FINANCIAL SECTOR ASSESSMENT PROGRAM

PAKISTAN

TECHNICAL NOTE: CONDITION OF THE BANKING SYSTEM

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I. PAKISTAN—CONDITION OF THE BANKING SYSTEM

1. **This note analyses the condition of the banking system in Pakistan**. Section A describes the structure of the banking system, Section B assesses the financial soundness indicators, and Section C contains the mission's recommendations aimed at preserving stability and soundness of the banking system.

A. Structure of the Banking Sector

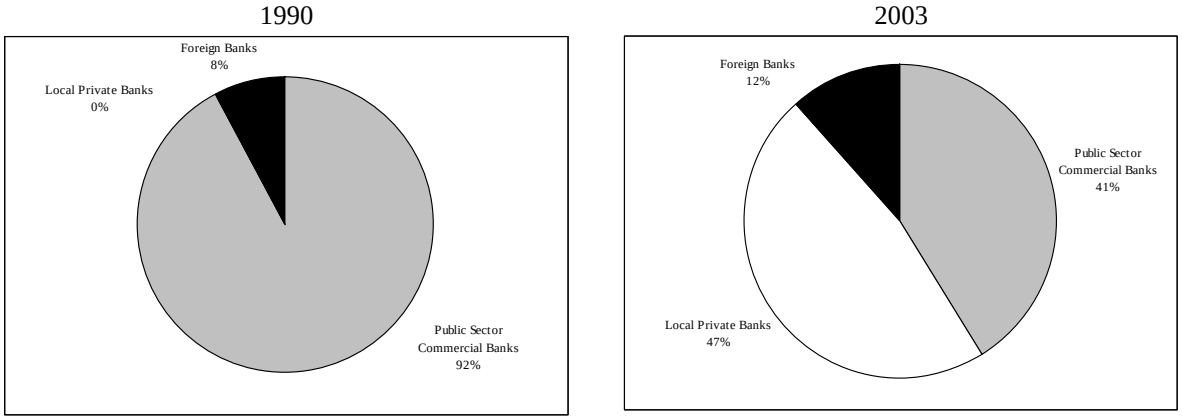
2. **Structure of the Pakistani banking sector has substantially changed in the last decade, particularly following the privatization of the state-owned banks** (Figure 1). In 1990, the banking system was dominated by five commercial banks which were all state-owned. The 1990 amendments to the Banking Companies Ordinance launched the process of financial sector reforms by allowing privatization of the state-owned banks. During the first round of reform, two of the state-owned banks, Muslim Commercial Bank (MCB) and Allied Bank (ABL), were privatized between 1991 and 1993. The reforms process was subsequently delayed for several years and resumed significantly only in the early 2000s. With the privatization of the third large bank, United Bank (UBL), in 2002, the domination of the state-owned banks was ended. As of September 2003, the asset share of local private banks and public sector commercial banks was 47 percent and 41 percent respectively (Tables 1, 2, and 3). Another large state-owned bank, Habib Bank (HBL), completed its privatization process in February 2004. As a result of this privatization, the share of banking system assets held by public sector commercial banks decreased to less than 25 percent. The largest bank in the country, National Bank of Pakistan (NBP), with a market share of approximately 20 percent, remains state-owned and its privatization prospects are uncertain at this stage, although the government divested approximately 25 percent of its capital in 2001-03.

3. **The privatization of state-owned banks has been accompanied by the liberalization in the financial system and the openness to domestic and foreign competition**. The number of commercial banks and various nonbank financial institutions grew rapidly in the early 1990s (the number of commercial banks increased to more than 40 by the year 1995). Worried by the health and soundness of the newly entering smaller banks, the authorities imposed a moratorium on the establishment of new banks in 1995, which still remains in force. In addition, the authorities sought to consolidate the banking sector by increasing the minimum capital requirement from PRs 500 million to PRs 750 million from end-December 2001 and to PRs 1 billion (around US$17 million) from end December 2002.

4. **Efforts have been made in recent years to promote Islamic banking services**. In particular, the State Bank of Pakistan (SBP) exempted Islamic commercial banks from the moratorium on the establishment of new banks, and the first full-fledged Islamic bank, Meezan Bank, was licensed in 2002. Several conventional banks have also opened branches that provide only Islamic financial services. The size of these Islamic banking institutions

remains very small.[1] Although legal ambiguities remain regarding the process of Islamization of the financial system of Pakistan, the establishment of new Islamic banking institutions is likely to continue in the coming years.

Figure 1. Pakistan: Ownership Structure of the Banking System
(in percent of total banking system assets)



Source: SBP.

[1] The SBP estimates that total assets of these institutions equal approximately 1 percent of the total banking sector assets.

Table 1. Pakistan: Structure of the Banking Sector, 1999-2003

	December 1999			December 2001			September 2003		
	Number	Assets (in PRS billions)	Percent of total assets	Number	Assets (in PRS billions)	Percent of total assets	Number	Assets (in PRS billions)	Percent of total assets
Commercial Banks	40	1,546	100	40	1,837	100	37	2,380	100
Private	34	702	45	34	890	48	32	1,399	59
Domestic	14	449	29	14	566	31	17	1122	47
Foreign	20	253	16	20	324	18	15	277	12
State-owned	6	844	55	6	947	52	5	980	41

Source: SBP.

Table 2. Pakistan: Assets, Liabilities, and Income of Commercial Banks
(end-September 2003; in PRS billions)

	Public Sector Commercial Banks	Local Private Banks	Foreign Banks	All Commercial Banks
Assets				
Cash and Balances with SBP and Other Banks	139.7	105.3	55.2	300.3
Investments	360.8	400.5	50.3	811.6
Of which: government securities	299.9	341.7	46.9	688.5
Of which: other securities	60.9	58.7	3.4	123.1
Gross Advances	373.7	491.8	131.5	997.0
Of which: in local currency	292.0	433.0	120.3	845.3
Of which: in foreign currency	81.7	58.8	11.1	151.7
Provisions for NPLs	57.8	40.2	3.4	101.3
Lending to Financial Institution	43.9	65.6	31.0	140.5
Other Assets	62.1	59.2	8.9	130.3
Total Assets	980.3	1122.4	276.9	2379.6
Liabilities				
Customer Deposits	726.8	875.7	194.3	1796.7
Of which: current accounts	199.9	215.1	42.2	457.1
Of which: other deposits	526.9	660.6	152.1	1339.6
Due to Financial Institutions	29.2	94.2	39.7	163.1
Other Liabilities	167.4	93.3	16.2	276.8
Capital	56.9	59.3	26.7	143.0
Total Liabilities and Capital	980.3	1122.4	276.9	2379.6
Income Statement				
Interest Income	31.9	40.6	10.1	82.6
Interest Expense	11.8	15.4	4.1	31.2
Non-Interest Income	12.6	19.8	4.5	36.9
Non-Interest Expense	17.8	22.1	4.5	44.5
Of which: administrative expenses	17.3	21.7	4.5	43.6
Profit/Loss Before Taxation	11.1	20.5	5.9	37.5
Taxes Paid	3.7	8.3	2.4	14.5
Net Income After Taxes	7.4	12.1	3.5	23.0

Source: SBP.

Table 3. Pakistan: Structure of Assets and Liabilities of Commercial Banks
(end-September 2003; in percent of total assets)

	Public Sector Commercial Banks	Local Private Banks	Foreign Banks	All Commercial Banks
Assets				
Cash and Balances with SBP and Other Banks	14.3	9.4	19.9	12.6
Investments	36.8	35.7	18.2	34.1
Of which: government securities	30.6	30.4	16.9	28.9
Of which: other securities	6.2	5.2	1.2	5.2
Gross Advances	38.1	43.8	47.5	41.9
Of which: in local currency	29.8	38.6	43.5	35.5
Of which: in foreign currency	8.3	5.2	4.0	6.4
Provisions for NPLs	5.9	3.6	1.2	4.3
Lending to Financial Institution	4.5	5.8	11.2	5.9
Other Assets	6.3	5.3	3.2	5.5
Total Assets	100.0	100.0	100.0	100.0
Liabilities				
Customer Deposits	74.1	78.0	70.2	75.5
Of which: current accounts	20.4	19.2	15.2	19.2
Of which: other deposits	53.8	58.9	54.9	56.3
Due to Financial Institutions	3.0	8.4	14.3	6.9
Other Liabilities	17.1	8.3	5.8	11.6
Capital	5.8	5.3	9.7	6.0
Total Liabilities and Capital	100.0	100.0	100.0	100.0

Source: SBP.

B. Performance of Commercial Banks

5. **While poor asset quality of commercial banks had long been a drag on the financial system in Pakistan, aggregate financial soundness indicators have been improving in recent years** (Table 4). In the past, large amounts of non-performing loans (NPLs) restricted the earning potential of the banking system and posed a threat to the banks' capital position. The recent improvement reflects favorable external and macroeconomic developments, as well as significant structural changes and policy initiatives in the banking system. In particular, the authorities launched various recovery drives, promulgated a foreclosure law, issued write-off settlement guidelines, and established the Corporate and Industrial Restructuring Corporation (CIRC). In addition, the divestiture of government from the capital of banks has been accompanied by a substantial retrenchment of personnel and a closure of numerous unprofitable bank branches. Notwithstanding these developments, the newly privatized banks still face several challenges, including developing a credit culture for prudent lending to new sectors—such as housing and consumer goods—timely recovery of defaulted loans, and the maintenance of loss-making branches in the "unbanked" areas.

Capital adequacy

6. **Solvency of the banking sector has been improving somewhat in recent years, but has held up well despite tightening of prudential requirements and relatively rapid credit expansion**. The average capital adequacy ratio (capital-to-risk weighted assets) was 13.1 percent in September 2003, up from 11.3 percent in December 2001.[2] Notwithstanding the generally comfortable capital positions of most banks in the system, it is worth noting that local private banks and public sector commercial banks generally report substantially lower solvency ratios than foreign banks. A number of factors contributed to the increase in capital adequacy ratio, which included a better profitability of banks, fresh injections of capital (including recapitalization of the state-owned banks prior to their privatization), and an increasing share of government securities in banks portfolios, which bear a zero risk weight.

7. **Revaluation of assets, particularly fixed interest rate investments, has been another factor affecting the capital position of banks in recent years**. In an environment of declining interest rates and increasing real estate prices, revaluation accounts have been in large surplus from 2002. For the four largest banks, for example, surplus on revaluation accounts averaged 36.5 percent of their capital as of end-2002 (surplus on revaluation of investments was on average 24.5 percent of capital), according to the financial statements of these banks. Large surpluses on revaluation accounts were also likely recorded in 2003. Although Pakistani banks are allowed to include only 50 percent of their revaluation accounts in the calculation of Tier II Capital, large surpluses on revaluation accounts should

[2] The average capital ratio (capital-to-gross assets) for commercial banks stood at 6.2 percent.

be seen with caution since they may be quickly absorbed by significant market reversals (e.g., in case of an increase in interest rates or a major fall in fixed asset prices).

Table 4. Pakistan: Financial Soundness Indicators for the Banking Sector, 1999-2003
(in percent)

	Dec-99	Dec-00	Dec-01	Dec-02	Sep-03
Capital Adequacy					
Regulatory capital to risk-weighted assets	12.2	11.4	11.3	12.6	13.1
Tier I capital to risk-weighted assets	10.3	9.8	9.7	9.7	10.9
Capital to total assets	5.0	4.9	4.6	6.1	6.2
Asset composition and quality					
NPLs to gross loans	22.0	19.5	19.6	18.0	16.1
Provisions to NPLs	46.6	53.9	53.2	58.3	63.0
NPLs net of provisions to capital	117.4	96.7	100.7	54.5	41.8
Earnings and Profitability					
ROA (after tax)	-0.3	0.0	0.0	0.8	1.4
ROE (after tax)	-6.2	-0.3	-0.3	13.8	22.1
Net interest income to gross income	54.3	61.2	68.9	67.4	58.2
Noninterest expenses to gross income	76.9	71.6	62.7	57.3	50.4
Personnel expenses to noninterest expenses	57.0	54.3	52.6	51.4	50.1
Non-interest income to total income	17.6	16.5	14.5	18.1	30.9
Liquidity					
Liquid assets to total assets	38.7	37.5	39.9	47.0	48.6
Liquid assets to total deposits	48.2	48.0	50.3	60.2	59.4

Source: SBP.

8. **Despite the satisfactory level of average solvency ratio, several banks remain deficient in maintaining the minimum regulatory capital of PRS 1 billion**. As of September 2003, the overall capital of the banking system stood at PRS 143 billions, but 12 banks were not complying with the minimum capital requirement, and one of these banks was insolvent. According to the SBP, the number of non-compliant banks will be reduced with the expected mergers of several small institutions.

Asset quality

9. **Total nonperforming loans (NPLs) of commercial banks have maintained their downward trend**. This has partly reflected an increase in the amount of gross loans, but also has been recently facilitated by the SBP's write-off guidelines, issued in October 2002, which enabled banks to clear the stock of the old NPLs more aggressively. This process is likely to continue in the near future, since banks have long maintained a practice to keep NPLs on their books indefinitely, even after 100 percent provisioning. Banks have generally

been reluctant to write off bad loans out of concern that this would compromise their legal position in pursuing loan recovery.

10. **The aggregate ratio of NPLs to total loans masks the wide variation in asset quality across individual banks**. The ratio of NPLs to total loans ranges from 0.4 percent to 35.1 percent across banks. Asset quality of the five largest banks is generally poor, with the ratio of gross NPLs to total loans ranging from 15 percent to 35 percent. On the other hand, smaller banks, especially foreign banks, report very small ratio of NPLs to total loans. The ratio of provisions to NPLs in foreign banks is also substantially higher than in other banks (79.5 percent, against 63.0 percent for the system as a whole). The ratio of NPLs net of provisions to capital stood at 41.8 percent in September 2003, down from 117.4 percent in December 1999.

11. **Bank credit to the private sector has been growing steadily in recent years**. While the outstanding stock of credit to corporate sector has been generally stable (or even declining in the case of credit to public sector enterprises), bank lending to small and medium enterprises, and especially consumer financing, have all been increasing rapidly. The share of personal loans (particularly, auto loans, house loans, and credit cards) has grown from virtually nothing in the mid-1990s to 12 percent of the total bank credit in September 2003. The rapid consumer credit growth, if sustained, could lead to a deterioration in banks' loan portfolios. Although the SBP attempted to deal with this issue by increasing the general provisions against unsecured consumer loans to 5 percent from early 2004 (the general provisions against secured consumer loans are set at 1.5 percent), rapid consumer lending growth requires careful monitoring.

Earnings

12. **Profitability indicators have registered a visible improvement**. After years of poor performance, returns on assets and equity are beginning to approach international norms. Measured profitability in the past was distorted by lax provisioning. The recent strengthening in the profit position of banks has largely resulted from an increase in interest income, as well as from expanded business volumes facilitated by macroeconomic stabilization. Net interest income somewhat slowed down in 2003, mainly due to contraction in interest margins likely stemming from increased competition, while banks reported strong gains on sale of securities and other non-interest income. As a result, the share of net interest income in gross income declined to 58 percent in September 2003, from 69 percent in December 2001.

Liquidity

13. **Helped by a substantial increase in workers' remittances following the events of September 11, 2001, liquidity in the banking sector has become abundant**. Liquid assets as a percentage of total assets increased to 49 percent by the end-September 2003, from 40 percent in December 2001. Liquidity held by banks was more than double the amount of

required liquid assets last year. The excess liquidity has led to a decline in interest rates and may be contributing to rapid increases in asset prices in the real estate and equity markets.

C. Preserving Stability and Soundness

14. **Although the condition of the banking system has been improving in recent years and most of the banks appear resilient to shocks, the stress tests results should not cause complacency**. Weaker banks, as expected, experience capital adequacy problems in the face of relatively modest NPL increases, suggesting that banks on the lower end of the capital adequacy and asset quality spectrum deserve closer attention of supervisors. Moreover, in the new environment of private sector dominated banking, sensitivity analysis based on historical experience of shocks needs to be interpreted with caution.

15. **The mission has the following general recommendations aimed at assisting the authorities to maintain and enhance the current financial stability and soundness**:

- **Government and SBP should develop a strategy to privatize the remaining public sector commercial banks (especially NBP) and continue divestiture from the capital of other banks**. Public ownership of commercial banks has generally proved to be inferior to private ownership in many countries worldwide. The experience of Pakistan also confirms that public sector commercial banks are less effective in intermediating financial resources than privately owned banks, except prehaps in remote areas where access to banking services would otherwise be unavailable. In this regard, the FSAP team welcomes the divestiture of government from the capital of several large banks in recent years, as well as the reported reduction in the government's interference in corporate governance of banks with minority or even majority public stake.

- **The effectiveness of the moratorium on the licensing of new conventional banks should be reassessed**. The establishment of this drastic measure might have been justified in the conditions of the mid-1990s. Since then, however, the system has been consolidated and the regulatory and supervisory frameworks have been strengthened. The current minimum capital requirement is already sufficiently high which together with adequate fit and proper criteria should be enough to prevent a proliferation of small and weak institutions. The abolishment of the moratorium may thus contribute to a more competitive environment and a more efficient functioning of the market.

- **The development of Islamic financial institutions and the risks associated with them should be closely monitored**. In particular, the SBP should ensure a proper coordination of regulation, off-site supervision, and on-site inspections of Islamic financial institutions.

- **BSD should continue working on the design of the stress testing framework, and use the stress testing exercise on a routine basis in the future**. The stress testing team of the SBP has already achieved a good level of proficiency in various aspects

of the stress testing framework. Further progress in the stress testing programm, especially improvement in technical capacities, is needed in order to make the stress tests as a valuable instrument of monitoring financial stability.

- **Finally, in light of the recent credit expansion, consideration may be given to tighten requirements for specific provisions**. As discussed in Section C of this note, the SBP's current loan provisioning rules are less tight than in many other countries. A tightening of these rules would not only bring the regulations in line with the those in other countries, but perhaps more importantly would also help to limit credit growth.

RECENT DEVELOPMENTS IN ISLAMIZATION OF THE FINANCIAL SYSTEM IN PAKISTAN

The Islamization of the financial system has received considerable attention in Pakistan in recent years. Apart from underlying demand from certain segments of the population for financial services that are accordance with religious injunctions, a ruling from the Shariat Court in 1991 and its affirmation by the Shariat Appellate Bench of the Supreme Court in 1999 that the existing banking practices in Pakistan did not conform to Islamic principles, has sparked further interest in Islamic financial services. Dedicated institutions are developing Islamic financial instruments, while the State Bank of Pakistan (SBP) is undertaking considerable work on an appropriate prudential and regulatory framework.

A. Legal Status of Islamic Banking

Efforts to promote the Islamization of the financial system have been underway for some time. From July 1985 commercial banking transactions in local currency have been on interest-free profit and loss sharing (PLS) and mark-up basis.[3] In November 1991, the PLS-based system was declared un-Islamic by the Federal Shariat Court. While legal proceedings seeking to clarify the Shariat Court ruling were set in motion, the PLS/mark-up-based banking continued in parallel with conventional banking until 2001.

In 1999 the Shariat Appellate Bench of the Supreme Court ordered the government to do away with interest in financial transactions in keeping with Islamic principles which forbid it. The court ordered that laws governing interest payments be revoked by March 30, 2000 and that other laws be changed by June 30, 2001. Subsequently the government appealed to the Supreme Court to delay the decision for another year. It argued that the new law would severely harm the economy and that the transformation of the entire financial system was not practicable. As a compromise, it offered to set up a parallel banking system for customers interested in Islamic financial services.

In June 2001, the Supreme Court extended the deadline for instituting interest-free banking to June 30, 2002. However, in June 2002, banks appealed to the court to review its earlier decision. The appeal was supported by the government, which argued that the initial ruling was flawed and that an overnight transformation to interest-free banking would create financial chaos. In response to this appeal, the Supreme Court referred the case back to the Federal Shariat Court to start fresh hearings. It is widely expected that this process could take several years before reverting to the Supreme Court. In light of this, the earlier Supreme Court rulings of 1999 and 2000 are not considered valid, but there remains a degree of legal uncertainty about the ultimate basis for banking activities in Pakistan.

[3] Except foreign currency deposits and on-lending of foreign loans, which continued to operate on conventional banking principles.

In the meantime, the authorities have moved to allow provision of Islamic banking services in parallel with conventional banking. In December 2001 the SBP issued detailed guidelines for the establishment of Islamic commercial banks, and in November 2002 the Banking Companies Ordinance (1962) was amended to allow the formation of banking subsidiaries dedicated to providing Islamic banking services. Also, detailed criteria for setting up subsidiaries and/or stand-alone branches for conducting Islamic banking were issued in January 2003. To separate Islamic banking activities from conventional banking, banks are not allowed to conduct Islamic banking transactions in their units involved in conventional operations.

The SBP is promoting further development of the Islamic banking in Pakistan. Currently new banking licenses for domestic banks are issued only for Islamic banks. The SBP is also developing a framework for the regulation, supervision and liquidity and monetary management arrangements for Islamic banks. The Islamic Banking Department (IBD) was set up in the SBP in September, 2003 for this purpose. The IBD is responsible for approving opening of Islamic banks, branches, and subsidiaries.

A Shariah Board has been established within the SBP. The Board consists of five members: two Shariah scholars, a charter accountant, a lawyer, and a representative of the SBP. The Board is responsible for approving financial instruments that can be offered by banks for their conformity to Islamic principles. Banks wishing to be involved in Islamic banking need Shariah advisors to adapt generic instruments for Shariah compliance and bank specific circumstances. The SBP has also designed Islamic government securities which will be reviewed by the Ministry of Finance. The legal basis for these instruments still needs to be finalized.

B. Recent Developments in Islamic Banking

The number of Islamic financial institutions has grown since 2001, although they do not as yet have a significant effect on the economy. The combined assets of the Islamic commercial banks and Islamic branches represented 0.5 percent of the entire banking system's assets as of September 30, 2003. The first license to a full-fledged Islamic bank was issued to Al-Meezan Bank Limited in January 2002. In addition, Al-Baraka Islamic Bank is in the process of converting from a conventional to a Islamic bank. Two more full-fledged Islamic banks are expected to open by 2005. As of February 27, 2004, four commercial banks had established a total of eight branches for conducting of Islamic banking.

The asset-liability structure of Islamic banks differs from that of conventional banks, reflecting the nature of their funding sources and lending/investment activities. For instance, Islamic banking products currently offered by Al-Meezan Bank include a riba (interest)-free rupee saving account, a riba-free dollar saving account, and certificates of Islamic

investment. On the asset side, Al-Meezan bank mainly uses the modes of Murabaha and Ijarah.[4]

Funding sources

There are three basic sources of funding for the Islamic banks: equity capital, transaction deposits, and investment deposits. Equity capital represents the owners' investment and is the same as in conventional banking. Transaction deposits are the equivalent of the demand deposit accounts in the conventional banking, although they do not pay a rate of return. Investment deposits are similar equity investment—they do not ex-ante specify a rate of return or guarantee the return of the deposited principal. Investment deposits are the main source of funding for the Islamic banks. Ex-post returns on investment deposits may be tied to the overall performance of an institution or to a specific pool of projects or investments undertaken by the bank. Such deposits cannot typically be withdrawn prior to maturity. The risk profile of deposits in an Islamic bank therefore differs from that in a conventional bank in that there is no contractual claim associated with the deposit or return on them. At the same time, depositors are not shareholders. They do not have voting rights at the bank and cannot influence investment policy of the bank.

A deposit at an Islamic bank specifies ex-ante the ratio at which the profits (losses) in investments will be distributed between depositors and the bank, which remains uncertain during the time of the project. Thus, balance sheet risks are shared between an Islamic bank and its depositors in the same proportion as shares of losses.[5] Depending on the type of their contract, depositors face the risk of loss of their principal. Islamic banks do not provide explicit guarantee of deposits.[6] The profit is determined on the actual outcome of the projects in which the funds were invested. Each period the profit is announced and distributed. Depositors are given information on potential profits in the form of performance record of similar products. The specific ratio of profit distribution depends on the type of deposit--investment or transaction.

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[4] Murabaha is a contract of sale in which the seller declares his cost and profit. It involves a request by the client to the bank to purchase a certain item for him. The bank does that for s definite profit over the cost which is settled in advance. Ijarah (or hire-purchase) is a contract in which an Islamic bank finances equipment, building or other facilities for the client against an agreed rental with a unilateral undertaking by the bank or the client that at the end of the lease period, the ownership I the asset would be transferred to the lessee.

[5] Islamic banks do not separate investment activities from commercial banking activities. Therefore, in their activities and risks Islamic banks are similar to mutual funds.

[6] In some countries, however, all types of deposits are implicitly guaranteed to maintain reputation of the Islamic financial institution.

Asset structure

The only full-fledged Islamic bank, Al-Meezan Bank, had PRs 8.8 billion on June 30, 2003. Data on the total assets of eight stand-alone Islamic branches are note available.
In April, 2004, the Shariah Board of the State Bank of Pakistan has approved the Essentials of Islamic Modes of Financing to ensure compliance with minimum Shariah standards by banks conducting Islamic banking.[7] These Essentials are proposed to be enforced as Prudential Regulations for Islamic banks in due course. They are the following.

- **Murabaha facility agreement** (agreed profit margin sale with cash or deferred payment of price): This is a contract of sale of real goods under an arrangement whereby the seller is obliged to disclose to the buyer the cost of goods sold either on cash basis or deferred payment basis and a margin of profit included in the sale price of goods agreed to be sold. Murabaha sale requires an offer and acceptance which include certainty of price, place and delivery, and date on which the price, if deferred, will be paid. Once the sale transaction has been concluded, the selling price determined cannot be changed.

- **Musawamah**: This is a general kind of sale in which price of the commodity to be traded is stipulated between seller and the buyer without any reference to the price paid or cost incurred by the former. Thus it is different from Murabaha in respect of pricing formula. Unlike Murabaha, seller in Musawamah is not obliged to reveal his cost. All other conditions relevant to Murabaha are valid for Musawamah as well.

- **Ijarah (leasing)**: In this leasing contract, the leased commodity remains in the ownership of the lesser. During the entire term of the lease, the lesser must retain title to the assets, and bear all risks and rewards pertaining to ownership. Either party can make a unilateral promise to buy/sell the assets upon expiry pf the term of the lease, or earlier at an agreed price and terms of condition.

- **Salam (advance payment – deferred delivery sale)**: Salam is equivalent to a future contract in conventional finance: the seller undertakes to supply specific goods to a buyer at a future date in consideration of a price fully paid in advance at the initial date of the contract, and the commodity is delivered on a pre-agreed date and place.

- **Musharakah**: This is a relationship established under a contract by the mutual consent of the parties for sharing of profits and losses arising from a joint enterprise or venture. Profit is distributed in the proportion mutually agreed in the contract. Losses are shared by all partners in proportion to their capital invested.

[7] The Essentials have been placed on SBP website, http://www.sbp.org.pk, as General Guidelines to be followed by banking institutions conducting Islamic banking in the country.

- **Mudarabah**: This is a form of partnership where one party provides the funds while the other provides expertise and management. The latter is referred as Mudarib. The profit accrued is shared between the two parties on a pre-agreed basis, while loss is borne by the provider of the capital.

- **Istisna**: This is a contractual agreement for manufacturing goods and commodities, allowing cash payment in advance and future delivery or a future payment and future delivery. The buyer cannot sell or transfer ownership to other party before taking possession of the good.

C. Regulation and Supervision of Islamic Banking Institutions

While existing prudential requirements are applicable, the SBP is developing a framework for regulating and supervising Islamic banks. In this connection, it is continuing to apply sound banking principles, keeping in view the accounting and auditing standards recommended by Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI, Bahrain) and international best practices. As a general principle, Islamic banks will have to comply with the regulations for conventional banks and additional requirements designed specifically for Islamic banking.

While issues related to statutory liquidity requirements have been resolved, work is underway for addressing other issues such as introducing Shariah compliant Audit and Accounting Standards.[8] A requirement, that an Islamic bank should have a Shariah Board or at least a Shariah Advisor who is not allowed to work in another Islamic bank.[9] Work is also focused on the treatment of funds in the investment pool where customers' deposits together with shareholders funds are invested for the purchase of assets, leasing, trading, and other investments. Shareholders' funds in such pools are required to be at least 10 percent of the total investment of a specific pool.

Accounting and auditing standards for Islamic modes of financing are being developed by a Committee of the Institute of Chartered Accountants of Pakistan (ICAP) where the SBP is also represented. The Committee is reviewing the standards developed by the Bahrain based Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) with a view to adapting them to the Pakistani circumstances if necessary. Currently, audit regulations for the conventional banks are applied to the Islamic banking institutions. The SBP's Export Finance Scheme has also been revised to be on a Musharakah basis for Islamic

[8] The first Shariah Audit for Al-Meezan Bank will be conducted by Sedat Audit Company in 2004. This company was chosen by the SBP from 4 audit companies on a competitive basis.

[9] Two members of the SBP Shariah Board are also Shariah advisors for Islamic banks. They have to abstain from the Board meetings, when issues related to the banks where they are employed as the Shariah advisors are under consideration.

banks. Taxation laws are also being reviewed with a view to ensuring that banks do not bear an additional burden on account of their involvement in trading and leasing activities.

Minimum capital requirement for a full-fledged Islamic bank or subsidiary is PRs1 billion and for an Islamic banking branch is PRs 50 million—the same as for conventional banks. The current regulations allow Islamic banking institutions to make investment in shares up to 30 percent of the equity, however, investment in a single company's scrip should be limited to 5 percent of the equity of a banking institution.[10] At present, the SBP does not have other regulatory requirement for Islamic banks, which would reflect risks specific for Islamic banking.

The Islamic banks are subject to liquidity requirements. However, liquidity requirements are 11 percent for the Islamic banks compared to 15 percent for the conventional banks. This reflects the lack of Shariah compliant financial securities on the market. Conventional banks can meet the systemic liquidity requirements with government securities whereas Islamic banks can only meet them in cash. Thus, Islamic banks can invest the difference of liquidity requirements of four percent into profitable assets to compensate for the foregone return on government securities.

Capital adequacy and related definitions for Islamic banks are the same as for the conventional banks, although for the musharakah contracts the measurement of the capital is an outstanding issue.[11] The Islamic Banking Department of the SBP is working on this issue.

At present the SBP does not apply traditional lender of last resort policies to Islamic banking institutions, but how such support could be provided in accordance with Islamic principles is being considered. The issue of support from a conventional parent bank to its stand-alone Islamic banking branch also needs to be addressed. While banks may repay depositors funding a modarabah investment pool that suffers losses out their own resources in order to contain reputational risk, this issue also deserves to be addressed in an explicit and comprehensive lender of last resort policy for Islamic banks.

At present there are no specific risk management requirements for the Islamic banking institutions. In addition to typical risks for conventional banking sector, the Islamic banking

[10] The scope of activities of Islamic financial institutions confronts broader supervisory tasks than in the case of conventional banks. Risk-sharing nature of liability contracts raises issues on the definition of capital and capital adequacy ratio. Specific nature of asset contracts brings additional risks, not existing in conventional finance. Different structure of overall balance sheet of Islamic banks raises issues on uniform standards for income/loss recognition, the adequacy of reserves, and the overall operational risk.

[11] There is ongoing discussion on classification of risk sharing funds placed with Islamic banks. This uncertainty addresses a fundamental issues on how to judge if these funds are capital certain. If those funds were defined as bank deposits under conventional banking laws, they would be capital certain. However, if they were defined as investments in a collective investment scheme, they would not be necessarily capital certain, because they are not bank deposits. The classification of risk sharing funds of Islamic banks is not formalized.

sector faces specific risks which arise because Islamic banks share risks in profit outcomes with depositors.

D. Monetary Policy Issues for Islamic Banking

At present government securities conforming to Islamic principles are not available in Pakistan, so that Islamic banks do not have government securities at their disposal to meet liquidity requirements. To address the problem, the SBP has proposed two Islamic government securities, Ijarah and Salam. The Islamic interbank market can be established on Shariah compliant principles as soon as there will be 5-6 participants for this market. Ijarah is a long-term leasing financial instrument with the maturity of one year and above. The benchmark for the rate of rental will be 6-month KIBOR. The instrument will be repriced every half a year. KIBOR of 6-month maturity plus a margin will be used for the repricing. The government has to provide assets for the Ijarah government securities, which are to be defined. Those assets will be rented by the government and the rent will be used as a profit. The SBP is planning to Introduce Ijarah with 3 and 5 years of maturity. Salam is a 3-month prepayment arrangement, commodity based, which is also to be introduced by the government.

The plans for introducing Ijarah are being finalized and will need to be approved by the government. A proper regulatory framework is needed for the introduction of Islamic securities through the stock exchange. Legal issues related to Islamic government securities include the role of the SBP. The particular assets need to be specified by the government and their ownership status needs to be clarified.

From monetary policy perspective, because of its small size, Islamic banking does not as yet pose a problem. However, as Islamic securities become more mature, they may have significant effect on the monetary policy. The newly introduced Islamic banking instruments would therefore need to be consistent with the Shariah Code as well as with the monetary policy of the SBP.

E. Conclusions

Although Islamic banking does not yet influence much the Pakistani economy, there is potential for rapid growth of this sector in the foreseeable future. Such growth needs to be supported by an appropriate regulatory framework. In addition, accounting and auditing standards need to be in place. More importantly, the legal status of the dual—Islamic and conventional—banking system has to be resolved to provide clear legal basis for banking activities.

The SBP conceives the financial system in Pakistan as dual system, where Islamic banking co-exists with conventional banking. This gives users of such banking services the choice of a range of instruments compatible with their religious beliefs. At the same time, historically conventional banking has been dominant, consistent with the country’s position as an

emerging market that is integrated into the global economy. The vision of the SBP of co-existence of the two type of banking activities in parallel therefore seems appropriate.

Islamic banking products and contracts and Islamic financial instruments may bring welfare benefits—especially for rural households who may be inclined to favor Islamic instruments—and should be developed and standardized. This can make the Islamic banking sector more transparent and related accounting and auditing easier. While Islamic banking products are similar to some investment products in the conventional finance, they entail specific risks that require closer attention as the Islamic banking sector grows. Therefore, risk management in Islamic banks should receive closer attention and a specific framework needs to be developed. In addition, lender of last resort arrangements for Islamic banking sector should be developed.