

How Islamic Banking Can Help Entrepreneurs



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MUET Jamshoro
15 January 2020



Asian Development Bank

Presentation Outline



- Islamic Banking in Pakistan
- Financial Inclusion Statistics
- Basic Structure of an Islamic Bank
- Major Financing Contracts Used in Islamic Banking
- Questions and Answers

Islamic Banking in Pakistan



- Section 38(f), 1973 constitution said: **Riba should be eliminated.**
- Council of Islamic Ideology in 1980 clearly defined Riba:

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

- Historic Judgment on Interest in 1991 by the Supreme Court of Pakistan settled the debate in academics and in legal sphere.

Islamic Banking in Pakistan



- Yet, major share of banking is with conventional banks which operate on interest (Approximately 85% share).
- Government of Pakistan finances only a minor portion of its domestic borrowing through Islamic instruments like Sukuk.
- Almost half of all that we pay in taxes goes in the debt servicing payments which are primarily interest based.

Islamic Banking in Pakistan



- Islamic banking in Pakistan has **13.8%** and **16.1%** market share in total banking assets and deposits respectively by Sep-2019.
- 5 Full-Fledged Islamic Banks and 17 Conventional Banks with Islamic Banking Windows.
- 3,000 Branches in 115 Districts across Pakistan.
- Size:
 - Total Assets ~ Rs 3 trillion.
 - Deposits ~ Rs 2.5 trillion.
 - Financing ~ Rs 1.6 trillion.

Islamic Banking & Finance in Pakistan



- Best Bank of the Year award went to Islamic Bank in 2018.
- Housing portfolio in Islamic Banking is now more than conventional.
- NPLs in Islamic Banks are much less than as in conventional banks.
- Largest AMC in Pakistan is an Islamic AMC.
- KMI-30 Index repeatedly outperforms KSE-100.

Financial Inclusion Statistics



Demand Side Statistics		
Percentage of Adult population:	A2FS 2015	A2FS 2008
A. Banked	16%	11%
B. Other formal	7%	1%
Formally Served (A+B)	23%	12%
C. Informally Served	24%	32%
Financially Served (A+B+C)	47%	44%
Financially Excluded	53%	56%
Source: Access to Finance Survey, 2015		

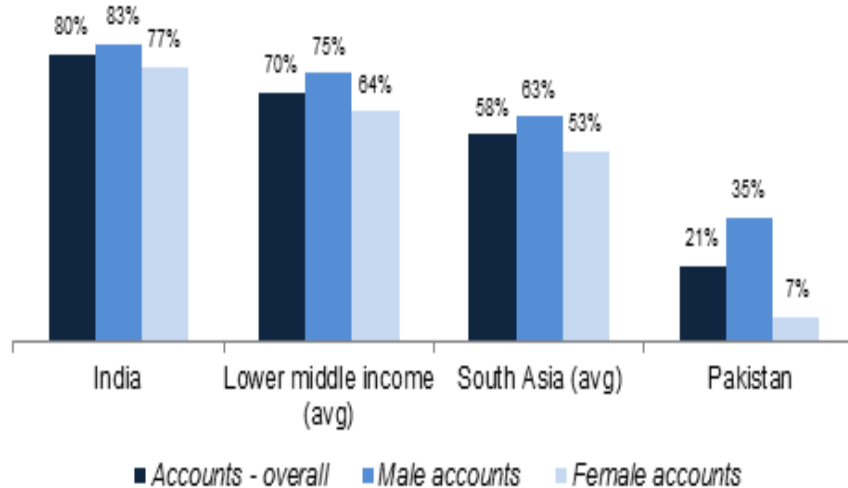
Country	Bank Accounts (% of Adult Population)	Domestic Credit by Finance Sector (% GDP)	Domestic Credit by Banks (% GDP)
Pakistan	21.29	58.28	18.89
Low income	34.85	25.91	20.40
Middle income	65.31	148.80	101.60
High income	93.71	188.44	79.20

Source: World Development Indicators, World Bank 2018

Financial Inclusion Statistics

Pakistan's Account Ownership in relation to its Peers

(as of 2017; among adults of age 15+) *Data source: Findex, World Bank*



Headline targets relating to Transaction Accounts

National Financial Inclusion Strategy (2015)	Target for 2020
Percent of adults with a transaction account	50%
Percent of women with a transaction account	25%
Enhanced National Financial Inclusion Strategy (2018)	Target for 2023
Number of active digital accounts - overall	65 million
Number of active digital accounts - women	20 million

Source: NFIS (SBP); Enhanced NFIS (MoF)

Reasons of Financial Exclusion



- Less number of branches (15,000 across Pakistan), especially in rural areas.
- High levels of poverty (38% multi-dimensional poverty as per UNDP Report 2016).
- Voluntary exclusion due to religious reasons.
 - In 2015 KAP study, 98% of the un-banked respondents stated that they consider riba as prohibited (Source: SBP, 2015).
 - In 2015 KAP study, 93% of the un-banked respondents stated that conventional interest is Riba (Source: SBP, 2015).

Structure of Islamic Banking



Asset Side	Liabilities + Equity
Cash and Bank Balances	Current Account
Investments	Savings Account
Financing Assets	Fixed Deposit Account
Fixed Assets	Equity
Other Assets	Reserves

Deposit Mobilization

- **Non-Remunerative: (Qard) in Current Account**
- **Remunerative: (Mudarabah) in Savings and Fixed Deposit Accounts**

Financing Operations

- **Trade Based (Murabaha, Salam, Istisna)**
- **Lease Based (Ijarah, Diminishing Musharakah)**
- **Equity Based (Mudarabah, Musharakah)**

Murabaha



- Murabaha is a sale transaction.
- Murabaha Muajjal is a deferred payment sale.
- Used to provide short term financing.
- Murabaha as a mode of finance is used in:
 - Trade financing
 - Working capital financing
 - Small and medium enterprise financing for short term period.
- For instance, raw material, machinery etc.

Use of Murabaha



- Sara runs a bakery and wants to purchase a heavy duty oven for the bakery. The oven costs Rs 1 million on spot payment.
- She does not have money now, so she wants to obtain financing.
- But, she expects to be able to pay the amount in short period of time.
- Islamic bank agrees to finance the asset purchase.

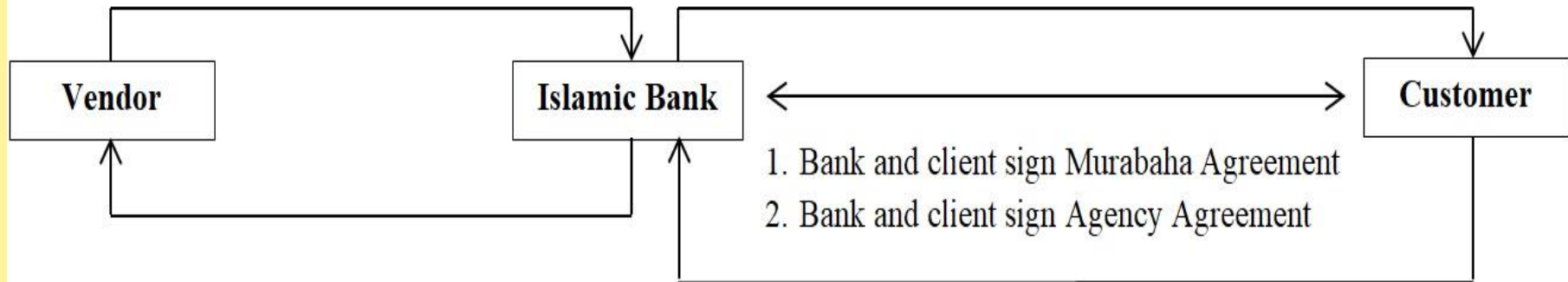
Murabaha



Murabaha Process Flow

3. Bank buys asset and vendor transfers asset to the bank or bank's agent

5. Customer offers to buy asset from the bank which the bank accepts and sells asset



4. Price paid to vendor by the bank directly or via agent

6. Customer pays the agreed Murabaha price to the bank which includes cost plus profit

Suitable for Short Term Finance need for purchasing raw material and machinery

Ijarah



- Ijarah means to sell usufruct of an asset on rent.
- In Ijarah, right of use of an asset is transferred to another person for a consideration.
- It is an Islamic alternative for leasing a tangible movable or immovable asset.
- For instance, generator, pickup, truck, machinery etc.

Use of Ijarah

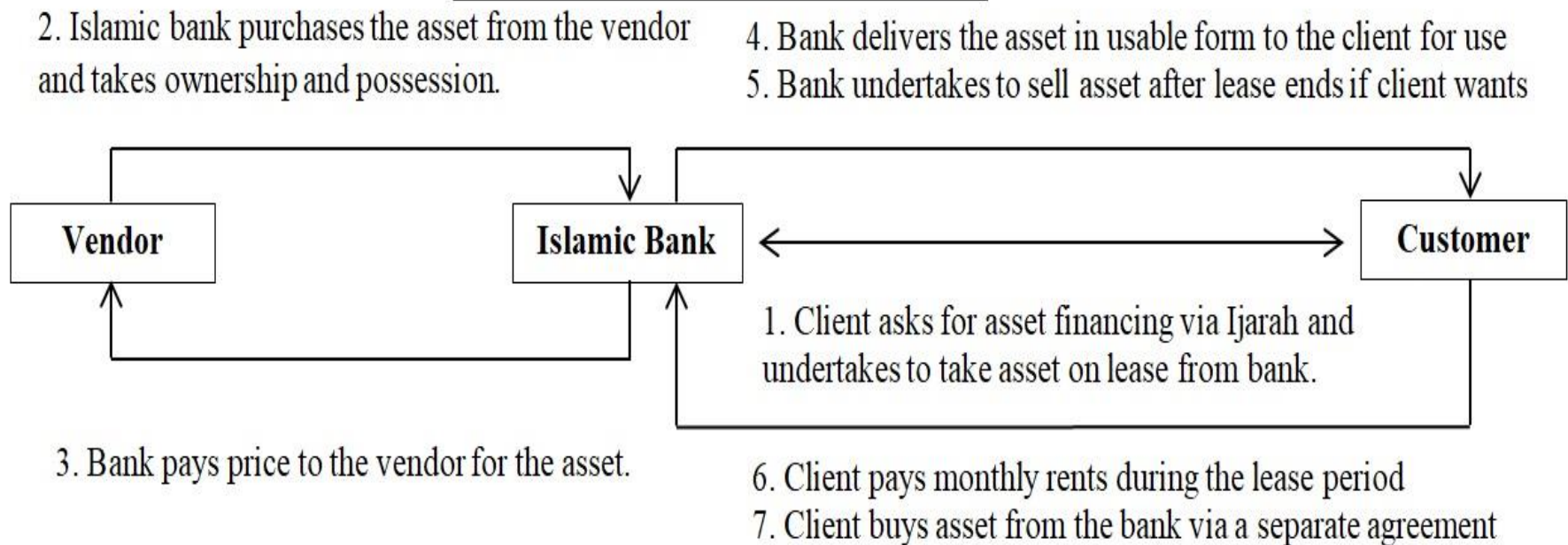


- Sara is starting a bakery business and wants to purchase a heavy duty oven for the bakery. The oven costs Rs 1 million on spot payment.
- She does not have money now, so she wants to obtain financing.
- She expects to be able to pay the amount in long period of time. So, she is looking for a long-term finance option.
- Islamic bank agrees to finance the asset purchase.

Ijarah



Ijarah Process Flow



Suitable for Long Term Finance need for purchasing machinery.

Mudarabah



- It is a partnership in which there are two partners i.e. Rabb-ul-Maal and Mudarib.
- Rabb-ul-Maal is the investing partner which contributes capital in the partnership.
- Mudarib is the working partner which contributes through enterprise and effort.
- In case of profit, both partners share the profit based on profit sharing ratio agreed between the Rabb-ul-Maal and the Mudarib.
- In case of loss, Rabb-ul-Maal bears the complete risk of all financial losses. Mudarib loses the remuneration for his services.

Use of Mudarabah

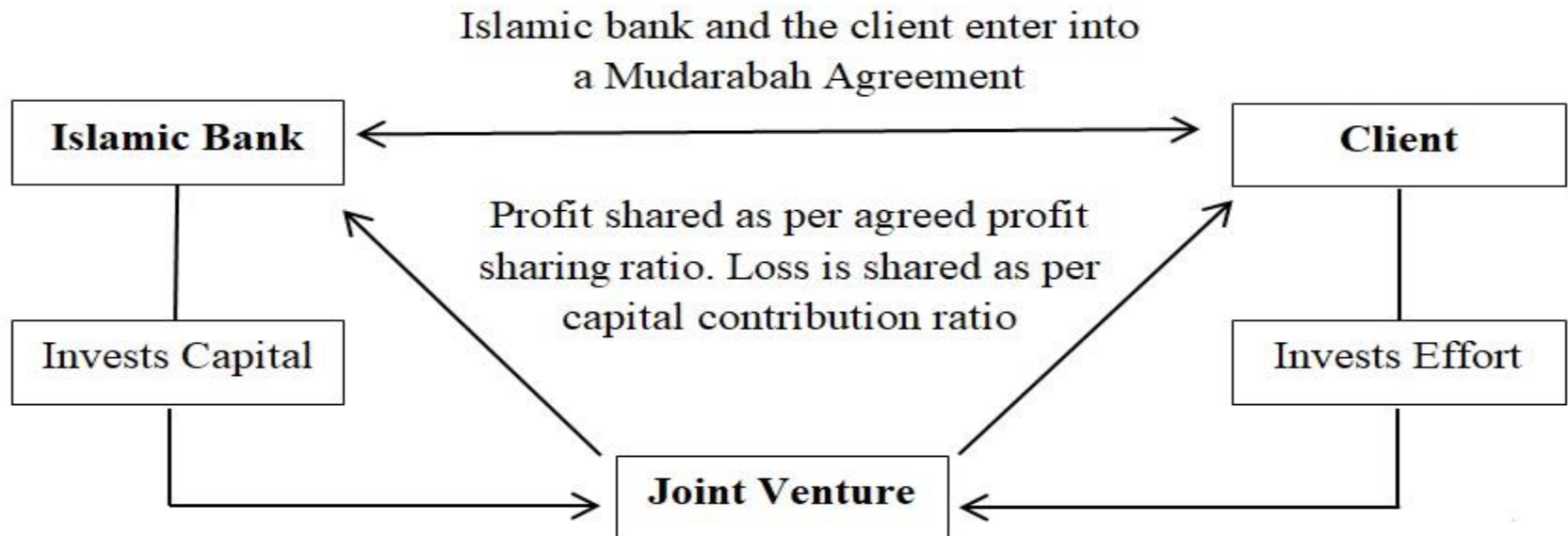


- Salma wants to open a furniture business. She has done courses in interior designing.
- She is looking for initial seed capital.
- She has served some clients in the vicinity.
- With a portfolio of her successful business transactions with clients and her educational qualifications, she contacts an Islamic bank for making initial investment in the production facility and showroom.

Mudarabah



Mudarabah Process Flow



Suitable for Short/Long Term Finance need without debt obligation and restriction on utilization of capital. No capital investment needed.

Musharakah



- It is a partnership in which partners invest as well as perform services for the joint enterprise.
- In Musharakah, profit sharing ratio has to be agreed at the start of the Musharakah contract.
- No partner is allowed any fixed profit.
- Profit sharing ratio is applied to the actual profit earned. Each partner shares in the profit as per the pre-agreed profit sharing ratio.
- In case of loss, loss is shared between partners based on capital contribution ratio.

Use of Musharakah

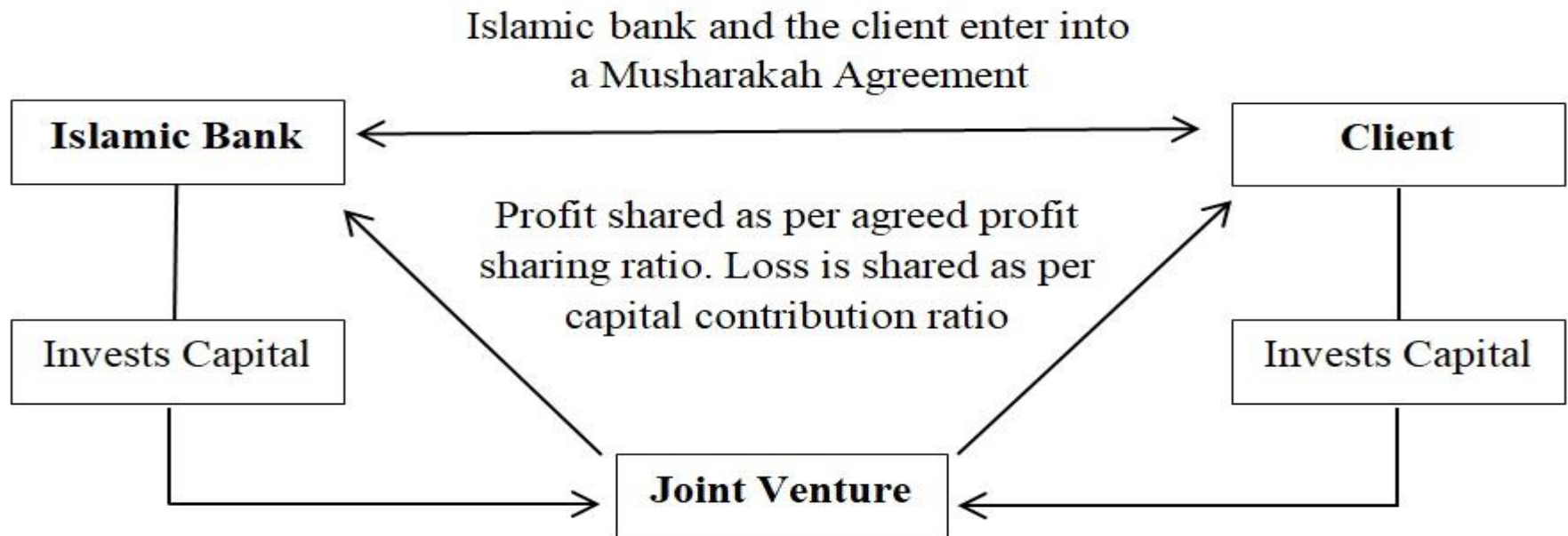


- Salma wants to open a furniture business. She has done courses in interior designing.
- She is looking for initial seed capital.
- She has served some clients in the vicinity.
- With a portfolio of her successful business transactions with clients and her educational qualifications, she contacts an Islamic bank for making initial investment in the production facility and showroom. She would invest her own savings in the business too.

Musharakah



Musharakah Process Flow



Suitable for Short/Long Term Finance need without debt repayment obligation and restriction on utilization of capital.

Salam



- Salam is used in financing goods and services that are not ready for spot sale and will have to be delivered later.
- In Salam, payment is on spot basis, but the delivery is deferred.
- Salam is used in providing financing in agriculture sector.
- For instance, if a farmer requires growing a crop and needs financing to buy fertilizer, pesticides and seeds, then she can be provided with financing by an Islamic bank using Salam.

Use of Salam

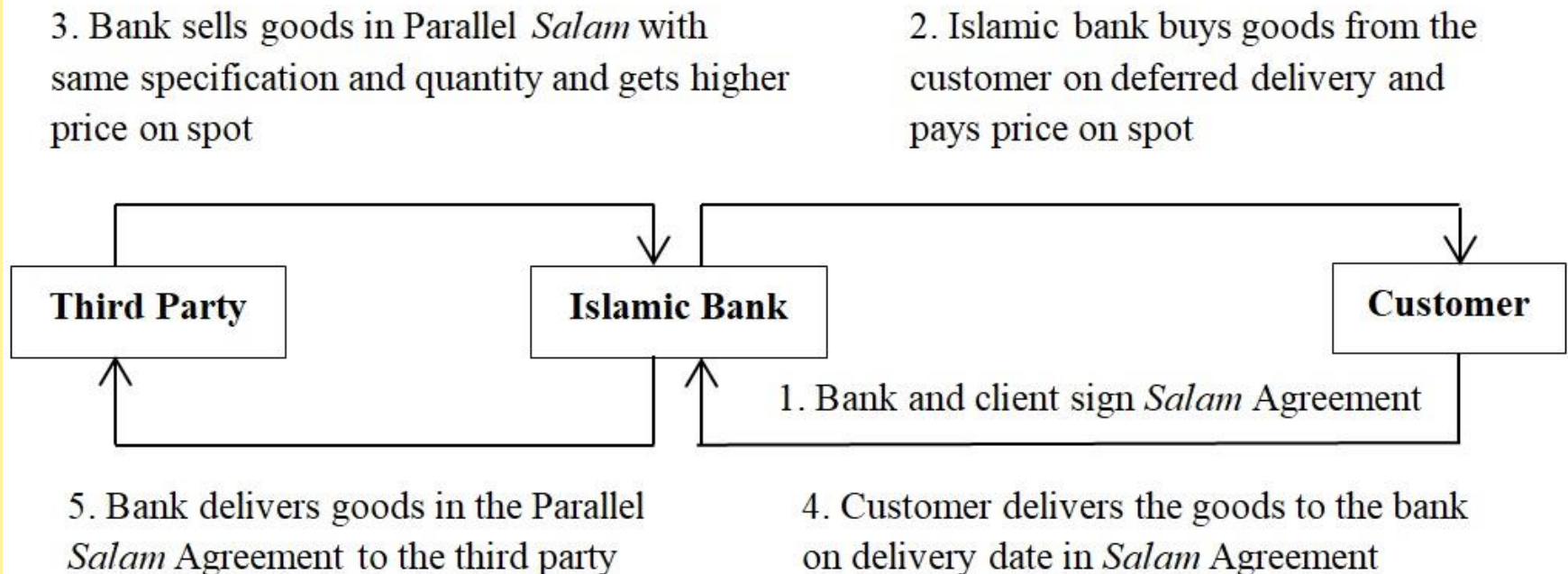


- Najma is an entrepreneur having specialization in Bio-Technology. She sells high-quality cotton.
- She is facing working capital shortfall to continue production. She has purchase orders from customers, but limited capital to undertake and pay the production cost.
- She contacts an Islamic bank for working capital financing for her venture.

Salam



Salam Process Flow



Suitable for Short Term Finance need for working capital with flexible use of finance.

Istisna



- Istisna is a sale transaction in which the subject matter needs to be manufactured.
- In Istisna, there is no restriction on time of payment.
- It is used in financing working capital for goods that are not yet ready for sale and will have to be manufactured.
- For instance, furniture, motorcycles, handicrafts etc.

Use of Istisna

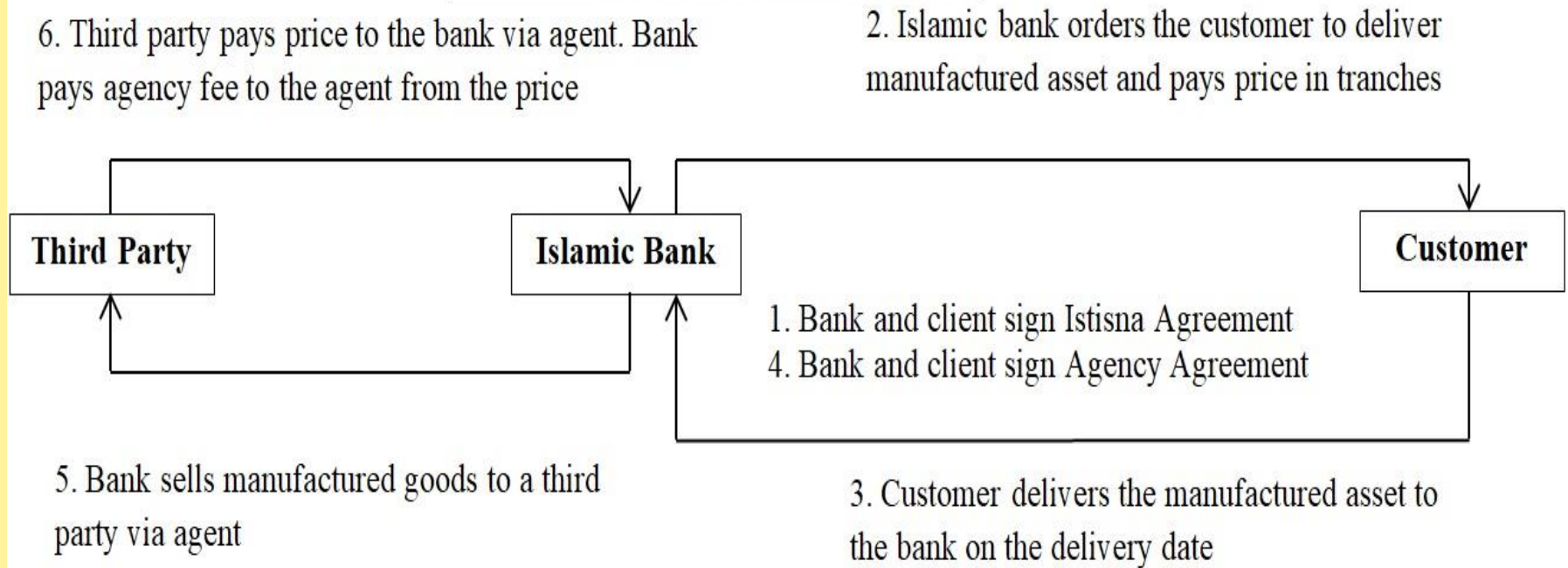


- Faiza is a architect having served clients in interior designing of their apartments on one-off basis.
- Now, she got a big breakthrough with an offer from a well-known builder to construct false-ceiling and wooden cabinets in a residential apartment building. She has expertise, but no capital to undertake the project.
- The builder will have booking starting after 30% work completion and can not pay Faiza the whole amount now. But, the builder undertakes to buy the assets from Faiza upon deivery.
- So, Faiza contacts an Islamic bank for financing.

Istisna



Istisna Process Flow



Suitable for Short/Medium Term Finance need for working capital with flexible use of finance where the subject matter of sale is an asset requiring manufacturing.

Challenges for Islamic Banking



- Lack of Awareness about Islamic Banking
- Perceived Economic Similarity with Conventional
- Limited Product Structures
- Commercial Displacement Risk on Price/Return
- Short Term Liquidity Management
- No Discount Window / Lender of Last Resort Option
- Lack of Regulatory Approval for Commodity Trade

Opportunities for Islamic Banks



- Room for Financial Inclusion
- Use Fintech for Expanding Outreach & Cost Cutting
- Penetration via M&As & Corporate Restructuring
 - E.g. MCBI, MBL-HSBC, BI-Citi, BI-KASB, Faysal Islamic
- Having an Islamic Product for Running Finance
- New Retail Sukuk
- Government Housing Scheme, Agriculture Sector, SMEs, Microfinance, Startups.



Thank You

Questions & Feedback

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