Financial Inclusiveness in Islamic Banking: Comparison of Ideals and Practices Based on Maqasid-e-Shari'ah

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Abstract

In this study, we attempt to document the progress in Islamic banking industry of Pakistan towards fostering an egalitarian and equitable financial intermediation. We use a set of quantitative indicators to objectively asses the performance of Islamic banks towards fostering a participative, inclusive, cost effective and real sector oriented financial intermediation. We highlight that currently, the performance of Islamic banks on these fronts leaves much to be desired. We highlight that the low finance to deposit ratio and high average cost of financing is inconsistent with Maqasid-e-Shari'ah. We also identify various categories of poor people who need finance for their health, education and small business working capital needs, but they cannot be served by Islamic banks by using the available product structures. We give a geographical presence of Islamic banks which shows that they are mainly based in big urban cities. We argue that most of the Islamic banking debt based products are close, but relatively expensive substitutes. Finally, we discuss that the distinctive and preferable imperfect substitute product structures like equity based financing contracts are not acceptable to the major part of the real sector industries as well as to the Islamic banking stakeholders, i.e. depositors and shareholders in their current form.

Keywords Islamic Banking, Islamic Finance, Financial Inclusion, Microfinance

JEL Classification**:** A1, H2, G0, B5

1. Introduction

It is well established in literature that financial development compliments economic growth. Countries with greater degrees of financial development – as measured by aggregate measures of bank development and market development – enjoy substantially greater economic growth rates. We give a brief account of studies which establish this relationship. North (1990) and Neal (1990) conclude that regions that developed the relatively more sophisticated and well-functioning financial systems were the ones that were the subsequent leaders in economic development of their times. Odedokun (1998) also concludes that 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. Hassan et al. (2011) find positive relationship between financial development and economic growth in OIC (Organization of Islamic Cooperation) developing countries.

Moreover, the component of financial development explained by the legal rights of outside investors and the efficiency of the legal system in enforcing those rights is strongly and positively linked with long-run growth. Levine et al. (2000) evaluate whether cross-country differences in legal system (e.g., creditor rights, and contract enforcement) and accounting system explain differences in the level of financial development. They conclude that cross-country differences in legal and accounting systems help account for differences in financial development. This suggests that legal and accounting reforms that strengthen creditor rights, contract enforcement, and accounting practices can boost financial development and accelerate economic growth.

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%, 26.8%, 25.6%, 23.6% and 22.8%, 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% in Afghanistan, 26% to 27% in Iraq and Tunisia, and 23% to 24% in Djibouti and Saudi Arabia. This highlights the need for interest-free banking in these Muslim-majority regions.

In Table 1, we see that there are a lot of populous Muslim-majority countries where savings ratio is very low. Part of the reason why savings culture is weak is that people do not want to invest in interest-based investment options. The evidence for this argument is the sustained increase in deposits growth in Islamic banking wherever it is being offered. Hence, if Islamic banks increase their outreach, these economies will also benefit by reducing their savings–investment gap.

Table 1: Savings Investment Gap in Muslim Countries

Country	Investment to GDP (%)	Savings to GDP (%)	Gap (%)
Afghanistan	25.4	-19.8	-45.2
Albania	25.3	3.1	-22.2
Jordan	24.5	2.8	-21.7
Kyrgyz Republic	24.4	-2.9	-27.3
Lebanon	32.0	6.4	-25.6
Morocco	30.6	21.5	-9.1
Mozambique	24.3	7.8	-16.5
Pakistan	11.5	8.0	-3.5
Senegal	30.6	10.9	-19.7
Sierra Leone	14.9	4.6	-10.3
Tajikistan	18.7	-2.8	-21.5
Tunisia	24.0	24.0	0.0
Turkey	21.8	14.9	-6.9
Uganda	24.4	13.8	-10.6

Source: Statistical Monograph 2013, IDB

Due to the lack of formal financial services in less privileged areas in developing countries, certain non-market institutions also start to appear. 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 from 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% points less likely to anticipate drawing down assets, and 25% less likely to anticipate reducing meals upon receipt of a payout.

Using the Indonesian Family Life Survey, Berloffa & 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 on real sector and 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, we see that 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 Shari'ah 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 Middle East, East Asia, South Asia, Central Asia and 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 voluntary excluded households in the financial network. On the other hand, their vision and link with ethical precepts of Islam creates an additional expectation for making an egalitarian contribution in the society. 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. In this paper, we assess by how far this vision of Islamic banking matches up with reality. The study will help the industry to review its performance on contributing towards financial inclusiveness, social mobility, need fulfillment and equitable income distribution.

We proceed to review stylized facts of Islamic banking in Pakistan in section 2. In section 3, we discuss how Islamic banking is assessed by the front seat 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 guide to its practical institutional operations. In section 4, we present empirical evidence from Pakistan to enable a more objective assessment of Islamic banking in Pakistan with regards to cost competitiveness and operational efficiency. In section 5, we extend our discussion by analyzing the performance of Islamic banking towards facilitating effective and comprehensive financial intermediation, outreach and financial inclusiveness.

1.1. Objectives of the Study

We set forth following objectives in this study:

- To document the progress in Islamic banking in Pakistan with regards to growth in assets, deposits, financing, investments, market share and profitability.

- To document the areas of concern in Islamic banking industry which are hampering its assimilation and realizing its egalitarian vision.

- To highlight areas of improvements in Islamic banking industry with regards to outreach, product structures, financing mix, financing cost and effective utilization of deposit funds.

- To evaluate the progress of Islamic banking in enhancing socio-economic mobility, financial inclusiveness and fostering equitable distribution of income.

1.2. Research Methodology

The research utilizes various quantitative indicators to focus discussion and evaluate Islamic banking towards enhancing financial inclusion for socio-economic mobility. Before we proceed 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% 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. We use 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) Advance to deposit ratio.
5) Islamic banking spreads vis-à-vis conventional banking spreads.
6) Capital to assets ratio in Islamic banks vis-à-vis conventional banks.
7) Mapping target market for major consumer products from stated income requirements.

2. The Stylized Facts about Islamic Banking in Pakistan

The first phase of Islamic banking in Pakistan 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 since 2002. Now, Islamic banking in Pakistan is an established industry with 11% market share achieved in just over a decade. Out of 44 commercial banks operating in Pakistan, there are 5 full-fledged Islamic banks operating in the country along with 17 conventional banks with a total branch network of 1,597 branches. Table 2 gives brief details of key figures in Islamic banking industry in Pakistan.

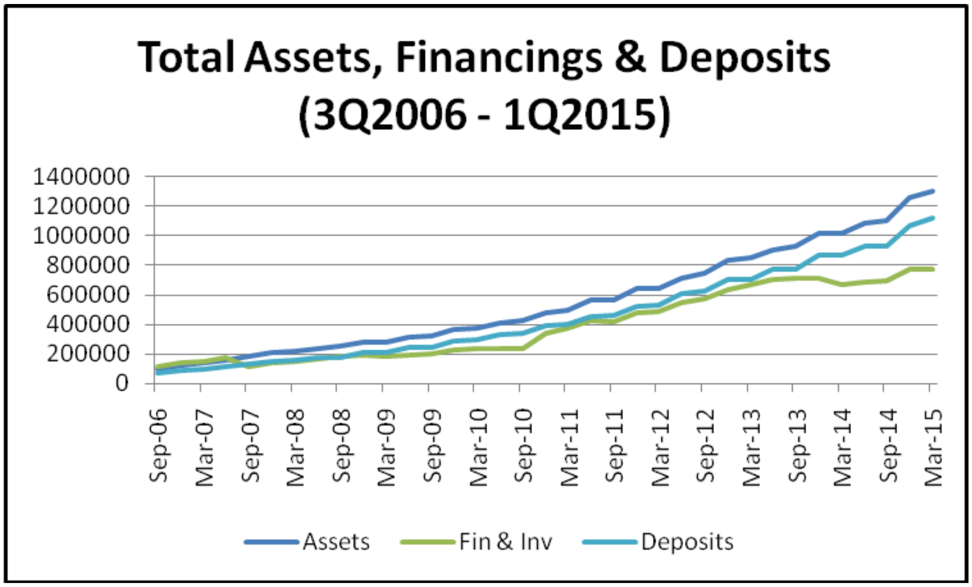
Table 2: Stylized Facts in Islamic Banking Industry in Pakistan

Islamic Banking Industry Progress in Pakistan (As at March 31, 2015)	
Total Assets (in billion Rs.)	1,302
Total Deposits (in billion Rs.)	1,122
Net Financing & Investments (in billion Rs.)	768
Total Islamic Banking Institutions	22
Total Islamic Banking Branches	1,597

Source: State Bank of Pakistan, Islamic Banking Bulletin

In the more recent statistics published by State Bank of Pakistan (SBP) on Islamic banking, the return on equity in Islamic banking has reached 18% and is now more than the industry average of 17% in Pakistan. 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 1 presents the trend in total assets, total deposits and total financing & investments in Islamic banking based on quarterly data for the period 3QCY06-1QCY15. It can be seen that the growth is uninterrupted and more pronounced since 3QCY10.

Figure 1: Total Assets, Total Deposits & Total Financings & Investments (mln PKR) for 2006-2015



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

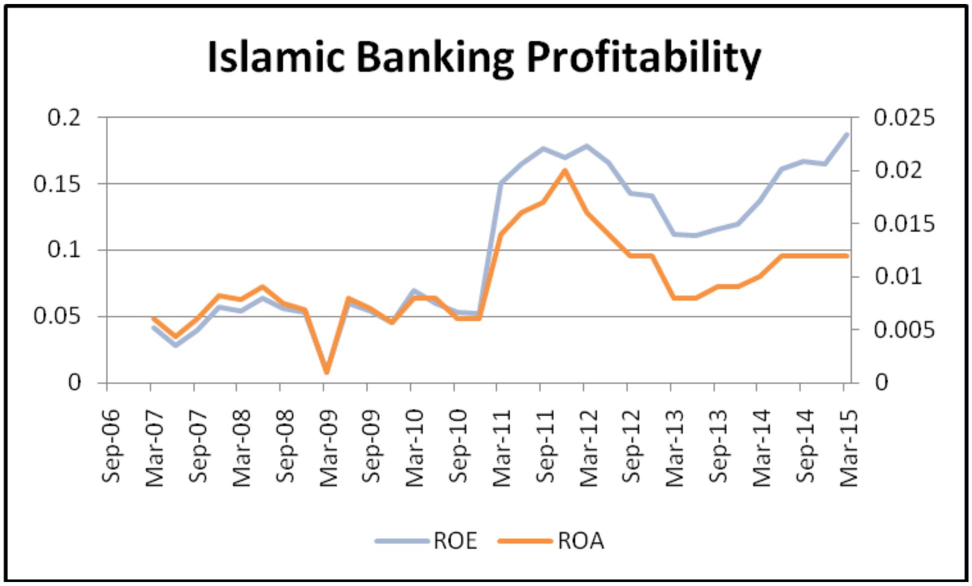
The basic structure of Islamic banking as explained in Ibrahim & Ismail (2015) among others can be briefly summarized as follows. First, an Islamic bank creates an asset pool which consists of bank's equity and deposits. Deposits include two further classifications, i.e. remunerative deposits and non-remunerative 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, Murabaha, Istisna etc. 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. Income stream is generated either through profit on credit sale or rental income for the use of 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 rentals necessary to amortize the cost of asset during the lease period. Income from the sale or lease of real assets is distributed among the contributors in 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 2 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 banks took time to consolidate and break even, but in later periods, they have registered strong growth with ROE reaching even 18% and sustaining to be in double digits despite the security, energy and fiscal crisis in the country.

Figure 2: Profitability Growth in Islamic Banking

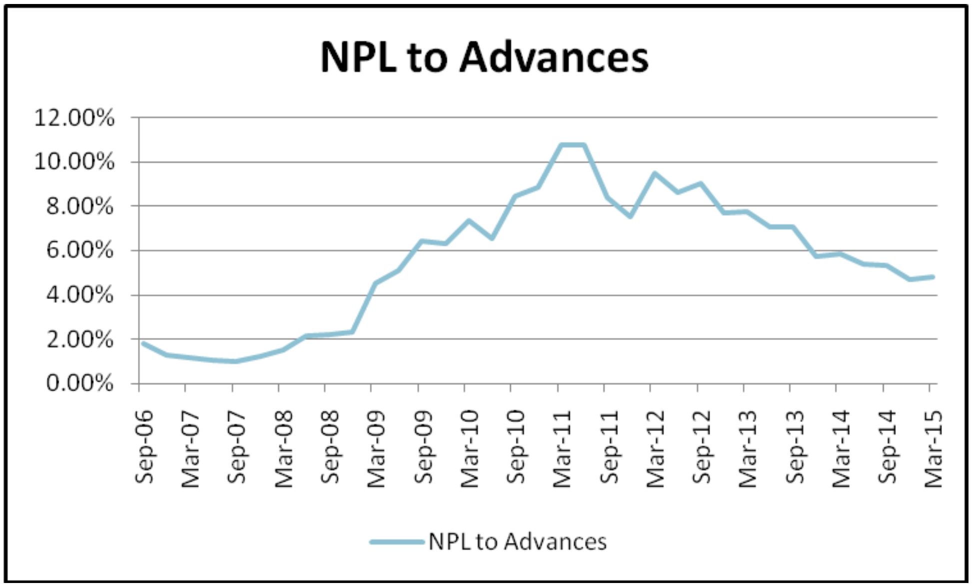


Source: Islamic Banking Bulletin, SBP, Various Issues

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.

Figure 3 shows the non-performing loans to total advances ratio. During the credit crunch and low economic growth (2008-2011), the NPLs rose sharply. But, since 2011, the NPLs are declining and now they remain at less than 5%, which is considerably lower than the 12.8% ratio for the overall banking industry.

Figure 3: NPLs to Advances Ratio – 2006-2015



Source: Islamic Banking Bulletin, SBP, Various Issues

3. Islamic Banks as Intermediaries: Idealism Versus Realism

Islamic banks use Shari'ah 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 Shari'ah compliant, but also distinctively contributing towards 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 priority basis. This has created a wedge between the realists and the idealists. The realists are the executioners of Islamic banking on 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. The products though Shari'ah compliant are structured to compete with 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, we give a brief sketch of how the idealists and the realists assess the performance of Islamic banking practice so far.

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. They argue that fulfilling minimal Shari'ah legal compliance in product structuring is insufficient to make progress towards these specific ends.

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 banks think that unless Islamic banking gradually moves away from debt like financing, it cannot claim to be a substantive alternative of 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 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-Shari'ah (purposes of the law) has 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 Shari'ah arbitrageurs, whose efforts continue to be focused on synthesizing contemporary financial products and services from classical nominate contracts, without regard to corporate structure of financial institutions.

4. Financial Inclusion and Islamic Banking

If we look at the situation on ground in Pakistan with regards to financial inclusion, only around 18% of people in Pakistan hold bank accounts. Furthermore, only 3% of the women in Pakistan have a bank account. On the other hand, Financial credit is available to an even meager 3% of the population. Table 3 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 3: 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 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.

Table 4: 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

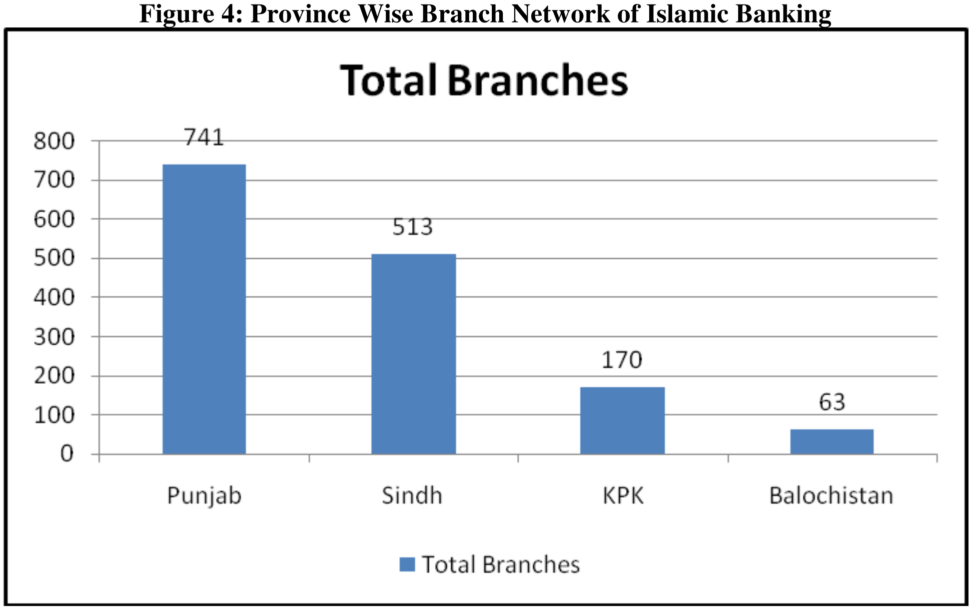
Source: World Bank Financial Inclusion Database (FINDEX 2014)

To change matters, National Financial Inclusion Strategy (NFIS) aims 50% 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) in a most recent study conclude that as many as 58.7 million people in Pakistan are living in multidimensional poverty with 46% of rural population and 18% of urban households falling below the poverty line. Only 2.35 million people out of 58.7 million poor people are served with microfinance. It shows that only 4% 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 microfinance needs in urban areas. Documentation, collateral and contract enforcement problems are also less challenging in urban areas as compared to the rural areas.

It is striking that less than 1% 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-e-Hasan and Islamic modes of financing which mostly include Murabaha, Ijarah and Salam. However, it is disappointing to note that despite huge profits, liquidity and scale advantages, Islamic banks exclude major part of the population from their product mix. Now, if we look 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. Figure 4 reports the total number of Islamic banking branches in the four provinces of Pakistan.

Figure 4: Province Wise Branch Network of Islamic Banking



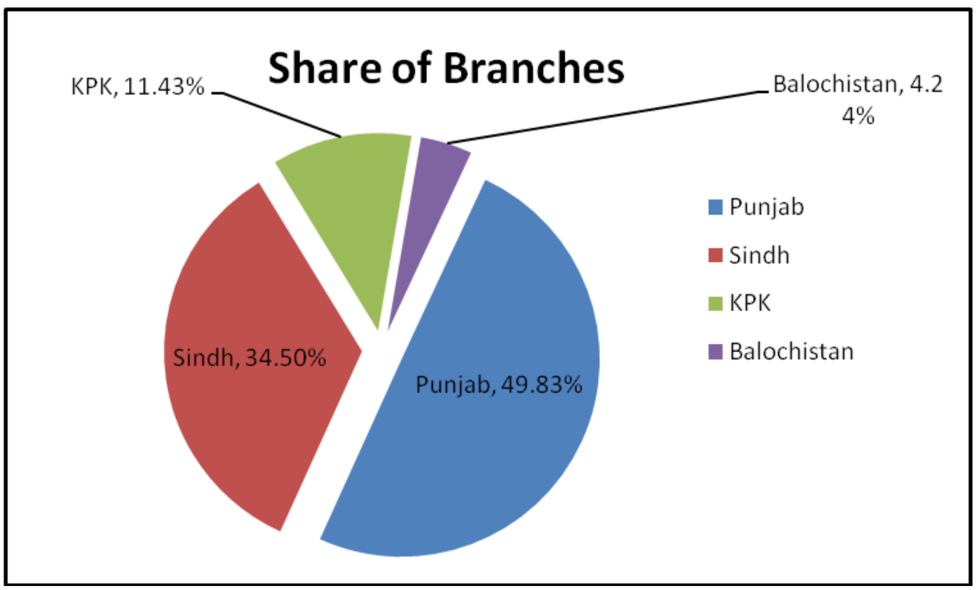
Source: Islamic Banking Bulletin, SBP, Various Issues

Figure 5 reports that Punjab and Sindh province together host 85% of total branches. The other two provinces with higher incidence of poverty and lesser per capita income host only 15% of total Islamic banking branches.

Karachi and Lahore are two major cities of Pakistan. Total branches in these two cities combined constitute 46% 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 84% of total branches in the Sindh province. Lahore city hosts 34% of total branches in the Punjab province. Quetta city hosts 64% of total branches in the Baluchistan province. Peshawar city hosts 33% of total branches in the KPK province.

Together, the four federal capitals of Pakistan host 52% of all branches in Pakistan. It is interesting to note that 5 big cities of Pakistan host 54% of all branches in Pakistan. This geographical distribution of branch network goes hand in hand with the income distribution. There is more presence of Islamic banks in high-income regions.

Figure 5: Province Wise Branch Network of Islamic Banking



Source: Islamic Banking Bulletin, SBP, Various Issues

Table 5 presents the percentage distribution of employed population by average monthly payments. It can be seen that only a quarter of 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. If we compare the last column of Table 5 with Figure 6, 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 5: Distribution of Employees by Average Monthly Payments (Rs.)

Distribution of Employees by Average Monthly Payments (Rs.)		
Area	**Greater Than Rs 15,000 Monthly Income (%)**	**Distribution - Province Wise (%)**
Pakistan	24.31	
KPK	3.47	14.72
Punjab	11.49	47.26
Sindh	7.35	30.23
Baluchistan	2.01	8.27

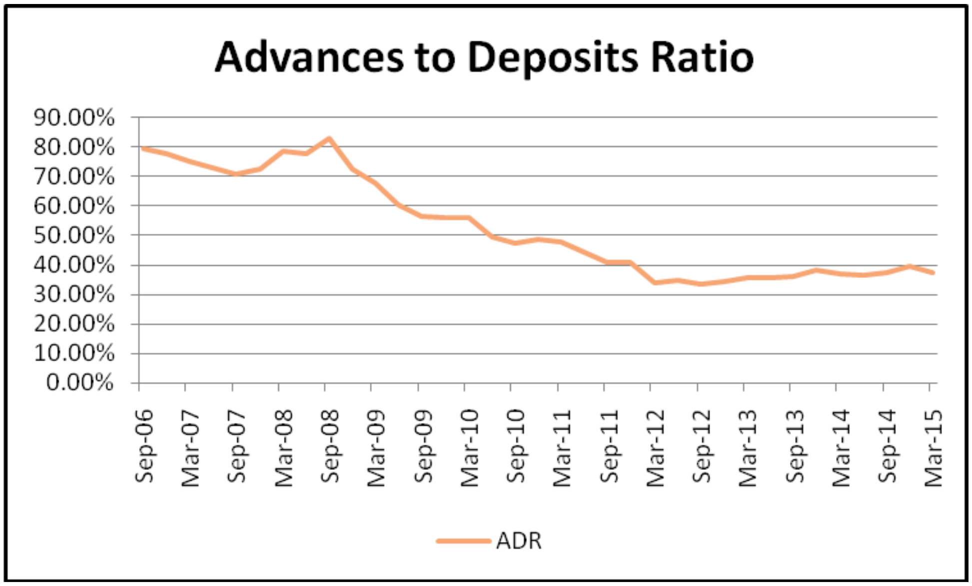
Source: Labor Force Survey 2013-14

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. 6.6% as compared to 10% 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 is in motion at both types of institutions. In the overall deposits, only one-third of deposits are placed in 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 calculation of returns by assigning weightage that takes care of time value of money. Hence, due to 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.

Circulation of wealth is a desirable objective discussed in theoretical Islamic economics literature. Even from a pure economics perspective, it is a desirable end in order to achieve economic stabilization and inclusive as well as sustainable growth. However, Islamic banks are relatively less active in providing finance as a ratio of deposits even if compared against conventional banks. The financing to deposit ratio is as low as 35% in Islamic banks as shown in Figure 6.

Figure 6: Financing to Deposits Ratio – 2006-2015



Source: Islamic Banking Bulletin, SBP, Various Issues

In Islamic banking, deposit mobilization has much less contractual frictions than creating a Shari'ah compliant financing asset. In providing finance, it is important that finance is provided for genuine purchase of an asset whose ownership, possession and risk has to be borne by the bank so as to be able to earn any sale premium or rents. While ease in 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% of the people in the labor force. Out of these 43% employed people in agriculture, approximately 41.5% employment is in rural areas and only 1.5% is in urban areas. If we look at sector wise financing mix of Islamic banks, they provide only 1.4% financing to this sector. The banking industry average for agriculture finance is more than 5 times as much, i.e. 8% as against 1.4% 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-fourth of the Islamic banks' financing portfolio is provided to the corporate sector. As against the overall banking industry, SME finance share in Islamic banks' financing portfolio is even only half of that of conventional banks as shown in Table 6. Furthermore, as against the overall banking industry, agriculture finance share in Islamic banks' financing portfolio is not even 10% of that of conventional banks. We noted before that agriculture directly employs 43% of the labor force in Pakistan. Apart from corporate sector, the 'individuals' is the only other segment to which Islamic banks provide more financing relatively to conventional banks. Here too, there is no financing product for individuals looking to finance education, health, utility bills and basic food requirements.

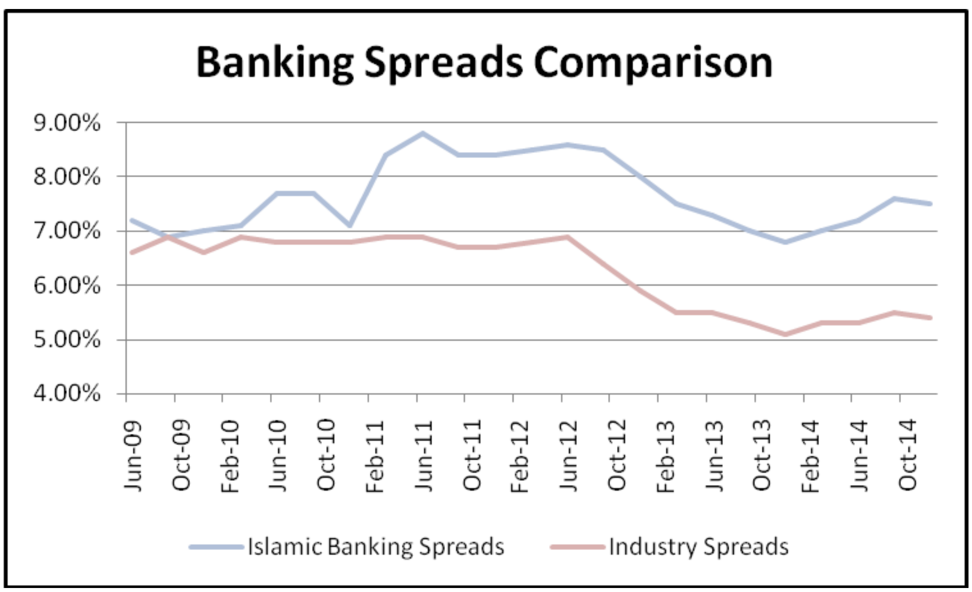
Table 6: Client Wise Financing Portfolio (%) - March 2015

Client Wise Financing Portfolio (%) - March 2015		
	Islamic Banks	**Industry**
Corporate Sector	76.6	67.9
SMEs	3.4	5.9
Agriculture	0.4	5.8
Consumer Finance	12.4	6.4
Commodity Finance	2.9	11.8
Staff Financing	1.7	2.1
Others	2.7	0.1
Total	100	100

Source: Islamic Banking Bulletin, SBP, Various Issues

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% in the 2010-2014 period as shown in Figure 7.

Figure 7: Banking Spreads Comparison – 2009-2014



Source: Islamic Banking Bulletin, SBP, Various Issues

Lastly, we present who qualifies for financing from Islamic banks as an individual. Table 7 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. We saw in

Table 5 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 per capita income and income of most people of Pakistan except the people in the top income quintile.

Table 7: Distribution of Employees by Average Monthly Payments (Rs.)

Minimum Monthly Income Required				
Banks	**Car Finance (Rs.)**		**Home Finance (Rs.)**	
	Salaried	**Businessperson**	**Salaried**	**Businessperson**
Meezan Bank	40,000[1]	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 Websites of These Banks

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 results 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 products 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 increase in the size, penetration and inclusiveness in Islamic banking.

5. Conclusion & Way Forward

The return on equity in Islamic banking has reached 18% and is now more than the industry average of 17% in Pakistan. The total Islamic banking branch network has also swelled to reach 1,600. Islamic banking share in Pakistan's total banking industry stands at 11%. However, we note that there are other aspects in which there is still room for improvement. Operating efficiency is still comparatively lower in Islamic banks as compared to the industry standards.

[1] It is computed on lowest cost car for highest possible tenor.

The finance to deposit ratio is still lower and below 40% despite the start of economic revival period since 2013. In Pakistan, agriculture provides employment to 43% of the people in the labor force. But, if we look at the sector wise financing mix of Islamic banks, they provide only 1.4% financing to this sector. This represents an opportunity for Islamic banks to put their focus on this critical sector on which almost half of the labor force is directly dependent for their livelihoods. The persistence of higher banking spreads as compared to the overall banking industry also deserves attention. Narrowing of this spread will result in faster growth and assimilation of Islamic finance products and services in the economy.

In the geographical expansion of Islamic banking branches, there is opportunity and need for expansion of branches in the peripheral and less privileged areas of Pakistan as well. Percent of branches in Karachi and Lahore city combined constitute 46% 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 federal capitals of Pakistan host 52% 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 months and years to come, it is expected that Islamic banks would give equal priority to agriculture finance, SME finance and in ensuring their presence in less privileged areas of the country. With lowering of both policy rate as well as inflation in the country, it is expected that demand for financing from banks will increase. Hence, it will help the Islamic banking sector to improve their finance to deposit ratio, narrow the banking spreads and revisit the financing portfolio mix to give renewed emphasis to agriculture finance and SME finance in the future.

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