

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



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Presentation Outline



- Introduction
- Salient Features of Inclusive Finance
- Stylized Facts About Islamic Banking in Pakistan
- State of Financial Inclusion in Pakistan
- Assessment of Islamic Banks Towards Inclusive Finance
- Conclusion

Introduction



- It is well established in literature that financial development complements economic growth.
- But, financial services are not accessible to the masses of poor people in developing countries.
- Voluntary exclusion due to faith reasons creates yet another hindrance in the way of financial inclusion.

Introduction



- Demirgüç-Kunt et al. (2013) present percentage of adult population with no bank accounts for religious reasons. Some Muslim majority countries have significant voluntary financial exclusion due to religious reasons.

Countries	Percent Respondents
Afghanistan	33.6
Morocco	26.8
Iraq	25.6
Niger	23.6
Djibouti	22.8

Introduction



- There are a lot of populous Muslim-majority countries where savings ratio is very low.

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

Introduction



- 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.

Introduction



- Inclusive finance can assist people to achieve income and consumption smoothing and higher social mobility.
- 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.

Introduction



- 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.
- Their vision and link with Islamic ethical precepts creates an additional expectation for making an egalitarian contribution.
- Islamic banking is marketed, supported and defended as being participatory, inclusive and egalitarian in its scope, operations and goals.

Introduction



- 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.
 - Equitable income distribution.

Salient Features of Inclusive Finance



- Firstly, an inclusive financial system would cater to the financial needs of a broad based section of society. Banks are expected to be richer in products and services catering to the bottom 40% people in 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 product mix shall include fulfilling people's financial needs for commercial expansion as well as financial needs of meeting necessary expenditures like education and health.

Salient Features of Inclusive Finance

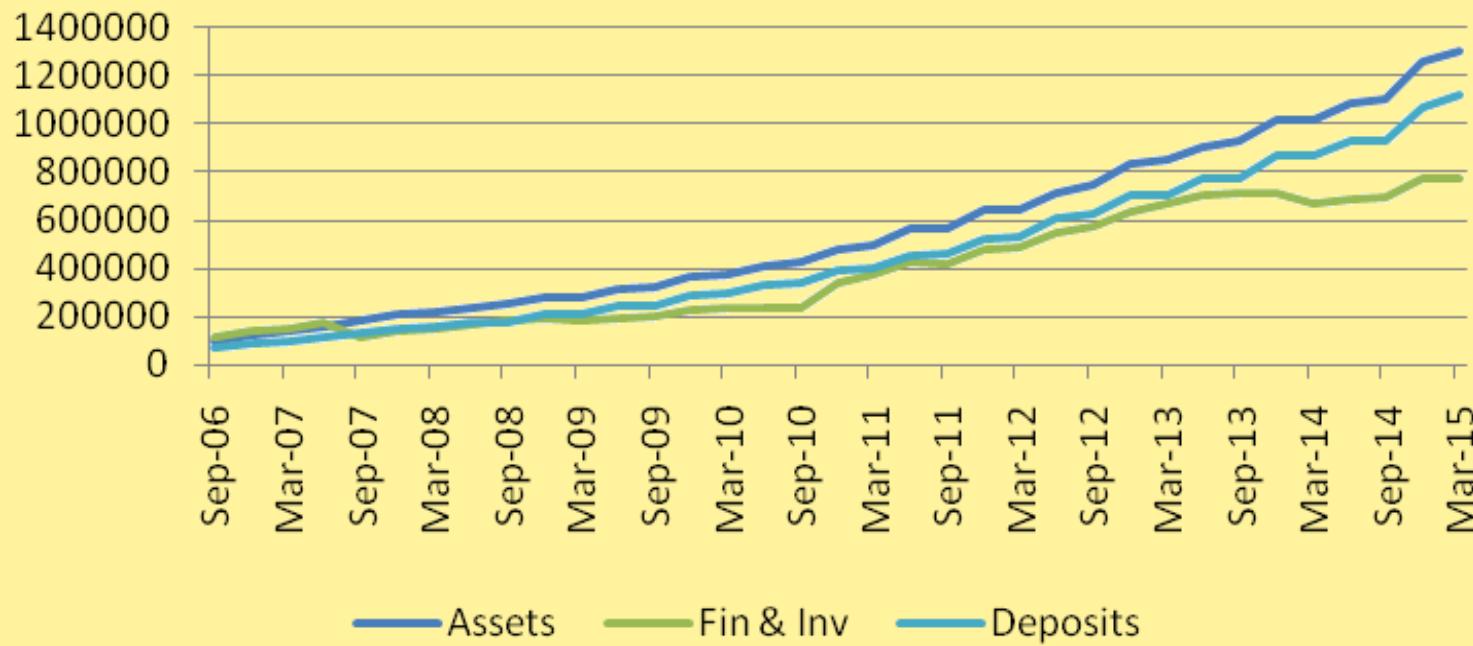


- Furthermore, since Islamic banks are expected to be egalitarian in their operations and equitable in their distributional effects, it will be interesting to note how far they contribute towards:
 - Circulation of wealth.
 - Reducing financial costs.
 - Use participatory equity based modes of financing.
 - Achieve equitable profit distribution among depositors and the shareholders in contrast with conventional banks.

Islamic Banking in Pakistan



Total Assets, Financings & Deposits (3Q2006 - 1Q2015)

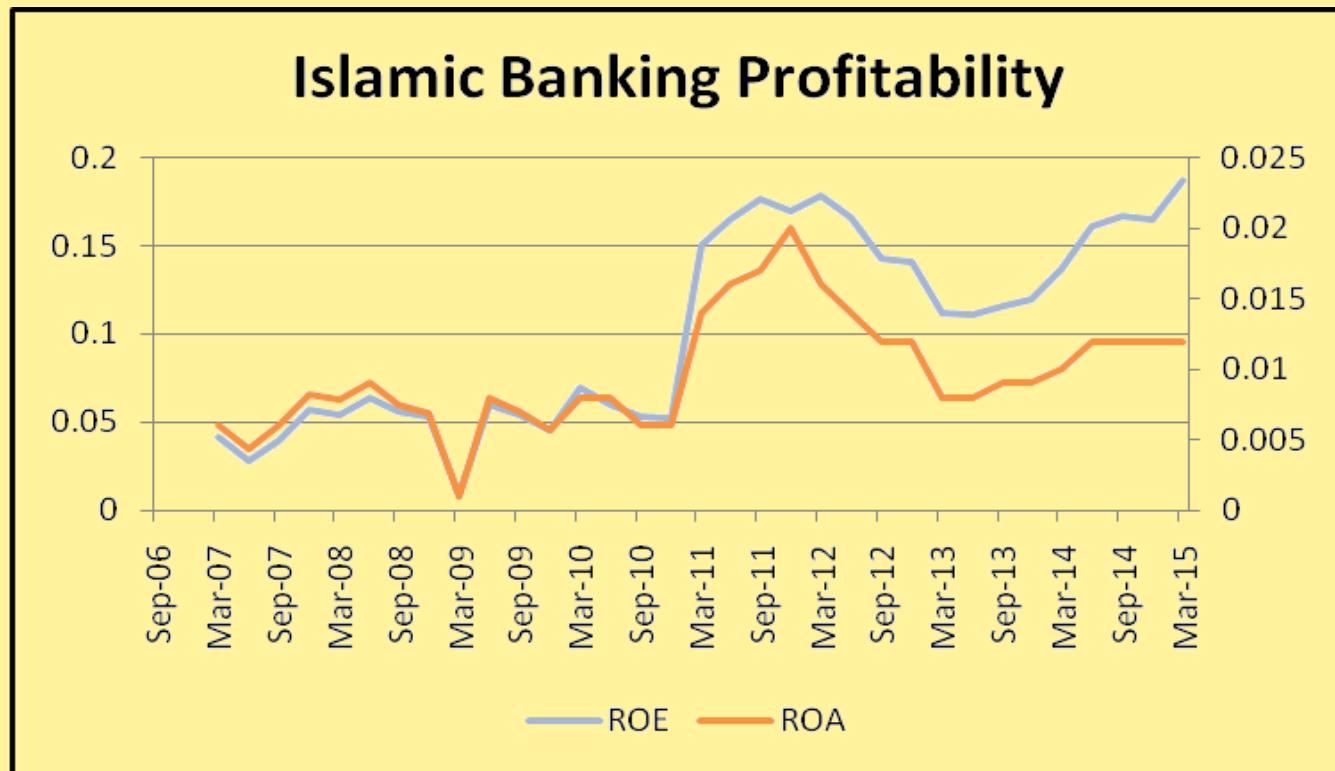


Source: Islamic Banking Bulletin, SBP, Various Issues

Islamic Banking in Pakistan



The return on equity in Islamic banking has reached 18% and is now more than the industry average of 17% in Pakistan.



Source: Islamic Banking Bulletin, SBP, Various Issues

State of Financial Inclusion in Pakistan



- Only around 18% of people in Pakistan hold bank accounts.
- Only 3% of the women in Pakistan have a bank account.
- Financial credit is available to an even meager 3% of the population.

State of Financial Inclusion in Pakistan



- WB financial inclusion survey from 1,000 respondents in Pakistan show that people mostly borrow from informal sources and for health and education.

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

State of Financial Inclusion in Pakistan



- WB survey shows that coming up with emergency finance is quite difficult for people, especially poor.
- The respondents were asked as to how easy it is to come up with possibility of financing $1/20^{\text{th}}$ of GNI per capita within the next month.

Emergency Finance Possibility (5% of GNI Per Capita Within a Month)	Overall	Poorest	Richest
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

State of Financial Inclusion in Pakistan



- 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.
- Currently, there is no Islamic microfinance bank in Pakistan at the moment.

State of Financial Inclusion in Pakistan

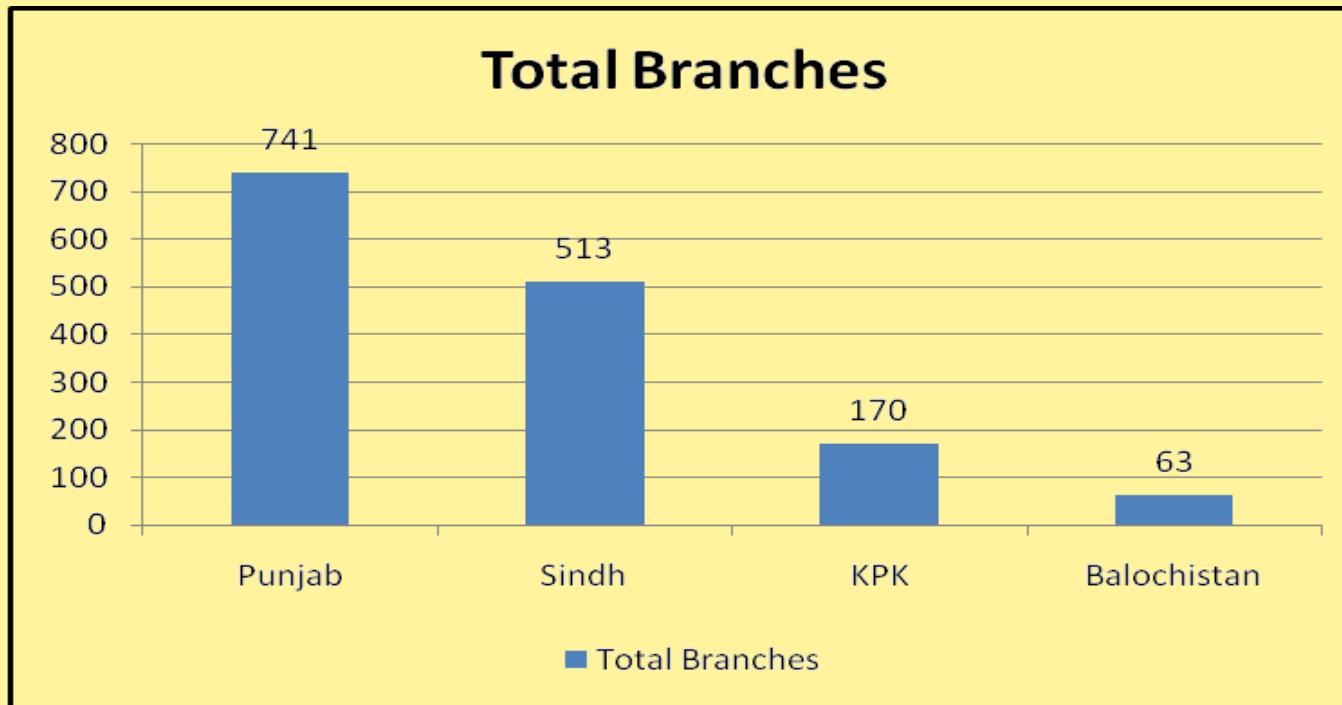


- Other institutions without the scale and liquidity advantage which Islamic banks enjoy had taken initiative to show what can be done with resolve, vision and commitment.
- Akhuwat, Wasil, Farz Foundation and Naymet are the major institutions offering Islamic microfinance through Qard-e-Hasan and Islamic 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.

Towards Inclusive Finance Assessment of Islamic Banks



- Punjab and Sindh province together host 85% of total branches.
- Baluchistan & KPK with higher incidence of poverty and lesser per capita income host only 15% of total branches.



Source: Islamic Banking Bulletin, SBP, Various Issues

Towards Inclusive Finance Assessment of Islamic Banks



- 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.

Towards Inclusive Finance Assessment of Islamic Banks



- 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.
- 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.

Towards Inclusive Finance Assessment of Islamic Banks

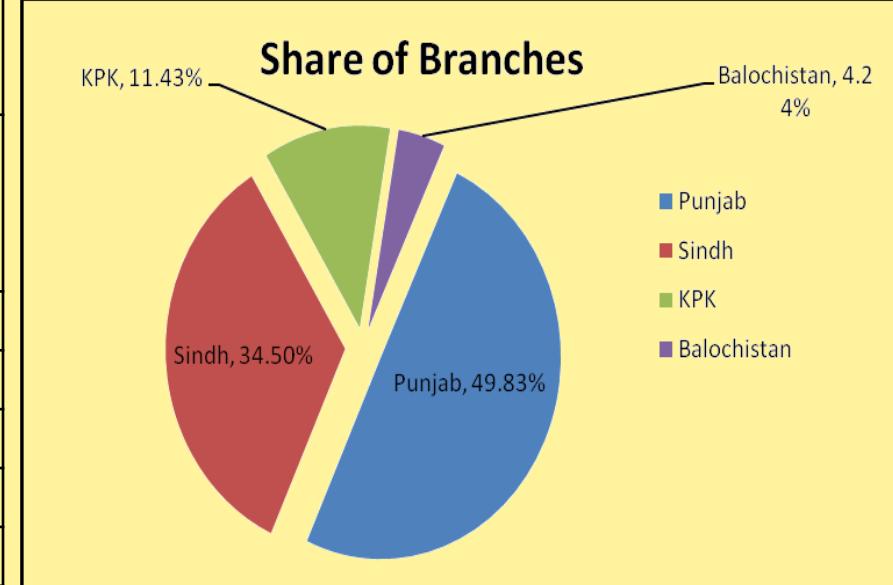


- Only 25% people earn monthly income in excess of Rs 15,000. Around half of these people live in Punjab and one-third in Sindh. It is apparent that branch network is concentrated in high income areas where people are able to save and earn sufficient income to qualify for financing from banks.

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



Source: Islamic Banking Bulletin, SBP

Towards Inclusive Finance

Assessment of Islamic Banks



- In line with neoclassical economics literature, such as Diamond (1984), Islamic banks as financial intermediaries 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.

Towards Inclusive Finance Assessment of Islamic Banks



- 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.

Towards Inclusive Finance Assessment of Islamic Banks

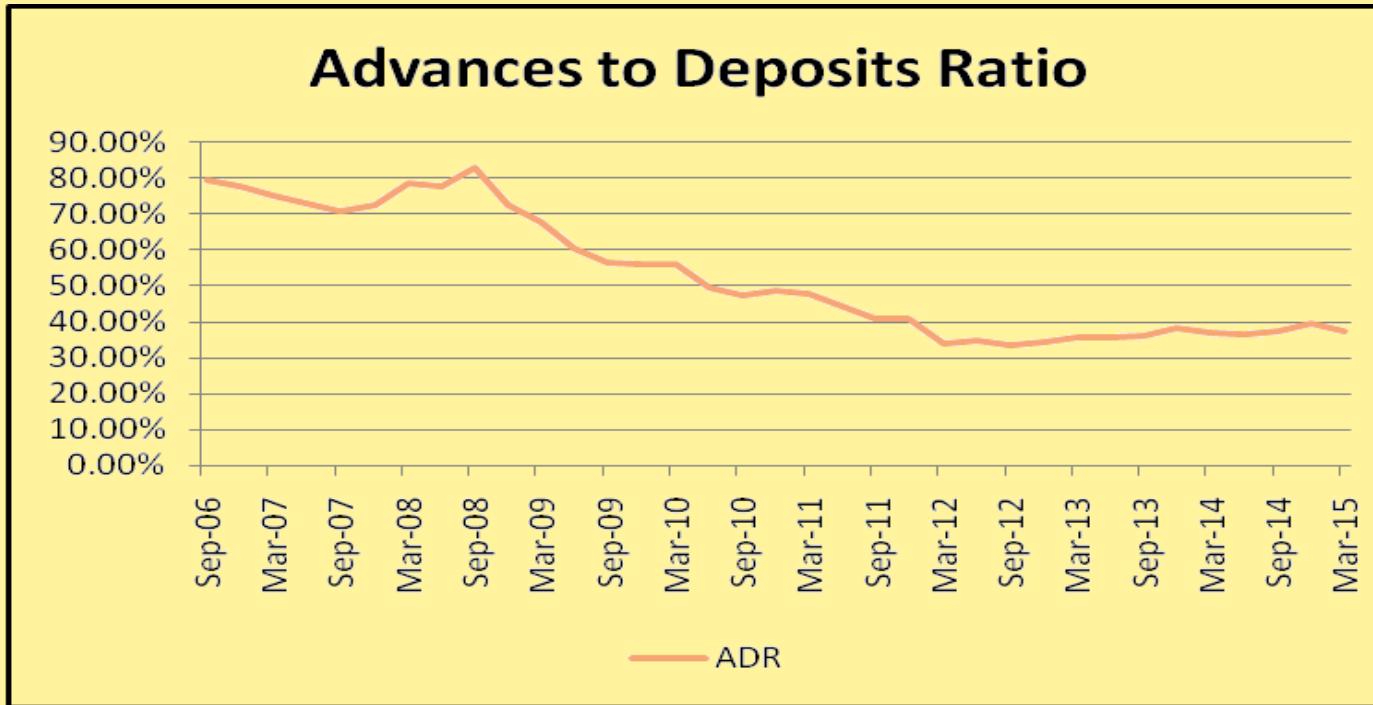


- In the overall deposits, only one-third of deposits are placed in fixed deposits category in Islamic banking.
- Current accounts are already interest free in most cases.
- In saving accounts, the central bank has directed all banks to pay a fixed rate of return. Islamic banks bypass this requirement 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 financing.

Towards Inclusive Finance Assessment of Islamic Banks



- Circulation of wealth is a cherished goal in Islamic Economics literature. The financing to deposit ratio is as low as 35% in Islamic banks.



Source: Islamic Banking Bulletin, SBP, Various Issues

Towards Inclusive Finance Assessment of Islamic Banks



- 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, 41.5% in rural and 1.5% in urban areas.
- Islamic banks 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.

Towards Inclusive Finance Assessment of Islamic Banks



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

Towards Inclusive Finance Assessment of Islamic Banks



- 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.

Towards Inclusive Finance Assessment of Islamic Banks

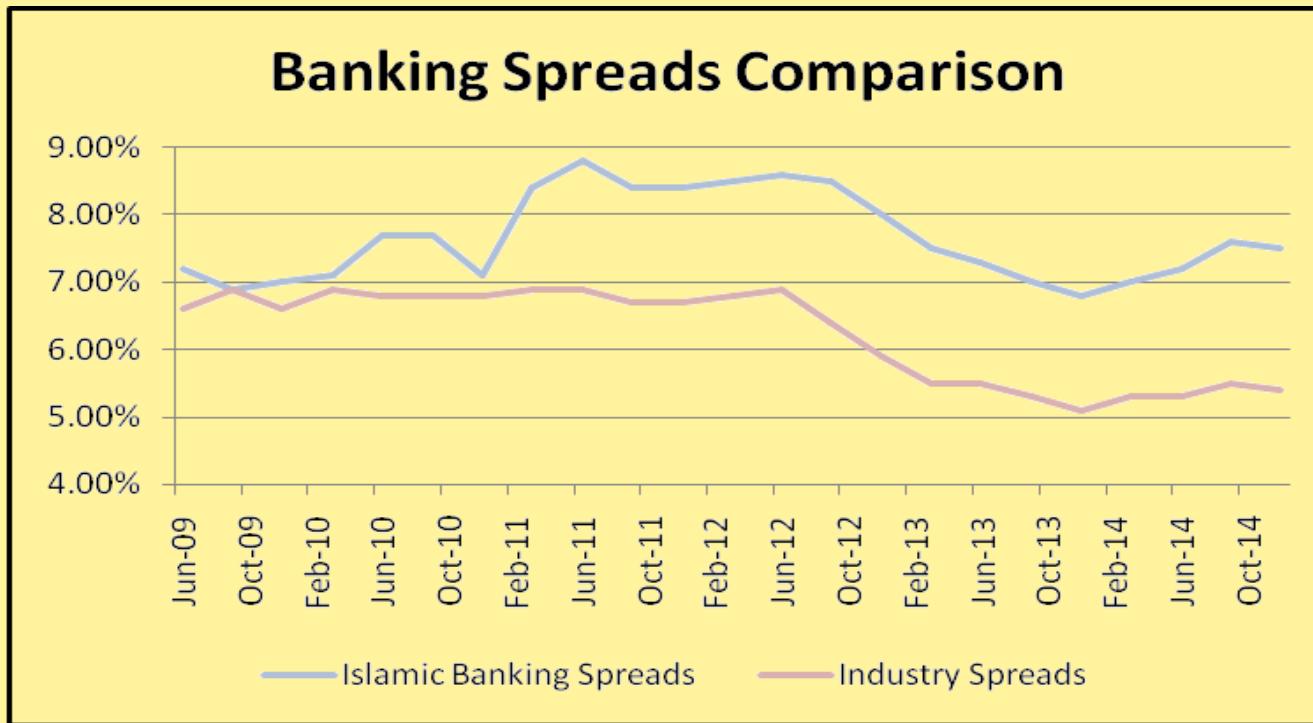


- Furthermore, as against the overall banking industry, agriculture finance share in Islamic banks' financing portfolio is not even 10% of that of conventional banks.
- Apart from corporate sector, the 'individuals' is the only other segment to which Islamic banks provide more financing relatively to conventional banks.
- Here too, there is no financing product for individuals looking to finance education, health, utility bills and basic food requirements.

Towards Inclusive Finance Assessment of Islamic Banks



- Even then, these financial services are provided less efficiently by Islamic banks than by conventional banks. Islamic banking spreads are higher than conventional banking spreads.



Source: Islamic Banking Bulletin, SBP, Various Issues

Towards Inclusive Finance Assessment of Islamic Banks



- Lastly, we present who qualifies for financing from Islamic banks as an individual.
- Monthly per capita income in Pakistan is ~ Rs 10,000.
- Only a quarter of employed people in Pakistan earn monthly income in excess of Rs 15,000.

Towards Inclusive Finance

Assessment of Islamic Banks



- 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.

Minimum Monthly Income Required				
Banks	Car Finance (Rs.)		Home Finance (Rs.)	
	Salaried	Businessperson	Salaried	Businessperson
Meezan Bank	40,000	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: Websites & Product Brochures of Islamic Banks

Towards Inclusive Finance Assessment of Islamic 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.
 - When their debt based financing products results in same, but expensive cash outflows for financing clients.
 - When they exclude and include similar kinds of clients.
 - When their banking spreads are 1.5% higher than industry average.

Conclusion



- 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.



Thank You
Questions & Feedback