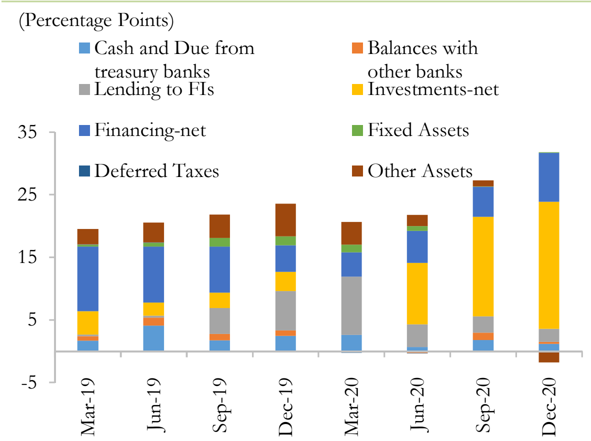
Chapter 3.2: Islamic Banking

Islamic Banking Institutions (IBIs) continued to outpace the conventional banks in growth of business. During CY20, their asset base recorded a 30 percent growth duly supported by a robust growth in deposits. As opposed to deceleration in advances of conventional-bank segment, IBIs recorded a healthy expansion in financing. The overall growth in asset base was however largely contributed by investments in new issue of Sukuk. The asset quality improved as infection ratios declined and provisioning against NPAs was prudently increased. Operating performance also improved with a significant increase in Profitability and related earning indicators. Consequently, solvency position improved further, thereby enhancing resilience of the IBIs to shocks.

Despite the Challenges of COVID 19, Islamic Banking continued to maintain its strong growth momentum during CY20…

Though COVID-19 posed various challenges for the banking industry, the Islamic Banking Institutions (**IBIs**)[104] maintained their growth momentum during CY20. Total assets grew by 30.0 percent that was well supported by growth in deposits. The major push in assets came from investments. However, unlike conventional counterparts whose loans portfolio contracted during the year[105], financing of IBIs marked a decent growth (**Chart 3.2.1 & Table 3.2.1**).

Chart 3.2.1: Contribution to Asset Growth of IBIs



Source: SBP

Table 3.2.1: Performance of Islamic Banking

	IBIs			Conventional Banks		
	CY18	CY19	CY20	CY18	CY19	CY20
	PKR Billion					
Total Assets	2,658.5	3,283.7	4,269.4	17,023.6	18,707.6	20,854.4
Investments (net)	515.0	596.9	1,261.2	7,398.9	8,342.5	10,673.5
Financing (net)	1,510.8	1,622.5	1,881.0	6,444.4	6,626.4	6,410.5
Deposits	2,202.9	2,652.1	3,389.0	12,051.3	13,301.4	15,129.6
	Percent Change					
Total Assets	17.0	23.5	30.0	5.9	9.9	11.5
Investments (net)	-3.6	15.9	111.3	-9.7	12.8	27.9
Financing (net)	25.2	7.4	15.9	21.5	2.8	-3.3
Deposits	16.9	20.4	27.8	8.3	10.4	13.7
	Share in Total Assets (Percent)					
Investments (net)	19.4	18.2	29.5	43.5	44.6	51.2
Financing (net)	56.8	49.4	44.1	37.9	35.4	30.7
FDR/ADR (Percent)*	68.6	61.2	55.5	53.5	49.8	42.4

* FDR= Financing to Deposits and ADR=Advances to Deposits

Source: SBP

Partnership-based financing products got further traction…

The partnership-based partnership modes of financing, such as Musharaka and Diminishing Musharaka, continued to increase during CY20. The combined share of these financing types increased to 56.3 percent in CY20 from 53.8 percent in CY19, whereas the share of other modes such as Ijarah continued to fall (4.82 percent in CY20 compared to 5.75 percent in CY19) (**Table 3.2.2**). While the combined share of partnership based modes was already higher in recent year, a further increase in its share suggested that IBIs continued to target more banking products under risk sharing modes.[106]

[104] IBIs include both full-fledged Islamic Banks and Islamic banking branches of conventional banks.

[105] During CY20, advances (net) of conventional banks declined by 3.3 percent, while aggregate advances/financing of the entire banking sector posted a marginal growth of 0.5 percent.

[106] Profit and loss sharing modes include, Musharaka and Diminishing Musharaka. Other broader modes of financing are Trade based and Lease based financing.

Table 3.2.2: Islamic modes of financing

	CY18		CY19		CY20	
	Amount	Share	Amount	Share	Amount	Share
	amount in PKR billion, share in percent					
Murabaha	212.9	13.8	214.9	12.9	263.8	13.7
Salam	36.4	2.4	43.8	2.6	37.4	1.9
Istisna	140.0	9.1	158.5	9.5	160.4	8.3
Musharaka	306.0	19.9	329.3	19.8	437.8	22.7
Ijara	95.5	6.2	95.5	5.7	92.8	4.8
Car Ijara	61.2	4.0	58.3	3.5	58.0	3.0
Plant and machinery Ijara	19.6	1.3	25.0	1.5	17.1	0.9
Equipment Ijara	2.7	0.2	2.5	0.2	1.2	0.1
Others Ijara	12.1	0.8	9.6	0.6	16.5	0.9
Diminishing Musharaka	513.1	33.3	564.9	34.0	649.1	33.6
Other Islamic modes of finance	237.1	15.4	253.2	15.2	290.1	15.0
Mudarabah	-	-	-	-	-	-
Qard/Qard-e-Hasan	0.7	0.0	0.7	0.0	0.7	0.0
Total	**1,541.7**	**100.0**	**1,660.7**	**100.0**	**1,932.2**	**100.0**

Source: SBP

Amid challenging operating environment, financing growth was decent as new SBP schemes also proved enabling factor ….

CY20 was a difficult year due to the challenges posed by the COVID-19 pandemic; however, IBI's performance in terms of financing was worth noting. In addition to the conventional modes of various SBP support measures such as Rozgar scheme (to prevent job losses in the economy), TERF (for BMR/new investment), and RFCC (for health sector), SBP (in collaboration with IBIs) also provided the Islamic versions of these schemes during CY20. These not only benefited businesses but also contributed in the revival of economic activity from the early H2CY20.

IBIs' total financing grew at 15.9 percent in CY20– more than double of the 7.4 percent growth in CY19. Moreover, the expansion in financing was encouraging and better than the conventional counterpart for the whole CY20. The flows were skewed towards public sector in first half of the year, as higher wheat financing[107] contributed to the rise in public financing during Q2CY20, and demand from private sector was subdued due to mobility restrictions and pandemic related uncertainties.

However, with the revival in business activities from June 2020 onwards, the pattern shifted towards private sector and its financing recorded healthy increase of PKR 128.1 billion during Q4CY20 **(Chart 3.2.2).** In addition to COVID-19 schemes, other refinance facilities such as Islamic Export Refinance Scheme (**IERS**) and Islamic Long Term Financing Facility (**ILTTF**) also helped IBIs to cater various needs of eligible borrowers.

Chart 3.2.2a: Trend in Outstanding Financing

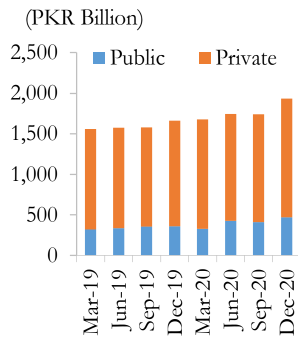
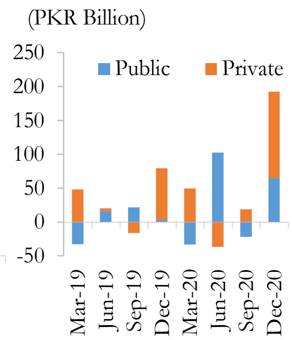


Chart 3.2.2b: Trend in Flows



Source: SBP

…and growth in commodity financing and corporate segments was prominent …

IBIs financing for commodity operations and corporate segments, recorded a prominent increase during CY20. Disaggregated data revealed that the government procurement agencies enhanced financing for commodity operations from IBIs due to their relatively competitive pricing. (**Table 3.2.3**). With the PKR 121.3 billion increase, the share of commodity finance in total financing of IBIs went up to 15.0 percent in CY20 (10.1 percent in CY19).

The corporate segment also recorded healthy increase of PKR 114.8 billion in CY20 **(Table 3.2.3)**.Within the corporate financing, the major rise was due to trade finance and fixed investment financing during the year.

[107] The government raised wheat procurement target to 8.25 million tons in 2020 from 6.25 million tons in 2019 and also increased support price to PKR 1,400 per 40 kg from PKR 1,300 per 40 kg, which contributed to rise in financing of the commodity.

Table 3.2.3: Segment-wise Islamic financing

	IBIs			Conv. Banks			IBIs		Conv. Banks	
	CY18	CY19	CY20	CY18	CY19	CY20	CY19	CY20	CY19	CY20
	PKR Billion						Flow PKR Billion			
Corporate Sector:	1144.8	1243.0	1357.8	4532.9	4736.4	4724.8	98.2	114.8	203.5	-11.6
Fixed Investment	541.2	586.6	636.3	1999.7	2106.0	2286.4	45.4	49.7	106.4	180.3
Working Capital	497.4	521.1	533.5	1533.0	1612.5	1428.7	23.7	12.3	79.5	-183.8
Trade Finance	106.2	135.3	188.1	1000.2	1017.9	1009.8	29.1	52.8	17.7	-8.1
SMEs:	57.2	57.5	57.6	439.0	414.2	394.5	0.4	0.0	-24.8	-19.7
Fixed Investment	23.1	25.8	27.5	94.7	79.4	77.0	2.7	1.7	-15.3	-2.4
Working Capital	31.5	28.7	26.6	299.4	295.7	281.0	-2.8	-2.2	-3.7	-14.7
Trade Finance	2.5	3.0	3.5	44.8	39.1	36.5	0.5	0.5	-5.8	-2.6
Agriculture	5.0	7.0	6.1	316.6	335.3	330.1	2.0	-0.9	18.8	-5.2
Consumer Finance	155.5	165.2	190.1	368.5	398.4	436.2	9.6	24.9	29.9	37.8
Commodity Financing	161.5	167.6	288.9	702.4	631.5	544.4	6.1	121.3	-70.9	-87.0
Staff Loans	14.6	19.0	23.1	111.9	131.6	140.4	4.3	4.1	19.7	8.8
Others	3.0	1.4	8.6	1.4	3.2	-4.5	-1.6	7.3	1.8	-7.7
Total	**1541.7**	**1660.7**	**1932.2**	**6472.7**	**6650.6**	**6566.0**	**119.0**	**271.5**	**178.0**	**-84.6**

Source: SBP

While the SBP refinance schemes such as IERS (to textile amid recovery in exports in H2CY20[108]) contributed to the rise in trade financing, the major increase in fixed investment financing could be traced in construction sector due to government package for this sector in CY20.[109] Supply side push to construction related financing also appeared, as in the mid of the year, SBP introduced mandatory targets for banks to achieve (by end December 2021) at least 5 percent of their domestic private credit to housing and construction of buildings.

Among other segments, the share of SMEs financing remained low and in fact further contracted during the year to 3.0 percent in CY20 from 3.5 percent last year. In this regard, SBP's pandemic-related support measures helped in preserving the credit flow to different sectors. In the absence of these policies, the significant stress and uncertainties created by the pandemic could have led to considerable decline in financing, especially to small and medium sized borrowers. A significant number of SMEs borrower availed financing under SBP's schemes[110].

The consumer finance segment of IBIs witnessed a healthy growth of 15.1 percent during CY20 (**Table 3.2.3**). Within consumer financing, auto financing was the major contributor with 56.7 percent share in overall growth in banking sector's auto finance. The increase could be attributed to several factors such as sharp fall in borrowing costs (amid significant reduction in Policy rate), the introduction of new car models during CY20 and revival in car sales in H2CY20, as the economy revived. In addition, SBP's regulatory polices e.g. temporary increase in Debt Burden Ratio from 50 percent to 60 percent along with reduction in SBP policy rate augmented the financing to households.[111]

Financing to agriculture fell by PKR 0.9 billion in CY20 (PKR 2.0 billion increase in CY19). Apart from the impact of cash flows constraints due to pandemic, other factors including disruptions e.g. scarcity of labor due to lockdown effect at the time of harvesting major crops like wheat and locust attacks also suppressed financing to the Agriculture.[112] Due to cash flows constraints, some of the borrowers delayed their loans repayments which led the IBIs to limit lending to segments such as Agriculture; its share in outstanding financing marginally fell to 0.3 percent in CY20 from 0.4 percent in CY19.[113]

108 Textile exports (USD terms) rose 5.1 percent YoY in H2CY20 compared to decline of 16.2 percent in H1CY20. In quantum terms, items such as hosiery and Yarn (other than cotton yarn) recorded double digit growth in H2CY20 compared to double digit decline in H1CY20, indicating recovery in exports of various textile's products. (Data source: PBS)

109 The government introduced a construction sector package in July 2020 to contain the economic impact of COVID-19. The package includes tax concessions for builders and developers on investment in Naya Pakistan housing schemes.

110 Share of approved applications was 61.5 percent for SMEs in the risk-sharing scheme (SBP Rozgar scheme). See SBP policies: https://www.sbp.org.pk/covid/index.html

111 BPRD Circular Letter No. 14 of 2020 dated March 26, 2020 available at: https://www.sbp.org.pk/bprd/2020/CL14.htm

112 Though farmers in Punjab did not report a major impact of the COVID lockdown on the wheat harvest, survey respondents (conducted by the Asian Development Bank (ADB) in lower Sindh in particular cited labor shortages and COVID disruption as a factor that delayed their wheat harvest and marketing efforts. (For details, see Chapter 2 of SBP's First Quarterly Report on the State of The Economy for FY21).

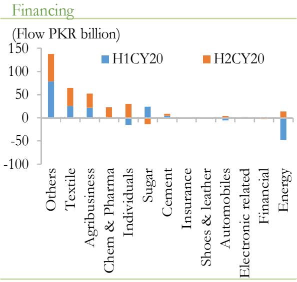
113 According to a recent survey by Pakistan Bureau of Statistics 12 percent of the households in the respondents delayed their loan repayment (of already taken) during the pandemic. Source: https://www.pbs.gov.pk/sites/default/files//other/covid/key_findings_presentation_covid_survey.pdf

The sector-wise flow of financing remained diversified…

Sector-wise flow suggested that the Islamic financing remained well diversified during CY20, though textile and Agribusinesses were prominent during CY20 **(Chart 3.2.3)**. With the revival of economic activity in H2CY20, a visible recovery in exports of several textile items was observed which contributed to the sector's financing needs. In the case of chemical and pharma sector, the increase was due to one of the pharma firms, which acquired 100 percent stake of a chemical manufacturer's business during CY20, leading to increase in the borrowing of the sector.

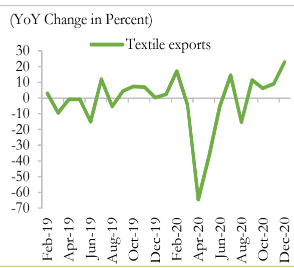
However, sectors such as automobile retired some of its financing during CY20. The recovery in the sales of cars in H2CY20 improved the liquidity position of the leading borrowers in the automobile sector, leading to decrease in financing during CY20.[114] It is important to highlight that the increase of PKR 21.7 billion in auto financing (by IBIs) played an important role in reviving car sales during CY20.

Chart 3.2.3a: Sector wise Change in Financing



Source: SBP

Chart 3.2.3b: V-shape Recovery in Textile



Source: PBS

Despite the COVID-19 pandemic, asset quality improved …

Despite a significant increase in financing, the asset quality of IBIs improved during CY20. The improvement was reflected on gross as well as net basis. Gross Non Performing Financing (**NPFs**) fell by PKR 8.5 billion to PKR 62.1 billion in CY20 compared to an increase of PKR 33.6 billion during CY19. Sector wise analysis shows that the fall in overall NPFs came from the decline in NPFs of real estate, textile and auto sectors.

Since gross financing posted strong growth, the infection ratio i.e. NPFs to Financing also fell to 3.22 percent in CY20, from 4.26 percent in CY19. Thus, as opposed to marginal deterioration in infection ratio for conventional counterparts (from 9.58 percent in CY19 to 10.81 percent in CY20), the asset quality of IBIs actually improved during CY20. However, disaggregated analysis shows that after rising to 5.0 percent in Mar-20, the infection ratio gradually came down to 3.22 percent by end of CY20 (**Chart 3.2.4**). This also suggests that the part of the improvement in NPFs was due to temporary regulatory measures of SBP (to dampen the impact of COVID-19) such as payment holiday on principal and rationalization of regulatory requirements on restructuring of financing.

Chart 3.2.4a: Asset quality indicators (IBIs)

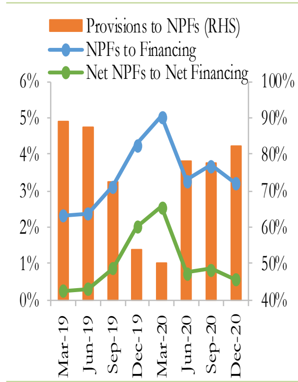
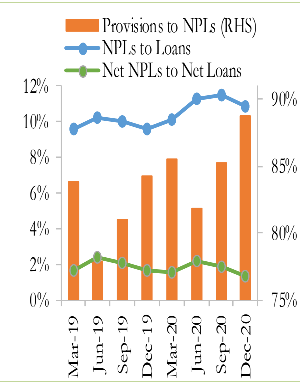


Chart 3.2.4b: Conventional banks



Source: SBP

Accordingly, IBIs also made increased provisioning from Q2 onwards totaling at PKR 13.0 billion in CY20 (PKR 7.3 billion in CY19) (**Chart 3.2.5**). The major increase in provisioning was of specific nature.[115] The provisioning coverage substantially improved to 82.37 percent

114 Last year automobiles financing needs remained elevated due to lower sales and associated cash flow challenges. Sales of local assembled car fell by 25.2 percent in CY19.

115 Banks are also targeting the implementation of IFRS-9 from January 01, 2021, which (among others) requires recognition of impairment charge based on "expected credit losses" (ECL) approach on assets rather than "incurred credit losses" approach. This also contributed to higher provisioning during CY20.

in CY20, resultantly, the Net NPFs to Net financing ratio fell to only 0.58 percent in CY20 from 2.01 percent in CY19; reflecting muted credit risk on net basis.

Chart 3.2.5a: Profile of NPFs of IBIs

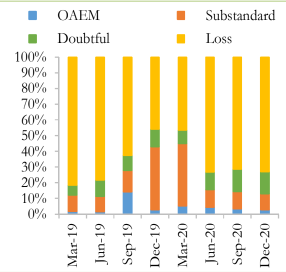
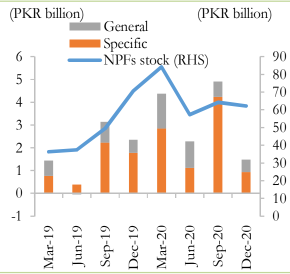


Chart 3.2.5b: Flows of Provisioing



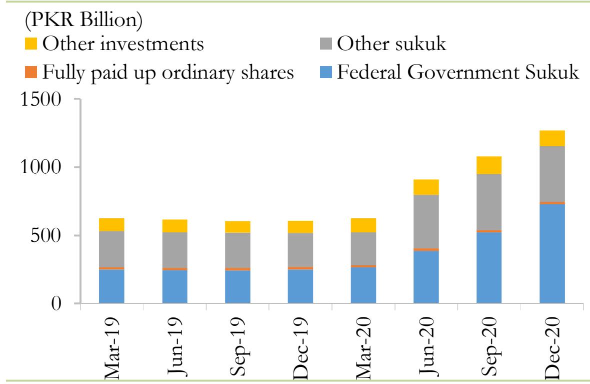
Source: SBP

Coupled with Fresh Ijarah Sukuk, another Issuance of energy Sukuk contributed in rise in investments…

IBIs' investments surged by 111.3 percent (or increase of PKR 664.3 billion) in CY20, compared to a 15.9 percent rise in CY19 (or increase of PKR 81.9 billion). The rise mainly comprised Federal government Ijarah Sukuk as well as Pakistan Energy Sukuk II (PES-II) **(Chart 3.2.6)**. A major part of the Ijarah Sukuk issuance was Variable Rate Rental (VRR) of 5 year tenor. The first auction of Sukuk during CY20 was held after a hiatus of almost 3 years; last time PKR 71.0 billion of 3 year Fixed Rental Rate (**FRR**) Sukuk were issued by the Federal Government on June 23, 2017. Within the year under review, H2CY20 witnessed higher increase in Federal Government Sukuk as the government aimed at better resource mobilization from Sukuk in federal budget of FY21.

Other Sukuk category mainly rose with the issuance of Pakistan Energy Sukuk-II (**PES-II**) of PKR 200 billion by Power Holding (Pvt.) Ltd. in H1CY20. IBIs financed a major part of this issue. This was the second consecutive year, when the government entity issued the energy Sukuk to inject liquidity in the energy supply chain. Furthermore, this was the first ever issuance of secured instrument through book building in Pakistan Stock Exchange's history as the Government of Pakistan aimed to ensure transparency and competitive bidding.[116]

Chart 3.2.6: Breakdown of IBIs' investments



Source: SBP

…better Shariah-compliant avenues improved liquidity management in IBIs….

Since IBIs were able to place their liquidity in Shariah-compliant investment and financing avenues during CY20, the combined increase in cash, placements in other financial institutions, and financing to other financial institutions was lower at PKR 118.6 billion in CY20 compared to PKR 256.1 billion last year, reflecting better liquidity management during CY20.

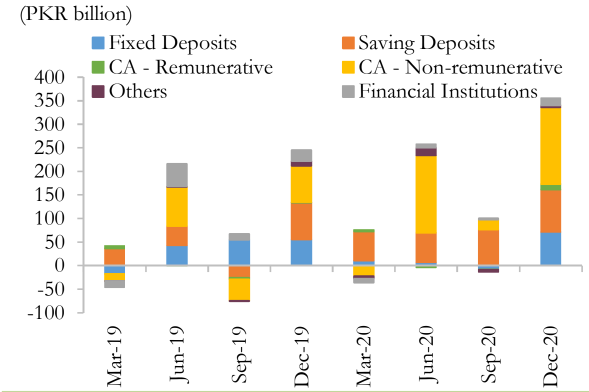
Deposits provided the necessary funding support for assets' growth…

IBIs' deposits rose by 27.8 percent during CY20—5-year high growth since CY15. The growth was also well above the 13.7 percent achieved by the conventional banks during CY20. Resultantly, IBIs' share in total banking deposits increased to 18.3 percent in CY20 from 16.6 percent in CY19.The rise in deposits mainly emanated from current-non remunerative deposits as well as saving and fixed deposits. Data suggested that IBIs' growth strategy was focused on mobilizing the low cost funding[117] **(Chart 3.2.7)**.

[116] Source: PSX press release dated May 19, 2020 available at: https://www.psx.com.pk/psx/files/?file=147951-1.pdf

[117] The combined share of non-remunerative deposits rose to 34.5 percent in CY20 form 31.7 percent in CY19.

Chart 3.2.7: Quarterly Flows of IBIs' Deposits



Source: SBP

Several factors such as COVID-19 related business closures and limited spending avenues during lockdowns, precautionary motives among economic agents, SBP's measures to encourage digital payments (such as waiving fee on digital transfers), government social spending to provide relief to low income households, and bar on institutional investments in NSS instruments contributed in deposit growth (**For details, see Chapter 3.1**).

Moreover, the expansion in branch network of IBIs from 3,226 branches at the end of CY19 to 3,456 branches as of Dec-20 also helped in deposit mobilization during CY20. As a result, the share of IBIs branch network in total bank branches also inched up to 22.7 percent in CY20 (21.6 percent in CY19).

Despite better deposits mobilization, higher borrowing was necessary to fund the assets growth during CY20…

The higher deposit mobilization though provided the main funding support, some increase in borrowing also occurred during CY20 to support both funding requirements and liquidity management. Since the combined increase in investment (net) and financing (net) in CY20 was higher at PKR 922.8 billion[118] than the corresponding increase of PKR 736.9 billion in deposits, borrowing from other financial institutions increased by PKR 176.8 billion (36.3 billion increase in CY19) to fund asset growth. Resultantly, the proportion of assets financed from borrowing rose to 8.2 percent in Dec-20 from 5.3 percent in Dec-19. However, this share was still lower than conventional banks whose 13.7 percent of the asset base was financed through borrowing in Dec-20 (14.7 percent in Dec-19).

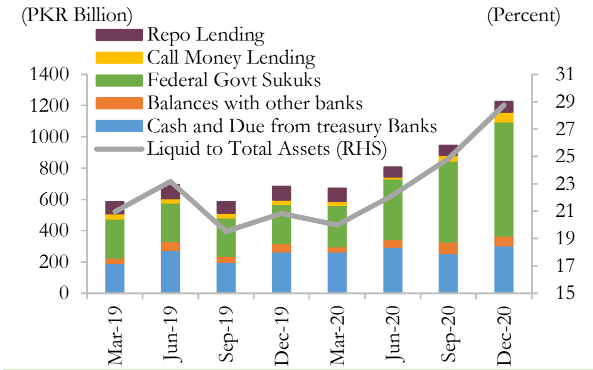
IBIs' share of liquid assets improved significantly during CY20, however, it was still lower than historical average

Though CY20 was a very challenging year, it provided opportunities to IBIs to deploy funds in Shariah-compliant investment instruments (government (Ijarah Sukuk) and energy Sukuk) in CY20. The liquid assets to total assets ratio improved to 28.7 percent in CY20 from 20.8 percent in CY19. However, the IBIs continue to face the limited availability of high-quality liquid assets (e.g. risk-free instruments) to manage the liquidity. That is why; the liquid asset ratio of IBIs was still below the recent historical average of 31.1 percent (from CY08 to CY20) and 60.1 percent ratio of conventional banks in CY20. Nonetheless, the IBIs witnessed a marked improvement in the stock of the liquid assets in CY20 and the share of these assets in balance sheet footing marked a significant improvement, reflecting that the IBIs are now relatively better positioned to cater the funding and liquidity needs of their operations **(Chart 3.2.8)**.[119]

[118] Investment (net) and financing (net) rose by PKR 193.6 billion in CY19 when compared to CY18.

[119] The increased share of liquid assets in short term Shariah-compliant instruments also reduced the share of 'cash' and 'balances with other banks' in total liquid assets to 30.0 percent in CY20 from, as 46.5 percent in CY19.

Chart 3.2.8: Composition of Liquid Assets of IBIs



Source: SBP

Importantly, IBIs' stock of liquid assets remained well above the Statutory Liquidity Requirement (**SLR**) of 14 percent.[120]

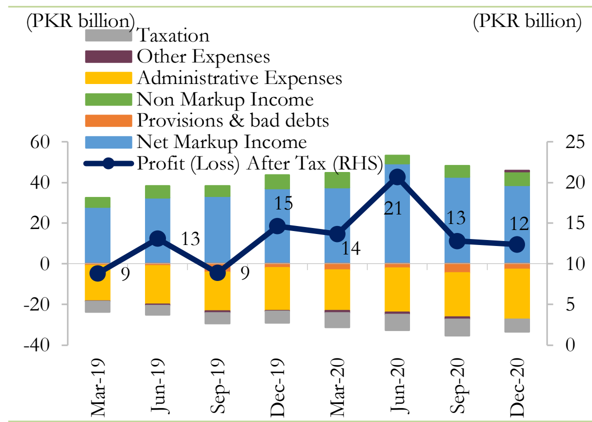
Profitability increased albeit at lower pace due to decline in profit rate…

IBIs' bottom line increased by 31.1 percent during the year under review, as they posted profit after tax of PKR 59.5 billion in CY20, compared to PKR 45.4 billion in CY19. Related profitability indicators of after-tax ROA and ROE improved to 1.62 percent and 24.51 percent, respectively, in CY20 from 1.54 percent and 23.68 percent, respectively, in CY19. Net Markup margin (**NMM**) also marginally improved to 5.39 percent in Dec-20 from 5.21 percent at the end CY19.

The major push to profitability came from Net Markup/Profit Income, which grew by 28.5 percent during CY20 and contributed 87.7 percent of the gross income. Non-markup income on the other hand grew marginally[121], as the fee, commission & brokerage income posted slower growth and income from dealing in FX fell during the year. Accordingly, the share of non-markup income in gross income contracted to 12.3 percent.

Net profit income of PKR 168.3 billion for CY20 was higher than last year, however, the growth therein decelerated to 28.5 percent in CY20 compared to 57.4 percent growth in last year. The major drag came from the sharp fall in profit rate following the reduction in benchmark rates (such as KIBOR following the reduction in SBP policy rate), which decelerated the profits on earning assets, especially in the last two quarters of CY20 (**Chart 3.2.9**).[122] Though the volume of deposit – the main funding source– grew by 27.8 percent in CY20, the sharp fall in profit rate and shift in the deposit mix towards non-remunerative deposits led to lower funding costs, supporting the net profit income.

Chart 3.2.9: Composition of Quarterly Profit After Tax



Source: SBP

Rate effect suppressed Markup income as well expense…

The contribution from change in volume was positive on profits/markup on earning assets as well as expenses/costs of funds during CY20. However, the change in profit rates have contracted both profit/markup income on assets and funding costs, and offset most of the positive impact of change in volume on earning assets and

120 The IBIs were required to maintain the liquid assets (excluding statutory Cash Reserve maintained under section 36(1) of the SBP Act, 1956) at 14 percent of their total demand and time deposits with tenor of less than one year in Pakistan. The same SLR requirement was 19 percent for the conventional banks.

121 During CY20, non-markup income increased by only PKR 1.8 billion to PKR 23.7 billion – whereas non-markup income was 21.9 billion in CY19, reflecting an increase of PKR 5.7 billion over CY18.

122 Markup expense rose 120.5 percent YoY to PKR 149.0 billion in CY19.

fund base; on overall basis the net profit/markup income increased by 28.5 percent during the year CY20 **(Chart 3.2.10 & Chart 3.2.11)**.

Chart 3.2.10a: Change in Markup Earned on Financing due to ....

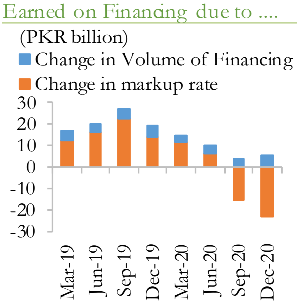
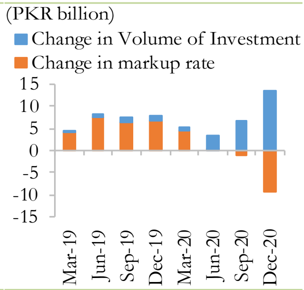


Chart 3.2.10b: Change in Markup Earned on Investment due to ....



*This chart splits the YoY change (PKR terms) in Markup earning in rate volume impact
Source: SBP

Chart 3.2.11a: Change in Markup Expense on Deposits due to ....

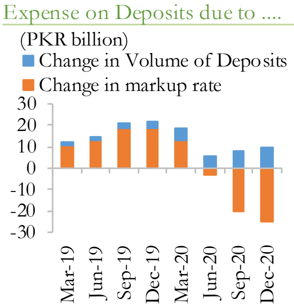
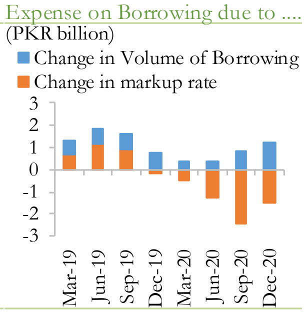


Chart 3.2.11b: Change in Markup Expense on Borrowing due to ....



*This chart splits the YoY change (PKR terms) in Markup expenses in rate volume impact
Source: SBP

Improvement in profitability and contained risk exposures improved the solvency of IBIs

The CAR improved further to 16.64 percent in CY20 from 15.36 percent in CY19 **(Chart 3.2.12)**. The improvement resulted from growth in both components of eligible capital i.e. Tier I and Tier II capital. However, in line with its high share in capital, the Tier I contributed major part of the increase (around 68 percent) in eligible capital, as the higher profits, which were ploughed back supported the solvency position during CY20. Besides 23.0 percent growth in eligible capital, a relatively slower expansion in risk weighted assets (by 13.6 percent) led to improvement in CAR.

Among the risk weighted categories, the increase was skewed towards **CRWA**, which was in line with growth in financing during CY20.

Disaggregated analysis shows that in addition to fast rise in CRWA during Q4CY20, ORWA also recorded noticeable increase, resulting in a notable increase in total RWA (**Chart 3.2.13**). The ORWA increased due to higher gross income, which forms the base for calculating ORWA under basic indicator approach of the Basel capital accord.[123] Resultantly, the CAR level fell to 16.6 percent in Dec-20 from the 19.5 percent in Sep-20, however, it was still above the local regulatory requirement of 11.5 percent as well as international standard of 10.5 percent.

Chart 3.2.12a: IBIs' CAR improved

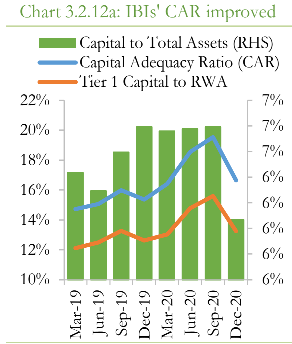
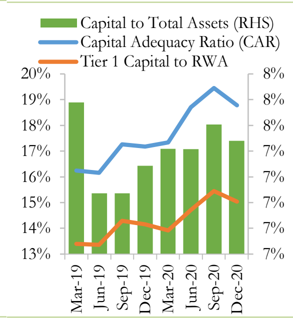


Chart 3.2.12b: CAR of Conventional

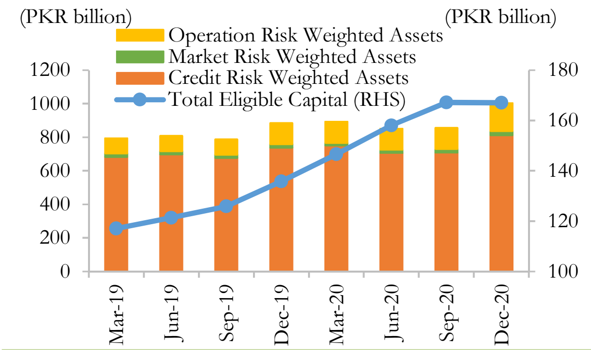


Source: SBP

It is important to note that the central bank's measures during the pandemic also played a key role in enhancing CAR level during CY20. SBP instructed banks to suspend dividend declaration for a period of two quarters to conserve capital and enhance the lending and loss absorption capacity.[124] The policy measures facilitated banks in restructuring the distressed financing and deferring principal payments on the request of borrowers also helped in containing NPLs as well as the need for provisioning that could have significant impact on the earnings and capital positions of banks.

[123] The gross income is an important input in calculating capital charge under the various approaches used in Basel-III instructions.
[124] The banks/DFIs that had approved dividend declaration for Quarter ended March 2020 by 22nd April 2020 were advised to suspend dividend distribution for June and September quarters of 2020. All other banks were advised to suspend dividend distribution for March and June 2020 quarters. Source: SBP press release available at: https://www.sbp.org.pk/press/2020/Pr1-22-Apr-20.pdf

Chart 3.2.13: Trend in Eligible Capital and Risk Weighted Assets of IBs (Full Fledged)



Source: SBP

Shariah compliance framework was further strengthened

In addition to usual risks for the banking industry, Shariah non-compliance risk (**SNCR**) is one of the important risks in business models of IBIs. In order to further strengthen Shariah compliance framework and harmonize the Shariah practices in Islamic banking industry, Accounting and Auditing Organization for Islamic Financial Institutions (**AAOIFI**) Shariah Standards are being adopted in gradual manner, after a detailed review, keeping in view the local environment and needs of Islamic Banking Industry in Pakistan.

During the period under review, the AAOIFI Shariah Standards No. 19 (Loan (Qard)), No. 23 (Agency and the Act of an Uncommissioned Agent (Fodooli)), and No. 28 (Banking Services in Islamic Banks) have been adopted from the start of CY20[125] while Standard No. 49 - Unilateral and Bilateral Promise (SS – 49)[126] was adopted from September 2020 onwards. The adoption of standards help in harmonizing Shariah practices and products in line with international Shariah standards and it may be characterized as a control to mitigate Shariah non-compliance risk in IBIs.

[125] IBD Circular No. 01 of 2020 dated January 3, 2020

[126] IBD Circular No. 03 of 2020 dated September 02, 2020