PERSPECTIVE ON ISLAMIC FINANCE[1]

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President Arif Alvi, Distinguished Ladies and Gentlemen,

Let me first thank the organizers of this important event for inviting me to address this conference. I deem it as my duty as in doing so I pay my tribute to the memory of Mr. Zahid Malik, a devoted patriot.

As you all know Islamic banking system has vast potential to meet the challenges faced by our society and economy ie. Poverty alleviation, income and regional inequality, access to finance by small farmers and SMEs , investment in human development , unemployment and inclusive growth .Impact financing , Ethical and particularly Environmental, social and governance (ESG) financing are expanding on the global scene quite rapidly .

I have argued before the non Islamic audiences that Islamic financing incorporates all the salient features of Impact, Ethical financing and ESG but it has an added attractive feature ie asset backed financing mitigates the risks inherent in the present financial architecture . Global financial crisis of 2008 has clearly demonstrated that exotic products such as Collateral debt obligation raised to cube and Credit default swaps stacked up piles of additional risks over the underlying risk. Credit rating agencies failed to comprehend the complex structure of these products.

The principal tenet of Islamic finance as enjoined as Quran is Justice and Equity. The rules governing property rights, contracts, distribution and transfer of wealth, use of excessive wealth by individual beyond moderate limits, entitlement of the poor and downtrodden are all aimed at ensuring justice and Equity. The challenge before us is how to translate this built in feature of Islamic economic system into action and operation. Under the Islamic system, societal material and physical well being along with spiritual well being are to be maximized rather than individual self interest that forms the sole basis of the capitalist system and guides the financial architecture.

Under Islamic finance, the supplier of funds or the investor demands the return on investment ex-post after the business transaction has produced the outcome. As the risk of business in Islamic finance is shared between the supplier and the user of the funds the returns on investment whether positive or negative are shared equitably between the two

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parties in the proportion they had agreed upon. The burden of misfortune of adversity does not fall upon the borrower and the supplier does not take it all while the borrower of funds does not become financially insolvent.

Islamic banking is growing globally. Over the last three decades, Islamic banking and finance have developed into a full-fledged system and discipline reportedly growing at the rate of 15 percent per annum. Today, Islamic financial institutions, in one form or the other, are working in about 75 countries of the world. The Islamic banking segment's performance grew by 4.3% in 2020, compared To 12.4% in 2019. The overall worth of the Islamic finance service industry has increased from USD 2.44 trillion to USD 2.70 trillion in 2020. The Islamic finance services industry sustained its 10.7 percent growth in 2020 despite the fact that we have challenging economic conditions due to COVID-19 and oil price and volume volatility.

If you look at the Islamic banking sector in Pakistan ,ladies and gentlemen, assets and deposits growth is 30.6 percent and 28.4 percent respectively. However, the overall Market share of the Islamic banking industry's assets and deposits was accounted only at 17.0 percent and 18.7 percent despite being in operations since 2002. Islamic banking segment's performance is not satisfactory at all. Though the Meezan bank is setting itself up well in Islamic banking to take off as a key player among the Islamic banks as well as Conventional banks like Habib Bank Limited (HBL), United Bank Limited (UBL), and Muslim Commercial Bank (MCB). Meezan bank crosses Rs. 200 billion market capitalization (overall share value in PSX). But we need more Islamic banks to tap unbanked population of Pakistan and provide innovative products for the financially poor people.

We should ask ourselves; why is the Islamic banking industry lagging in this market in which it has a comparative advantage given the preferences of the Muslim population. My point is that why the share of the Islamic banking industry is still around 20 percent while the unbanked are 71 percent in the country? My analysis of the factors responsible for this dismal performance indicates:

First, there's a need to raise awareness and educate the public as there is hardly any common or shared understanding about the objectives, underlying principles, mechanics, mode of operation and outcomes of Islamic finance.

Second, there is a lack of new products and services. Islamic banks in Pakistan have been too obsessed with making conventional banking products Sharia-compliant. To critics, this is nothing more than bells and whistles wrapped around existing products.

Third, deposit mobilisation has picked up speed but asset deployment has not kept pace. The ratio of financing to deposits is dismally low.

Fourth, sectors such as agriculture, agribusiness, small and medium enterprises, low-cost housing, etc. neglected by conventional banks but forming the core of Islamic financing hasn't been covered.

Fifth, the proliferation of Shariah boards at the level of individual financial institutions has added to uncertainty and raises questions about the nature and legal force behind these boards. Are they part of the governance structure or decision-making process?

Sixth, the lack of standardisation of Islamic products has made transaction costs relatively higher, and the issuance of transaction-based fatwas by Shariah boards leads to lack of transparency and unpredictability.

Seventh, investment account holders are neither shareholders nor passive depositors. They are, however, not represented on the governance of the institutions and thus do not have much of a voice.

Eighth, the human resource base is becoming a major constraint in the expansion of Islamic banking. Individuals who are trained and competent in basic banking as well as Islamic jurisprudence are limited in supply.

Ninth, non-banking financial institutions should work with Islamic banking institutions for building the Islamic financial system as a whole. Takaful, Modaraba, Islamic mutual funds, and iREITs should expand and work in the territories where no financial institutions is working.

In my opinion the areas where Islamic financial institutions should focus are:

Higher digitalization and fintech collaborations to strengthen the portfolio of IFIs in the volatile environment and open new growth avenues. In Pakistan, 80% population have access to mobile phone. This is huge opportunity for the IFIs for making new customers and create impact. Islamic financial social instrument like zakat, Waqf, Social Sukuk, Qard Hasna, charity to serve the institutions, individual economically affected by the Covid.

Poverty, Income inequality, Regional disparity and illiteracy are four key problems hindering Pakistan’s economic growth and Islamic banking could playa key role to address these challenges. In view of that, in my humble opinion , Islamic banks in Pakistan haven’t done much for the poor and underprivileged people of Pakistan . Islamic banks and Takafuls should help small farmers and small businesses. Takaful health cards should be issued to low income groups in collaboration with the Government. Islamic banks should use Ijarah for financing agriculture implements and equipment and offer financing for educating students from the deprived areas.

I believe that Islamic banking cannot make major impact unless the larger landscape of the economic system is also altered and practiced in conformity with the value, structure and thoughts of the Holy Quran.

Thank you very much.