now he is willing to purchase the asset. After offer and acceptance, sale is executed and the customer pays the agreed price to the bank.

- Rollover that is rescheduling in Murabaha is not allowed. The goods cannot be sold if they are consumed already. Penalty is charged if payment is delayed and is paid to charity. Figure 4 illustrates the share of Murabaha in total financing mix of Islamic banking institutions in Pakistan over the period 2006-2012.

Figure 4: Murabaha to Total Advances (%)



Source: Islamic Banking Bulletin, 2011

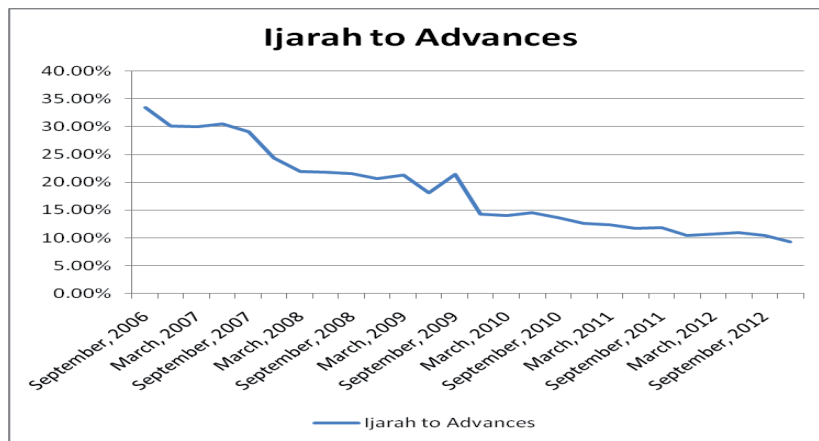
IJARAH

In Ijarah, the right to use an asset is obtained and rent is paid for the use of asset. The process flow is as follows:

- The customer approaches the bank for obtaining an asset on lease. The customer undertakes to make periodic lease payments over the lease period. Lease agreement and agency agreement is signed. The customer buys the asset as an agent to the bank. Bank pays the vendor and receives the title of the asset. The bank hands over the asset to the customer on lease and the customer starts using the asset and pays rent for each period. At maturity of lease, the customer can purchase the asset from the bank by way of a separate purchase agreement.

- The lease period starts when the asset has been delivered by the lessee in a usable condition. The bank (Lessor) bears the ownership related costs and the customer (Lessee) bears the usage related costs. If the asset is destroyed or becomes unusable, the bank stops taking rent and does not charge rent for that period. Figure 5 shows the share of Ijarah in total financing mix of Islamic banking institutions in Pakistan over the period 2006-2012.

Figure 5: Ijarah to Total Advances (%)

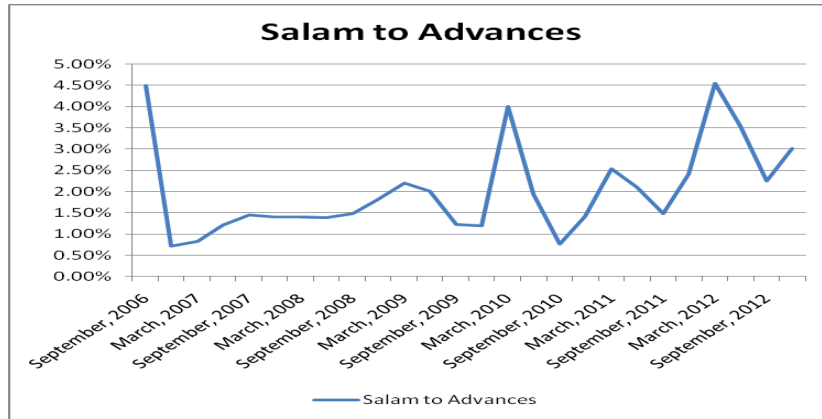


Source: Islamic Banking Bulletin, 2011

SALAM

It is used in financing goods and services that are not ready for spot sale and will have to be delivered later. In Salam, payment is spot, but the delivery is deferred. It is used in special cases to facilitate transactions. In current practice, it is used in currency trade as an alternative for bill of exchange discounting and in agriculture financing. Figure 6 shows the share of Salam in total financing mix of Islamic banking institutions in Pakistan over the period 2006-2012.

Figure 6: Salam to Total Advances (%)

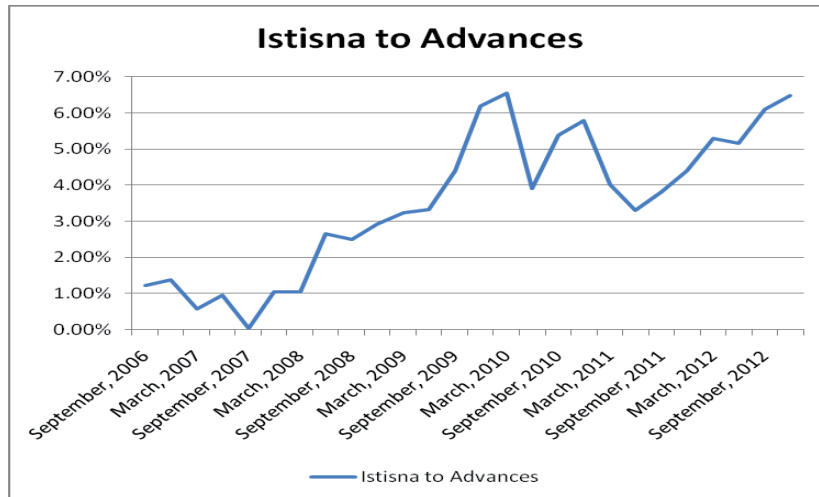


Source: Islamic Banking Bulletin, 2011

ISTISNA

It is used in financing goods that are not yet ready for sale and will have to be manufactured. Examples include tailoring services, architect services etc. It is an order to producer to manufacture a specific commodity for the purchaser. It is used in pre-shipment exports financing and usable in all other situations where goods have to be manufactured before sale. Figure 7 illustrates the share of Istisna in total financing mix of Islamic banking institutions in Pakistan over the period 2006-2012.

Figure 7: Istisna to Total Advances (%)



Source: Islamic Banking Bulletin, 2011

LIABILITIES: DEPOSITS

Liabilities are the deposits placed with the bank. The two main categories of deposits are checking accounts and non-checking accounts. Some accounts are remunerative and some are non-remunerative. In the following lines, the deposit products offered by Islamic banks are discussed below.

Non-Remunerative Accounts

Current account is an example of a non-remunerative checking account. The money deposited in such an account is considered ‘*Qard*’ (non-interest bearing loan). Bank utilizes the money to invest in Ijarah, Murabaha, Diminishing Musharakah, Salam, Istisna and others. The money is payable on demand. If the bank wants to offer a checking account that also allows some unilateral profit sharing, then ‘*Wadiah*’ structure is also used. In ‘*Wadiah*’ structure, the bank may give any part of benefit it received from the deposited property.

Remunerative Accounts

Remunerative accounts can be checking that is savings account or non-checking accounts such as term deposits. Usually, Mudarabah structure is used to offer remunerative deposit schemes. The deposited money by all depositors is pooled into a fund and invested in offering various financing products to clients. The bank acts as 'Mudarib' or '*Fund Manager*' and the depositors act as 'Rabb-ul-maal' or '*investor*'.

The money is only invested in Shari'ah compliant assets. Bank utilizes the money to invest in Ijarah, Murabaha, Diminishing Musharakah, Salam, Istisna and others. Profit is declared at the start of the month for the previous month based on the agreed profit sharing ratio.

ECONOMICS ANALYSIS OF ISLAMIC BANKING

Economic Analysis of Murabaha

There is often a need of short term financing for acquisition of an asset. Hence, it is not possible to issue new equity all the time and when retained earnings are not enough for the purchase of lumpy assets financing, bank financing is used as a source of short term funds. Murabaha serves the short term financing needs.

Often, it is desirable to lever the earnings when opportunity comes by. Keeping lumpy assets all the time will require inventory maintenance cost and may result in underemployment of assets at times. It will dampen liquidity and turnover ratios and hence affect stock price of companies. Hence, not all assets can be acquired from paid-up capital right away. So, it is desirable to use short term bank financing than to use expensive source of equity financing.

Equity financing may not be appropriate in running projects in which projects and income sources cannot be easily segregated. In such a case, Murabaha is an easy to use short term financing solution. Often, the investors with bank (the deposit holders) are risk averse and want consistent returns. With equity financing, the operating cycle of some enterprises maybe long and may not bring consistent cash flows required by such investors. In that case, Murabaha financing is beneficial for investors.

Murabaha enables financing of raw materials as well as finished goods. This improves the supply chain management and reduces bottlenecks caused due to cash flow problems or mismanagement. Share Murabaha can improve liquidity in equity markets and keep the market converge towards fundamental values of stocks. Sometimes, for the equity market to reach equilibrium and stability, liquidity is a big issue. Murabaha financing keeps the beneficial trades going and hence more trades will lead the market to trade near or at fundamental values.

Equity financing helps in establishment of businesses. But, once established, businesses have need for financing and managing cash flows recurrently. Murabaha financing allows a Shari'ah compliant alternative to finance short term assets purchase needs and hence increases production of goods and services in an economy which can bring about economic growth and its consequential benefits.

From the risk perspective, Murabaha financing keeps the Islamic financial system liquid and less prone to risk due to asset backing. Hence, with Murabaha, liquidity comes but not at the cost of increased financial risk to the system.

From the welfare and equity standpoint, with each additional financing provided, an asset is purchased. The expenditure on asset equals income received by factors of production used in the production process. Plus, the government gets to receive production and sales related levies which it can use to provide public goods and other welfare services for masses.

Economic Analysis of Istisna

Often, in commercial financing, huge financing is required for different projects that take time to be completed; for instance, construction of plant, highway, dams and others. The firm providing services to undertake and execute such projects may have expertise, but lack funds to undertake such projects. Financial intermediation can bring necessary financing, liquidity and risk mitigation that enables the unknown counterparties to undertake such projects.

Giving funds for raw material purchase directly by the client will pose certain challenges of agency conflict and moral hazard. In such a case, the financial intermediary can aid with better credibility, standing, and economies of scale in authenticating the counterparties and the ability to effectively and efficiently enforce contracts.

There is often need of making payments for resource supplies before production is complete. To keep the production cycle going, Istisna can be used to ensure resource supplies availability and production. Often, it is desirable to keep low levels of inventory and improve turnover ratios. Keeping huge inventory all the time will require inventory maintenance cost and may result in underemployment of assets at times. It will dampen liquidity and turnover ratios and hence affect stock price of companies. Using Istisna right when financing is needed for new project will reduce operational and financial inefficiencies.

Often, construction and engineering companies enter into big-volume, but customized contracts with institutional clients. Keeping inventory beforehand is neither financially possible nor operationally appropriate. Hence, financing the project requirements after project deal is signed will enable firms to work with less cash tied up.

From the risk and profitability perspective, Istisna financing keeps the Islamic financial system liquid and less prone to risk due to asset backing. Islamic financial intermediary enables credit availability to ensure that productive transactions are executed and also, it reduces the transaction and monitoring costs which result in more productive transactions happening in the economy.

Often, the investors with bank (the deposit holders) are risk averse and want consistent returns. But, small savers do not have enough funds to finance big volume projects directly. But, using investors' pool of funds to provide financing through Istisna, the investors are able to share in benefit of such economic activities.

Financing big projects without financial intermediation will be a very difficult task. Equity financing is also costly in some ways because of high floatation cost, risk of under subscription and inflexibility in modifying capital structure when needed. But, using investors' pool of funds to provide financing through Istisna, the banks can effectively finance such big projects that have positive benefits to direct parties involved as well as positive externalities enjoyed by masses in the society.

Economic Analysis of Salam

There is often need of making payments for resource supplies before production is complete. To keep the production cycle going, Salam can be used to ensure resource supplies availability and production. Salam

enables financing of raw materials for the production of standardized products. This reduces the supply chain bottlenecks caused due to cash flow problems.

Salam can also be used in bill of exchange discounting. Often, exporters receive payment after a few months. In the meantime, they might be looking to produce more and take more orders, but they may find shortage of cash inflows. In such a scenario, Salam can be used to sell local currency for a price to be paid in foreign exchange at a pre-agreed exchange rate.

Economic Benefits of Mudarabah and Musharakah

Islam encourages equity financing in which the loss/profit would be shared. This ensures better results from the perspective of redistribution and better co-operative behavior since payoffs for all parties are linked with productive sector of the economy. Consequently, markets will not have to produce speculative surplus output just to service exorbitant amount of debt and that could stabilize business cycles.

Mudarabah is considered to be one of the most preferable modes of Islamic finance both by earlier and contemporary jurists and Islamic scholars. Ibn Taymiyyah observed: "One who deliberates on the basic principles would easily conclude that *Musaqat*, *Muzara'ah* and *Mudarabah* are nearer to justice than hire" (Fatawa, Vol.20. p.356).

Usmani (2004) in his book "Introduction to Islamic Finance" wrote in at least 5 places that Mudarabah and Musharakah are ideal modes of financing respectively (p. 12, 17, 72, 107 and 164).

Khan and Mirakhor (1987) commenting on the preferable nature of Mudarabah commented as follows:

"Even though in practice the role of profit-sharing and partnership is very small at present, they continue to dominate the theory of Islamic banking. They are regarded as the norms towards which practice should and would, eventually gravitate" (p.185-199).

ECONOMIC CRITIQUE OF ISLAMIC BANKING

Predominant Use of Debt Based Financing

It is an empirical fact that Islamic banks prefer to offer debt related products (Ismail, 2011a). Chaudhry (2006) raised the concern that a narrow juristic interpretation of the Shari'ah is followed, leaving aside the Tawhidi core. Ismail (2011b) stated that recent growth experience and product innovation directed towards coming up with more sophisticated products using debt based structure exhibit that growth has taken more precedence over Shari'ah compliance in letter and spirit.

Usmani in his article 'New Steps in Islamic Finance' writes:

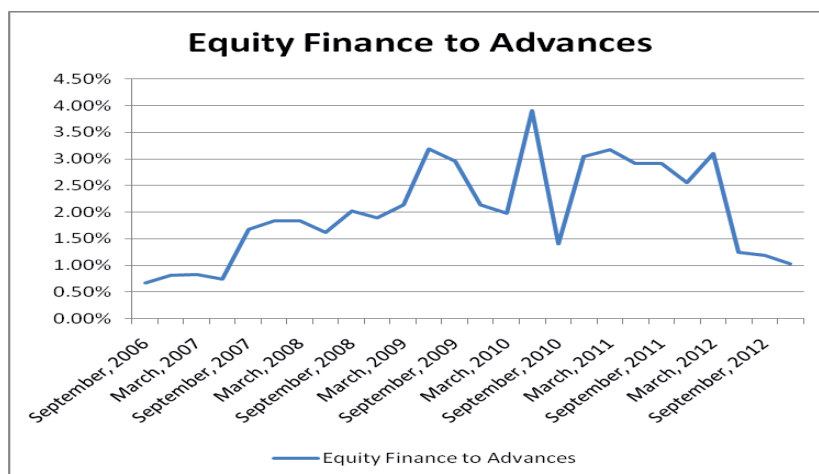
"...One must not forget that these instruments are not modes of financing in their origin. They are in fact some forms of trade that have been modified to serve the purpose of financing at initial stage as secondary and transitory measures. Since they are modified versions of certain forms of trade, they are subject to strict conditions and cannot be used as alternatives for interest-based transactions in all respects. And since they are secondary and transitory measures, they cannot be taken as final goal of Islamic finance on which Islamic Financial Institutions should sit content for all times to come. It is a matter of concern for a student of Islamic finance, like me, that both these points are increasingly neglected by the players in the field, and especially by the new-comers in the industry."

Furthermore, in his book, 'Introduction to Islamic Finance', the respected scholar, Usmani writes:

"It should never be overlooked that, originally, Murabaha is not a mode of financing. It is only a device to escape from "interest" and not an ideal instrument for carrying out the real economic objectives of Islam. Therefore, this instrument should be used as a transitory step taken in the process of the Islamization of the economy, and its use should be restricted only to those cases where Mudarabah or Musharakah are not practicable" (p. 72).

It is clear that Mudarabah is considered to be one of the most preferable modes of Islamic finance. But, still the share of equity financing is disappointing in total financing portfolio of Islamic Banks as can be seen in Figure 8.

Figure 8: Share of Equity Financing (Musharakah & Mudarabah)



Source: Islamic Banking Bulletin, 2011

High Spreads and Low Asset Turnover Ratios

What had been even more disappointing and surprising is the fact Islamic banking spreads - the difference between average financing and deposit rates - have been constantly higher than the overall banking spreads in Pakistan during the last three years as shown in Table 1.

Table 1: Comparison of Banking Spreads

Period	IB Spreads	Banking Spreads
Sep-11	8.40%	6.70%
Jun-11	8.80%	6.90%
Mar-11	8.40%	6.90%
Dec-10	7.10%	6.80%
Sep-10	7.70%	6.80%
Jun-10	7.70%	6.90%
Mar-10	7.70%	6.60%
Dec-09	7.00%	6.60%

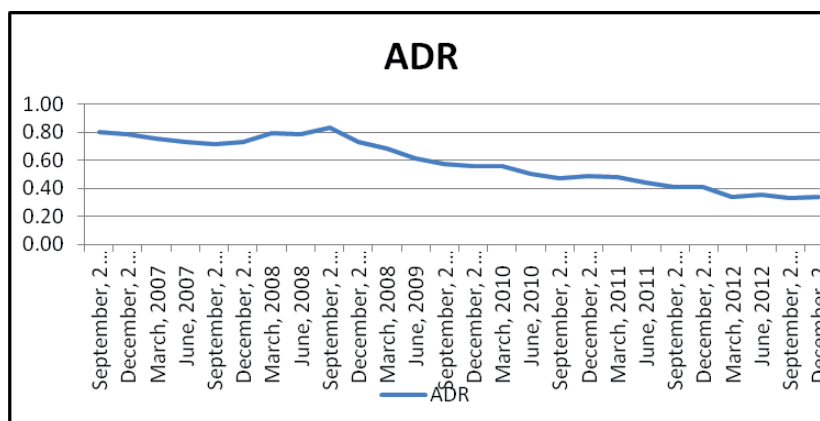
Source: Islamic Banking Bulletin, 2011

Furthermore, there is limited originality in product structures and most importantly, they do not hit the roots of the evils of interest based system and capitalism. If interest was prohibited due to exploitation as explained by Quran, then, how Islamic banking having higher spreads than conventional banking and using primarily the debt based modes of finance, justifies avoiding exploitation and providing anything substantially different from conventional banking system.

The so called asset backed nature of financing in Islamic finance deprives one to finance education, health, autonomous and necessary consumption. What it ensures is the rent seeking by Islamic institutions that insure the asset and add this insurance cost in the rentals and Murabaha price to make the receivable as secure as interest on loan. This is achieved by mitigating price, market and asset risk which is the basic distinguishing feature between trade and riba.

Figure 9 reports declining advance to deposit ratio in Islamic banking over the period 2006-12. Islamic banks in Pakistan have surplus liquidity, but rather than using the more preferable modes of financing with a lot of cushion in the form of liquidity, Islamic banks give their liquid funds to conventional banks. This is done by using financial innovativeness to bypass legal hitches and in a way, they are sometimes serving to strengthen interest based conventional banking.

Figure 9: Advance to Deposit Ratio in Islamic Banking



Source: Islamic Banking Bulletin, 2011

Challenging Questions for Islamic Banking in Pakistan

Islamic banks after having spent a decade of Islamic banking operations in Pakistan have to reflect on answers to the following points:

- How justified are high Islamic banking spreads (difference between average financing and average deposit rates) which have reached 8.40 percent and are one of the highest in the world and more than two percentage points higher than conventional banks in Pakistan?
- How do they justify their position and analyze their performance on social and egalitarian grounds when most of their products are priced using the same benchmark of the conventional banking industry, which is KIBOR?
- Equity financing is regarded as the most ideal mode of financing in an Islamic economy by Islamic scholars. Why it is hardly used in financing the clients with a contribution of less than two percent in total financing?
- Trust and documentation problems did not hinder 700 companies to get registered on Karachi Stock Exchange while thousands of public limited companies are operating in Pakistan as well. Why Islamic

financial institutions could not help support more Initial Public Offerings (IPOs) either through investment banking operations or alternate institutional structure when they have surplus liquidity?

- Lastly and most importantly, they must reflect on what was the real reason for prohibition of riba? If it was exploitation, then should an alternate system claiming to be founded on Islamic principles not differ in any substantial way in terms of cost?

CONCLUSION

We reviewed the financial statistics for the industry during the period 2006-12 and it is clearly evident that the industry has seen exceptional growth despite the tight monetary policy, consumer credit crisis and high inflation in Pakistan during the period. However, we also noted that the currently practiced Islamic banking is yet to offer substantially different economic results from conventional banking, both in terms of costs and as well as product structure. We noted that even though Islamic banks claim differences in contract mechanics which legitimize their product offerings in their view, but most of the product mix is heavily concentrated in debt based financing arrangements which are used for collateral based asset finance.

Going forward, it is hoped that after having completed one decade of successful operations of Islamic banking and exhibiting exemplary growth in commercial sense, Islamic banks will look towards increasing their outreach to the poor masses and start using more equity based modes of financing which help improve their image and bring some fruits of Islamic economic principles.

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