

FACILITATING ISLAMIC BANKING IN PAKISTAN

The situation calls for reforms in attitude and approach on both sides

By Muhammad Bashir Chaudhry, July 01 - 07, 2002

The State Bank of Pakistan on 1st December 2001 announced the criteria for the setting up of scheduled Islamic Commercial Banks in the private sector in Pakistan and has also invited applications from the interested sponsors. Overall the criteria are highly demanding on the prospective sponsors. Some suggestions in this context are offered towards end of this paper. The issuance of the criteria is a positive development in the sense that now the private sponsors will join the SBP / GOP efforts to finalize the truly Islamic products, prepare related draft agreements on Islamic finance and above all prepare the draft Islamic Banking Ordinance. A Commission and a number of committees are understood to be working on these and other related aspects.

RELEVANCE OF THE CRITERIA TO EXISTING BANKS AND DFIS

The points raised in this paper equally apply to the new Islamic commercial banks as well as the existing financial institutions. It is expected that soon the SBP might be issuing instructions to the existing banks and DFIs in Pakistan for taking steps more or less on lines prescribed for the new Islamic commercial banks. Particular attention might be given to the following areas:

- The modes of finance proposed to be used for raising resources and extending financial assistance.
- Expertise and other facilities available for ensuring compliance of their financing operations with Sharia.
- Proposed organization structure, business plans, risk management guidelines, internal controls, working systems and procedures for business operations.

RESPONSIBILITIES OF DIFFERENT PLAYERS UNDER ISLAMIC FINANCE

Banks and other financial institutions mobilize deposits and extend loans, and make money in the intermediation process. The Depositor and the User of Funds may be an individual, partnership or corporate entity. The GOP provides legal framework and the SBP is responsible for regulatory supervision and oversight of operations of the banks and other financial institution. SECP supervises the working of corporate sector, capital markets, leasing and insurance business. The external auditors audit the statutory accounts and provide other services. The transactions also involve inter-action with a large number of government functionaries. Under the Islamic system the responsibilities of all these players will change. Now in every thing quicker and justifies actions will have to be taken. It is perceived that under the Islamic system, operational procedures will also undergo big changes. Some thoughts on the new role of different players and other allied issues are discussed here with a view to clarify all the matters considered essential for the introduction of the Islamic financing in Pakistan.

THE DEPOSITOR

Largely part of the savings is turned into deposits. He or she will be expected to demonstrate to the bank that the money has been earned or acquired through legal means. He or she will decide with which bank or DFI the money is to be deposited, and in what particular scheme. Different people have different motives for keeping deposits. Under the new system, the depositors may fall in categories such as:

Some depositors will want safety of their capital. They would want that Rs.100 deposited by them today might remain nominally Rs.100 until they decide to withdraw part or whole of the deposit.

Other depositors may want safety of their capital and in addition they may want to share in a minimum profit (equal to GOP's consumer price index). They might not share in losses.

Some other depositors may place their deposits on full profit and loss sharing basis. They may pose confidence in the deposit taker to invest funds as it wishes. However, in case there are big losses, the deposit taker banks may be blamed and sued for negligence, pilferage, and other such things.

Some other people may place their deposits on full profit and loss sharing basis, and would wish to actually participate in the business undertaking where the funds will be invested. Such depositors will be few in number but large deposit amounts will be involved.

The banks or DFIs are required to know their customer and to satisfy about the genuineness of the deposit. The banks have to try to meet the maximum but legal expectation through design of their products and the quality of the service to them. The SBP is to assure that the banks / DFIs comply with its instructions in this regard. On the other hand, the GOP / SBP are expected to ensure that adequate information about the deposit taking institutions is made available to the depositors for making an educated deposit decision. Proper legal framework for protection of depositors from unscrupulous practices will also be required.

THE BANKS AND DFIS (*DEPOSIT ACCEPTING INSTITUTIONS*)

These institutions mainly have two roles, namely deposit taker and provider of finance. Both roles are important. As deposit taker, it has to establish the identity of the depositor, that the money is legitimate (to avoid money laundering), to provide sufficient information to the depositor and to take steps to protect the interest of the depositor. In this case the bank is in trustee relationship with the depositor. As provider of finance, it has to establish the eligibility of the User of funds, establish viability of the project, obtain required security and see that all conditions are complied with and the necessary documentation is complete before money is released to the User. Proper use of funds has to be ensured. It will provide for proper audit of business and valuation of assets for

determining the profit or loss situation. There has to be no pilferage of business assets for the illegitimate benefits of the User, the Bank or any other person. This is the difficult but an essential element for success of the new system.

The banks shall be organized to properly handle each type of deposit. A pool of deposits comprising small deposits will be established and funds out of this will be advanced for trade or industrial purposes. Separate account will be maintained of the income, expenses and profits from the pool funds. Deposit amounts exceeding the specified limit will be handled separately and separate account shall be maintained of each deposit for determining profit or loss situation. Bank personnel shall be trained and guidelines including internal controls will be put in place by the bank's board of directors who shall be responsible for full compliance for the guidelines and controls. Banks shall be scrutinized by SBP to see that they are equipped to handle the deposit taking function as per Islamic principles and that proper mechanism for profit determination is there. SBP and GOP shall provide the structure of the Islamic schemes and the standardized documentation to be used. SBP shall also be issuing Prudential Guidelines to them.

The tasks listed above will need to be handled by experienced and conscientious personnel who are properly motivated by the institutions concerned. Proper and up-dated manuals, guidelines, internal controls, procedures and formats are to be in place. In the present day conditions when employees are under fear of losing job as a result of rightsizing exercises, it will not be easy to keep the good personnel, keep them adequately motivated, and to also have updated guidelines and procedures.

Credibility Checks- the eligibility of the party desirous of Islamic finance for the purpose of trading or manufacturing activity is the most critical. They must be known to be honest, people honouring their legitimate commitments, no defaults to their name in the past, etc. The question is how this will be established and who will maintain such data for public benefit.

The bank as per prescribed guidelines will decide the exact mode in each case. It is presumed that in the meantime SBP Commission / Committees will have finalized their recommendations and in the light of such findings necessary changes will be made in the attributes and mechanism of these products to make them truly Islamic and permitted as per Sharia. For the sake of this paper names of the old mode of finance have been used though these will now carry truly Islamic characteristics. The following modes of finance will be introduced in the initial stages:

Qarze Hasna- there is urgent need to start such financing. Otherwise poverty will not be removed so easily. Micro-finance from Khush-hal Bank fall in this category. All banks may be required to advance minimum 10 % of finance in this particular activity. Criteria for eligibility, standardized documentation, security and dispute resolution mechanism might be provided by SBP, which may also supervise the banks.

Musharakah- banks may provide finance out of the small-deposits pool or individual large deposits to the eligible business and industrial entities for specified purposes and

time. Minimum 10% advance for the purpose will come from bank's own sources. Banks will see to it that the money is used for the specified purpose ensuring value-for-money and that proper accounts are prepared to determine the profit or loss situation. Bank may hire independent expert for this job. For participation at the Board level, the bank may appoint its senior officers as directors or appoint Independent Directors who are known for their experience or expertise. In case of profit, the bank will retain 10% of the profit as its intermediation fee and pass the rest to the respective depositors. The bank will also be eligible for the profit proportionate to finance provided from its own resources. In case of losses, bank will proportionately share loss with the respective depositors. The depositors shall have the right to check the accounts of the business or industrial entity as well as to see that loss is not due to negligence of the bank or the illegitimate activities of the entities. SBP to see that proper guidelines and controls exist for properly undertaking the activity. In this case it is a Mudarabah between the depositors and the bank and a Musharakah between the User of funds and the bank.

Mudarabah- it will be similar to the case described above, except that the bank will not take part in the management of the entity by appointing directors on the Board. In this case it is a Mudarabah between the depositors and the bank as well as a Mudarabah between the User of funds and the bank.

Equity Participation Mode- the bank will initially hold majority shares in the business or entity. The private sponsors will initially be minority owners but shall manage the entity as Agents to the bank. As long as the bank is satisfied, the private management will continue the business and share profits in the agreed proportions. As reward for good performance the bank will, in phases, sell its equity holding to the private sponsors. In case the private sponsors do not perform well, the bank will easily replace the management on the strength of its majority holding.

Open-end and Close-end Mutual Funds Type Shares Activity- the banks may use pool resources in activities such as purchase of shares for trading or long-term investment purposes. Care shall have to be taken to preclude chances of bank personnel shifting personal losses of share trade to the bank account. Insider trading shall also require to be controlled. Proper guidelines and internal controls are must for these operations.

Commodity Trade- the bank may on its account purchase commodities traded internationally and sell on profit to the customers in Pakistan.

The above are the most likely modes to be put into practice initially by the banks. There may be many other modes to be adopted after clearance by the Sharia Board. The GOP and the SBP are expected to pass relevant laws and institute proper guidelines for the smooth operation of different modes ultimately for use by the individuals and the banks involved. The above may be easily done for the new businesses or industries. Existing industries and other enterprises also need to be brought under the new system. This may involve more tricky questions. However, patience and hard work, most of all the sincerity of purpose can overcome this as well.

Getting Ready- it appears foreign banks are better prepared to handle Islamic finance as compared to the Pakistani banks. They are taking more interest to know the new system. They have better qualified and motivated personnel who will readily switch to the new system. They are expected to maintain their service quality and better decision-making edge over their Pakistani counterparts. The local banks need to gird up their lions. They have to train and motivate their employees, to be able to survive. For excelling in the field and profitability they shall have to do much more. It is time they realize it now and start working.

THE USER OF FUNDS

He or she may be expected to demonstrate that he or she is credit-worthy, has the capability to gainfully utilize the invested funds and has the financial means to contribute, if required, his or her share in the undertaking. For screening of users of funds as to their eligibility, the SBP will issue instructions to the banks and financial institutions as well as to the general public. For better control and safety of depositors' interest, the SBP may place certain restrictions including monetary limits on the financiers as well as the user of funds. The Users will maintain proper accounts, to be subjected to proper audit. The Users will account for all transactions done with the invested money.

High Intermediation Cost- these days depositors on annual basis gets only 5 to 6% which is subject to Zakat and with-holding tax. So the net return is very small. As against this, the borrowers at present pay 15% to 18% to the lender banks. The difference is the intermediation cost, which is very high and not sustainable, if the depositors have any say. Under Islamic finance if the intermediation cost is reduced to say 2% to 4%, both the depositors and the borrowers can get relief. The return to the depositor will be increased and the rate payable by the borrower will be brought down. This in turn will give a real boost to the economy. The SBP has already started asking the banks to reduce the intermediation cost. The banks will have to adjust to the new reality and control its expenses while increasing efficiency of its personnel.

THE REGULATORS (SBP AND SECP)

They shall have to be more vigilant in the supervision of the banks / corporate entities and in the protection of depositors' interest. Board of directors of the banks and the corporate entities will be required to demonstrate that proper guidelines and internal controls are in place and actually are complied with in letter and spirit. Pakistan cannot afford the sort of bad loaning as in the past. Qarze Hasna will also be institutionalized in the new era. The deposits will be insured. The SBP / SECP will provide regulatory and operational guidelines and controls for the smooth operations of all the parties involved.

The SBP and SECP will supervise activities of the deposit takers. Proper guidelines, restrictions and controls shall be put in place. SBP shall also put in place mechanism to see that each scheme introduced by the deposit takers meets the tenets of Islam. Documentation between the depositors and the deposit takers will be standardized. It shall be made clear to all that the violators will be severely penalized.

Bank Branch Network- Islamic finance, it appears, will need larger inter-action between banks and the users of funds. In that scenario, more wide spread banking networks are needed. However, under the restructuring exercise the number of bank branches is being reduced. The two activities do not appear compatible. Are we not creating a problem situation?

Foreign Investors for Banks- Pakistan is moving fast to privatize banks. Many foreign investors are interested in acquiring these banks and DFIs. The Islamic banking is to take full effect from 1st July 2002. It appears we want the foreign investors to own and operate these banks on Islamic finance principals. Is there some sort of a contradiction?

Licensing of Banks and Continued Supervision- the GOP and SBP will certify soundness of the banks collecting deposits and relevant details may be published in the newspapers every quarter. Boards of Directors of the banks will be reminded of their responsibility for providing proper guidelines and internal controls and to see that all of them are fully complied by the banks' personnel. The GOP and SBP will hold them responsible for the sloppy performance, if any.

THE GOP

Pivotal Role-The roles of the government are pivotal in many respects. To provide enabling environment and structure for the Islamic finance in the true sense, GOP shall identify and amend relevant laws, rules, and procedures. Possibly many new laws and rules shall have to be promulgated in order to provide for smooth operation of the new system and also for taking actions against persons acting in violation of the spirit of the new system. Incidence of Zakat, Income Tax, Sales Tax, Excise Duty and other Levies shall have to be rationalized. The depositors will be provided full protection. The GOP will also ensure that the Regulators are properly protecting the depositors and that there is level playing between the depositors, the banks and the Users of funds. For implementation of its various projects through finance from the banks, the GOP will demonstrate its eligibility to avail finance on commercial terms.

Training and Motivation of Public Functionaries- present day business conditions are such that some mis-guided public functionaries will not allow the things, which they know, are right and for which required documents are submitted and applicable fees are paid, unless some private personal benefit is offered to them. Per force, such expenditure is shown in the final accounts, but under different heads. For Islamic finance and the strict audit, the GOP is urged to resolve this difficulty by educating the public functionaries and by suitably motivating them by increasing their salary so that they also become a party for the success of the new system.

Deposit Insurance- the GOP and SBP to consider instituting deposit insurance up to minimum Rs. one million, per account as soon as possible.

Corporate Law- the new system will not work smoothly with the existing Company and other laws. Changes need to be made at the earliest. The Commission / Committees' reports might provide guidance in this regard.

Fear of the Unknown- in its true application in a society with all Islamic norms, Islamic finance is expected to result substantial profits for all parties involved. But how long it will take to reach that stage and what happens before that is not known. So the foreign investors will heavily discount the potential earnings of Pakistani banks being offered for privatisation. We will not get a fair price. It will not be a bad idea if the Islamic system in banking is introduced before the privatization.

EXTERNAL AUDITORS

They have been auditing corporate and other accounts since long and generally have had smooth sailing. Under the new system, their responsibilities will increase manifold. They shall have to do complete audit including valuation of assets, as otherwise it will not be possible to arrive at the true profit or loss amount to be shared by the parties involved. They may be required to do cost audit and other appropriate audits in order to discover over or under invoicing practices. They will naturally be rewarded for their services, but they may also be questioned for their poor performance. Also due to conflict of interest they may not be allowed to provide to these very entities the tax consultancy and financial advisory services.

Audit- Islamic finance is based on sharing of profit and loss. The profit and loss under the Islamic modes of finance is not the same to which we are accustomed. It is different. Accounting conventions will need to be adapted to yield profit and loss in the Islamic sense. Most realistic decisions shall have to be made in the cost allocation on time basis or valuation of assets at the end of more frequent intervals. This will require more work by the accounting and other experts. Unless the role and duties of the auditors are debated, clarified and agreed to be fair in the present day conditions, Islamic finance may not take root here in its true sense.

Valuation of Assets- at the end of agreed time period, valuation of all assets (and liabilities) will be done, in order to determine the total value now as compared to the time when the business was initiated. In case the valuation now is more than the original valuation, the difference will be termed as profit. The valuation has to be reliable. It has to be agreed if the valuation will be on going-concern basis or some other basis will be used. In each case results will be different and to that extent valuation will be higher or lower. It is understood that for reliability of accounts, the auditor will do more extensive work and is expected to certify the cost/price fairness, not only based on invoices but also on market judgment. The audit shall have to be planned appropriately with a view to give the final audited figures soon after the end of the period.

Time Interval for Audit- we are accustomed to the annual audit based on the calendar or fiscal year or the year, which suits the tax authorities or the main raw material cropping pattern. Under the new system, the time interval for determining profit in the business

will be flexible in relation to the nature of the business and the transactions financed by the depositors / banks. It may differ from case to case basis. The auditors have to be ready for that. An allied question is what will be the time basis for levying income tax.

THE SHARIA BOARDS

The products designed for taking deposits, for making advances or for the parking of spare funds, all need to be scrutinized by the Sharia Board. Transactions approved by the Board will be cleared for execution. For this purpose the Sharia Boards may have to work hard and also keep abreast with the developments in other banks and DFIs locally and abroad.

Financing the Skill Development- ordinarily the cost is charged to the bank now and so it will be for the future. However, there is one difference. The banks will be offering expert services to the depositors and charging fee for it. The cost of skill development may be met from bank's own capital or the fee earned and not directly charged to the account maintained for ultimately determining profit or loss for the depositors. There will be many other such costs, which need to be charged to the appropriate accounts. Fair basis for this will have to be developed.

BANKING COURT

Their workload is expected to increase substantially. New cases shall have to be heard and decided rather quickly. Existing defaulters may also ask forgiveness of old interests on the loans availed in the past. May be additional such courts are needed. The honourable judges shall have to be familiar with the new documentation and the actual transactions under Islamic finance.

SBP CRITERIA, PROSPECTS AND SUGGESTIONS

The criteria issued by the SBP are appropriate in conditions that are attractive for investment and the capital market is buoyant. The country is presently in some sort of recession and existing profitable companies are finding it not easy to offer to general public large share issues or the TFCs. Major portion of the recent TFC issues were privately placed with the financial institutions and a small portion was actually offered to general public. The new Islamic commercial banks are required to offer minimum Rs 500 million to general public. They may face major problems in raising such large capital by public floatation. The SBP / GOP has yet to decide on the Islamic modes of finance, the standardized agreements for the financing and the issuance of the Islamic Banking Ordinance as the Commission / Committees are still working on that. This had added further uncertainty for the prospective sponsors. Therefore, it is felt that the response to the SBP call will not be very encouraging unless the situation takes a dramatic turn for the better. In order to make progress towards the introduction of Islamic finance in the country, the SBP may as well consider options such as:

Let some of the criterion be relaxed for the time being. There might be better response if the sponsors are allowed to incorporate a private limited company having paid up capital of Rs 250 million and to start Islamic banking operations. Initially they may not be allowed to accept deposits more than four times of the paid up capital. All other criteria to be maintained as originally prescribed except that the processing fee may be reduced to Rs0.25 million.

The existing commercial banks and DFIs are to switch over to Islamic financing from July 1, 2002. Let them sponsor a new Islamic commercial bank in collaboration with Pakistani businessmen. The work done for setting up this new bank will also help them in the actual switching over.

CONCLUSION

The success of Islamic banking is predicated to a number of factors including a clear understanding of the environment in which various transactions will take place. The bankers, the depositors, the users of bank finance and services and the facilitators all have to be ready and committed to work for the success of the new system. In this context, an attempt has been made to flag the related issues for timely attention of all the concerned authorities. The Islamic Commercial Banking in Pakistan will flourish most when the norms in the society are fully in conformity with the Islamic teachings.