International Review of Business Research Papers
Vol. 4 No.4 Aug.-Sept 2008, Pp. 1-26

Inter-bank Cooperation Between Islamic and Conventional – The Case of Pakistan

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Abstract

Fast growth of the Pakistani economy in recent years, which coincides with the upsurge of Islamic financial industry, has created huge investment opportunities in the new ventures and development projects inside the country. Domestic financial institutions have not been able to provide easy financing because of the shortage of capital and the associated risk in the market. Although both the Islamic and conventional banks co-exist in the country and are trying to tap this huge market but they have not yet looked into the possibility of cooperation between the two systems. A risk-sharing mechanism between Islamic and conventional banks can be seen as a good alternative for availing these investment opportunities. This paper strives to present a few deal structures that can bridge the two financial systems not only for attracting Islamic but also conventional money from other countries to Pakistan. The deal structures can also be used for establishing cooperation between CFIs and IFIs inside the country.

Field of Research: Islamic Banking

1. Introduction

Islamic finance has become a significant phenomenon in the global financial community. Islamic financial institutions (IFIs) are currently managing assets worth more than US$300 billions, and are still growing with an estimated growth rate of about 15% per year. Even conventional financial institutions (CFIs), like HSBC, Citibank and many more, have started Islamic window operations in recent years.[i] Islamic wealth is still highly concentrated in the Middle East, however, and the number of Sharia-complaint investment opportunities is limited in that region. There seem to exist large demands for the flow of Islamic money to the other parts of the world where lucrative Sharia-complaint investment opportunities currently remain unavailed.

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Although fast growth of Islamic financial industry has triggered volumes of academic research in many different parts of the world, much of the research concentrates on the Islamization of conventional financial products. Little attention has been given to the possibility of enhancing the efficiency of the global financial markets through cooperation between the Islamic and the conventional financial systems. The Islamic and the conventional financial systems work on two fundamentally different concepts, and cooperation between the two systems has been limited because most of the CFIs were not familiar with the concept of income-sharing[ii].

Lee and Ullah (2007) developed several deal structures that would help pave the way for the flow of funds from the Islamic to the conventional financial systems. In this paper, we study potential applications of such deal mechanisms to the financial industry in Pakistan.Pakistan is the pioneer in taking policy measures on macro level for the full Islamization of the economy, although Egypt is said to be the host to the ever first IFI in modern history[iii]. Since 1970's, Islamic finance industry in Pakistan has seen considerable growth. The Sharia Appellate Bench of the Supreme Court declared all interest bearing transactions as illegal[iv] in 1991, and a significant surge in the Islamic financial industry has resulted. Pakistan is now host to 6 full-fledged IFIs which have captured 2.9% share in the total assets of the financial industry[v].

In Pakistan domestic financial institutions are unable to fully tap productive investment opportunities these days - mainly due to the short supply of money and risk-averse characteristics of CFIs. A lot of new ventures that have risky cashflows are created due to the fast growth of the economy, but most domestic CFIs are only interested in fixed-type cashflows from their investments and hence are reluctant to finance such businesses[vi,vii]. A recent report of the World Bank[viii] declared Pakistan as 10th best country in the world in terms of attractive business environment, but the same report says that companies have difficulty in getting credit from the existing CFIs. As a result, there seem to be huge demands for IFIs in the country. For example, Sami Al-Suwailem (1995) claimed that getting capital from IFIs on profit-sharing basis could become the best option for start-up companies. Also, getting funds for such ventures through IFIs rather than directly from CFIs may help improve the situation if proper incentive mechanisms for cooperation between Islamic and conventional financial systems could be established.[ix] Likewise, corporate restructuring with a non-interest-based funding from IFIs may turn out to be a good opportunity for financially-troubled young companies.[x]

Section 2 of the paper gives an overview of the Pakistani economy and the status of the Islamic finance industry in the country, and Section 3 looks into possible ways for bridging the two systems. Main purpose of the section is to develop deal structures that would help capital flows from the IFIs of oil-rich Islamic countries to the CFIs of Pakistan so that the expanding economy can be

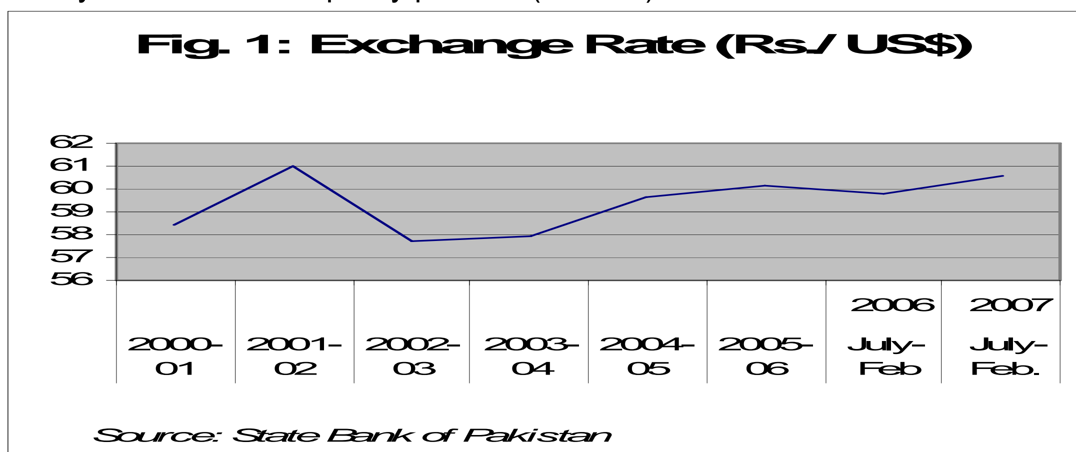
financed. We also look into the possibility of directing capital flows from foreign CFIs into the IFIs of Pakistan. Same models can be used to improve cooperation between CFIs and IFIs hosted by Pakistan. Section 4 provides a brief conclusion of the paper.

2. Pakistani Economy and Financial Industry

Economic Overview

Pakistan was formed by the division of British India into India and Pakistan in 1947. It has experienced an uneven but persistent development ever since: The 1960s witnessed a sharp economic growth approaching 6 percent per annum, and since then the country experienced fair economic growth with cyclical downturns. The trend was maintained until 1990s, but the country faced severe economic and financial difficulties during the 1990s mainly due to political instability. Besides political instability, financial resource limitation, persistent fiscal imbalances, inadequate infrastructure, declining export demand, declining foreign reserves and soaring international debt were also responsible for this decline in growth. Only timely assistance from IMF helped the country to avoid the worst scenario in 1998[xi]. In December 1999, the government formulated and started implementing policy to achieve macroeconomic stabilization through fundamental structural reforms and improved governance.

In recent years, Pakistan has been one the fastest growing economies of the world; it was the second fastest growing economy of the world in 2005 with an 8.4% growth in GDP. Persistent economic policies, privatization of state owned enterprises, stable political situation and stable exchange rate (Fig. 1) are some of the factors that enabled the recent upsurge in the economy and rapid inflow of FDI (Fig. 2). The country has increased its foreign exchange reserves by possessing 13.7 billion dollars that has added to the investors' confidence in the country's international liquidity position (Table 1).



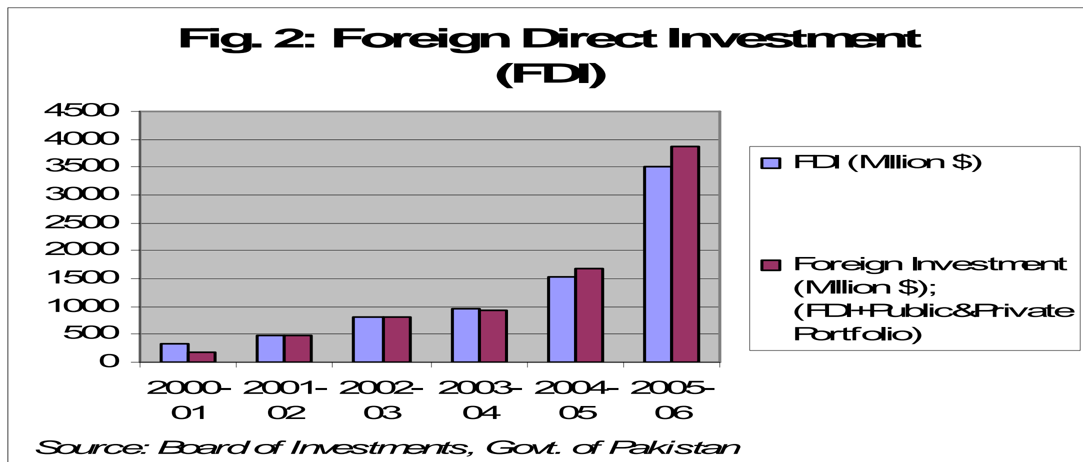
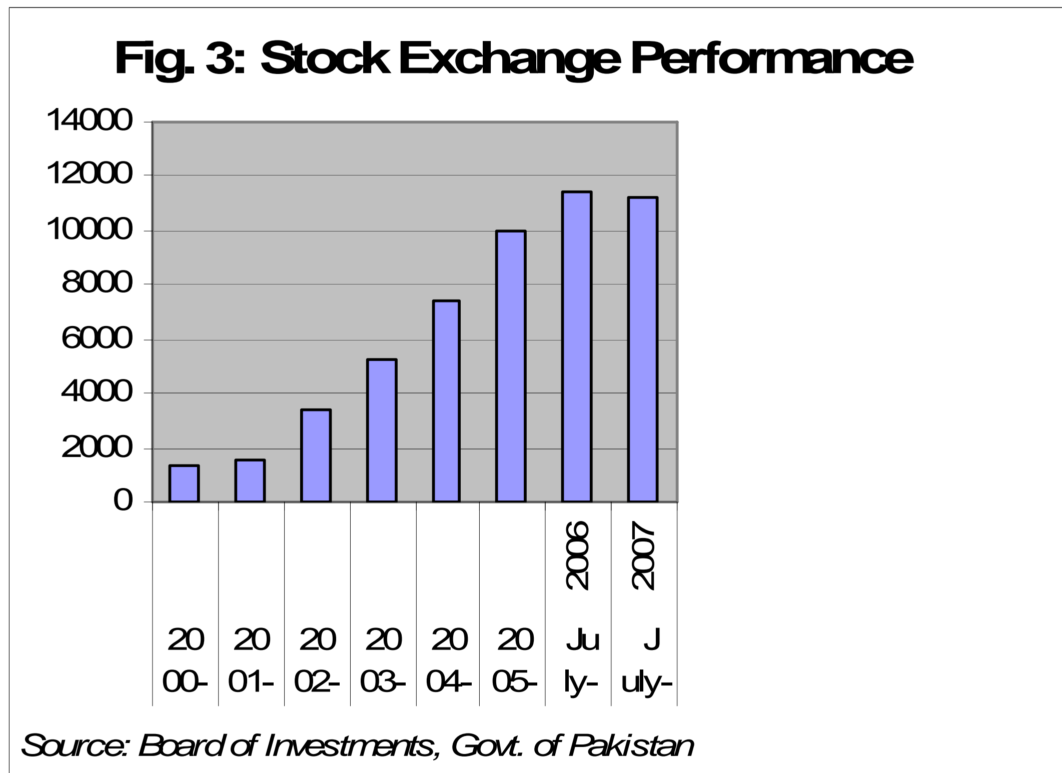


Table. 1: International Reserves and Foreign Currency Liquidity Position of Pakistan as of May 31, 2007 (Million US $)

A.Official reserve assets	13,703.9
(1) Foreign currency reserves (in convertible foreign currencies)	12,127.1
(a) Securitiesc	3,459.36
(b) total currency and deposits with:	8,667.75
(i) other national central banks,BIS and IMF	174.73
(ii) banks headquartered in the reporting country	
of which:located abroad	37.00
(iii) banks headquartered outside the reporting country	8,456.02
(2) IMF reserve position	0.18
(3) SDRs	214.70
(4) Gold (including gold deposits and,if appropriate,gold swapped)	1,361.93
— volume in millions of fine troy ounces	2.066

Source: State Bank of Pakistan

The economic development of the country has caused increased activities not only in new businesses but also in the capital markets which is an evidence of the investor's confidence in the country's business environment. The Karachi Stock Exchange (KSE)[xii] has been performing very well for the past few years (Fig. 3); it was declared as one of the best performing stock exchanges of the world in 2005.



Due to the fast economic growth, a large number of development projects and industrial expansions are currently underway. These projects are attracting foreign companies and investments to the country[xiii]. The problem is that, due to insufficient capital accumulation in the domestic capital markets, most of the development projects are financed by the World Bank, IMF and other international financial institutions. For example, CIDB Malaysia and the National Highway Authority (NHA) of Pakistan recently sealed an agreement worth US$102.6 million to build two highways in Pakistan[xiv]. Other examples of such projects are; the Gawadar Free Port, Gawadar Port City, Motorway Networks and road infrastructure and hydro-power dams.

The formation of new SMEs in Pakistan has also created a huge market for the financial institutions. The SME and consumer banking markets are very attractive these days (Table. 2), but domestic financial institutions are unable to provide easy financing to these sectors. A recent World Bank report pointed that the SMEs didn't have easy access to credit in Pakistan[xv] (Table. 3). Domestic banks are unable to finance many of the SMEs either due to shortage of capital or due to the associated risk. The huge financial risk of the country is also evident from the non-performing loans of the schedule banks (Table. 4)[xvi].

Table 2: SME and Consumer Banking Market in Pakistan (PKR in Millions)

Description	June 05	April 06	June 06	April 07
1. Loans to Private Sector Business	**1,244,043**	**1,474,417**	**1,488,892**	**1,696,653**
Agriculture, hunting and forestry	129,996	129,471	134,501	144,216
Fishing, fish farming	2,382	1,800	1,678	1,573
Mining and Quarrying	8,591	10,330	10,221	9,507
Manufacturing	755,870	886,968	899,727	1,012,002
Ship breaking and waste etc.	2,479	1,583	1,770	1,678
Electricity, gas and water supply	15,430	17,465	18,874	34,285
Construction	31,357	40,724	42,000	53,228
Commerce and Trade	144,752	194,560	190,851	213,046
Hotels, restaurants and clubs etc	8,484	9,558	8,828	12,882
Transport, storage and communications	50,580	58,958	62,490	76,155
Real estate, renting and business activities	49,135	71,613	69,515	78,192
Education	3,499	3,207	3,450	3,323
Health and social work	4,244	3,053	3,739	5,065
Other community	5,794	8,850	8,343	12,100
Other private business n.e.c	31,450	36,277	32,906	39,401
2. Trust Funds & NPOs	**13,446**	**14,745**	**13,727**	**13,636**
3. Personal	**249,068**	**322,395**	**342,852**	**385,848**
Bank Employees	41,550	44,177	45,076	49,377
Consumer Financing	207,518	278,219	297,776	336,471
4. Other	**17,860**	**12,197**	**10,598**	**18,431**

Source: Statistics & DWH Department, State Bank of Pakistan

Table. 3: Top Performers

Rank	Country	Starting a Business	Dealing with Licenses	Hiring and Firing	Registering Property	Getting Credit	Protecting Investors	Paying Taxes	Trading Across Borders	Enforcing Contracts	Closing a Business
1	Serbia and Montenegro	☼	☼	☼	☼	☼		☼		☼	☼
2	Georgia	☼	☼	☼	☼			☼			
3	Veitnam	☼			☼		☼			☼	☼
4	Slovakia	☼			☼	☼					
5	Germany	☼		☼					☼	☼	
6	Egypt	☼		☼	☼	☼			☼		
7	Finland		☼	☼				☼			☼
8	Romania	☼				☼		☼		☼	
9	Latvia	☼	☼		☼			☼		☼	
10	Pakistan	☼	☼		☼		☼		☼		
11	Rwanda					☼			☼	☼	
12	Neterlands		☼		☼			☼			

Source: World Bank and IFC Report, "Doing Business in 2006"

Table. 4: NPLs to Total Loans Ratio of Banks in Pakistan[xvii]

	CY02	***CY03***	***CY04***	***CY05***	***Jun-07***	***Sep-07***
PSCBs	25.5	20.4	13.3	10.0	9.4	9.3
LPBs	15.4	11.3	9.0	6.4	6.3	6.3
FBs	3.8	3.1	1.6	1.2	1.1	1.0
CBs	17.7	13.7	9.0	6.7	6.4	6.3
SBs	54.7	55.6	54.1	46.0	46.0	39.1
All	21.8	17.0	11.6	8.3	8.0	7.7

Source: State Bank of Pakistan

Overview of the Financial Industry

In Pakistan, Islamization of the financial industry was initiated in the late 1970s (chronology given in table 5).[xviii] There were no specialized IFIs in those days, and Islamization steps were taken only on macro levels. Regulatory measures for the Islamization of the financial transactions were taken in 1980s[xix]. However, these measures and the so-called Islamic financial transactions were declared un-Islamic by the Federal Shariat Court (FSC) in November 1991[xx]. This decision made Pakistan as the first Muslim country to officially declare modern bank

interest as ar-riba, declared haram (prohibited) by Qur'an. Consequently, serious regulatory changes were brought about in the country which led to the tremendous growth of the industry and Islamic banks were encouraged to start operations in Pakistan[xxi].

Table 5: Chronology of Islamic Banking in Pakistan

Date	Description of Developments
1949	The Objective resolution was passed by the National Assemble of Pakistan that declared Islamic as the State Religion of the country
1977-78	Steps for Islamization of banking and financial system of Pakistan were started
July, 1979	Elimination of interest from the operations of specialized financial institutions including HBFC, ICP and NIT
1981-85	Elimination of interest from the operations of nationalized commercial banks
June, 1980	Permit issuance of a new interest-free instrument of corporate financing named Participation Term Certificate (PTC)
January, 1981	Separate Interest-free counters started operating in all the nationalized commercial banks, and one foreign bank (Bank of Oman)
March, 1980	Financing of import and inland bills and that of the then Rice Export Corporation of Pakistan, Cotton Export Corporation and the Trading Corporation of Pakistan were shifted to mark-up basis
July, 1981	banks were allowed to provide finance for meeting the working capital needs of trade and industry on a selective basis under the technique of Musharaka
April, 1985	All finances to all entities including individuals began to be made in one of the specified interest-free modes
1985	The Eighth Amendment of the 1973 Constitution, adopted by the National Assembly, made room for creation of the Federal Shariat Court (FSC).
November, 1991	The procedure adopted by banks in Pakistan since July 1 1985, based largely on 'mark-up' technique with or without 'buy-back arrangement', was declared un-Islamic by the Federal Shariat Court (FSC)
January, 2000	The Commission for Transformation of Financial System (CTFS) was constituted in the State Bank of Pakistan under the Chairmanship of Mr. I.A. Hanfi, a former Governor State Bank of Pakistan
September, 2001	It was decided that the shift to interest free economy would be made in a gradual and phased manner and without causing any disruptions
December, 2001	The State Bank of Pakistan issued detailed criteria for establishment of full-fledged Islamic commercial banks in the private sector
January, 2002	Al Meezan Investment Bank received the first Islamic commercial banking license from SBP
March, 2002	Meezan Bank Limited (MBL) commenced full-fledged commercial banking operation
June, 2002	Meezan Bank Limited had a network of 5 branches all over the country
December, 2004	2 full-fledged Islamic Banks and 7 conventional Banks with Islamic window operations
December, 2005	2 full-fledged Islamic Banks and 9 conventional Banks with Islamic window operations
December, 2006	6 full-fledged Islamic Banks and 12 conventional Banks with Islamic window operations

Source: State Bank of Pakistan

Today, the banking sector in Pakistan is dual - i.e., both conventional and Islamic banks co-exist. The market share of Islamic banking is still very small, and

therefore the market is dominated by conventional banks (Table. 6). There are 54 conventional banking and other financial institutions out of which 6 are full-fledged Islamic banks [xxii] (Table 7). Additionally, 58 branches of thirteen conventional banks are also providing exclusive Islamic banking services to their customers[xxiii] (Table 8).

Table. 6: Industry Progress and Market Share (As a Percentage of Total Banking Industry) of Islamic Banking Industry

	2006	2005	2004	2003
Total Assets	2.9%	2.1%	1.4%	0.5%
Deposits	2.8%	1.9%	1.2%	0.4%
Financing and Investments	2.4%	1.8%	1.3%	0.5%

Source: Islamic Banking Bullitton, State Bank of Pakistan (Feb. 2007)

Table. 7: Financial Institutions in Pakistan

Description	Number	Number in %
Public Sector Banks	4	7.4
Private Sector Banks	21	38.9
Specialized Banks	4	7.4
Micro Finance Institutions	6	11.1
Islamic Banks	6	11.1
Foreign Banks	7	13.0
Development Financial Institutions	6	11.1
Total Banks in Pakistan	54	100.0

Source: State Bank of Pakistan

Table. 8: Islamic Banking Branches in Pakistan

Name of Institution	# of Branches	Name of Institution	# of Brch
A) Islamic Banks		B) Islamic Banking Branches of Conventional Banks	
Meezan Bank Limited	62	MCB Limited	6
Albaraka Islamic Bank	11	Bank of Khyber	5
Bank Islami Pakistan Limited	10	Bank Alfalah Limited	23
Dubai Islamic Bank Limited	10	Hibib Metro Bank	4
Emirates Global Islamic Bank	6	Standard Chartard Bank	3
First Dawood Islamic Bank	0	Bank Al Habib Limited	3
Total of (A)	**99**	Habib Bank Limited	1
		Soneri Bank Limited	2
		Prime Commercial Bank	2
		Askari Commercial Bank	6
		National Bank of Pakistan	1
		United Bank Limited	1
		ABN AMRO	1
		Total of (B)	**58**
Total of (A) + (B)		**157**	

Source: State Bank of Pakistan

Islamic finance in Pakistan now seems to be making its way towards providing the Islamic investors an adequate alternative to the conventional finance. In December 2006, the market share of IFIs in Pakistan represented 2.9% of the total assets of the domestic financial industry which has grown from 0.5% in 2003[xxiv]. The industry manages a total of PKR 118 billions with total deposits of PKR 83 billions and financing and investments of PKR 72 billions[xxv] (Fig. 4).

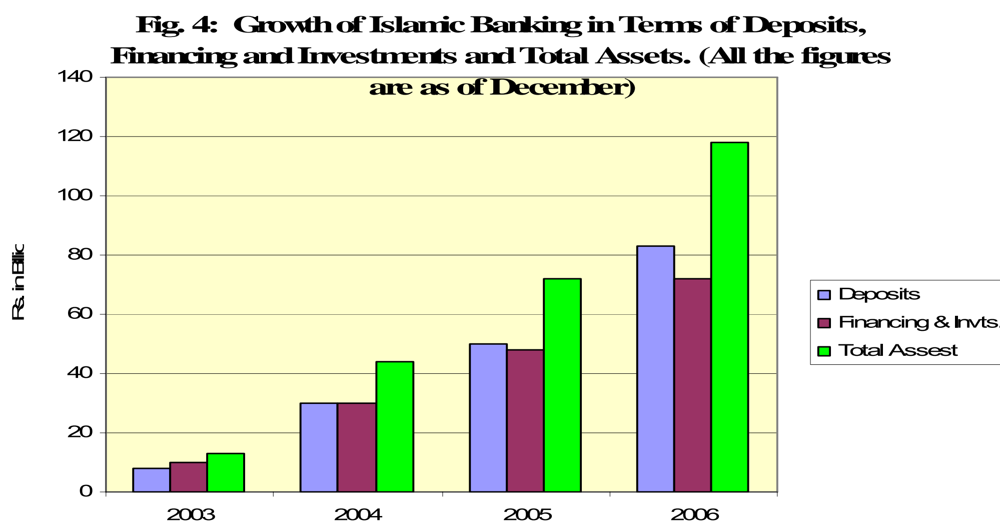


Table. 9: Key performance Indicators of Islamic Banks in Pakistan

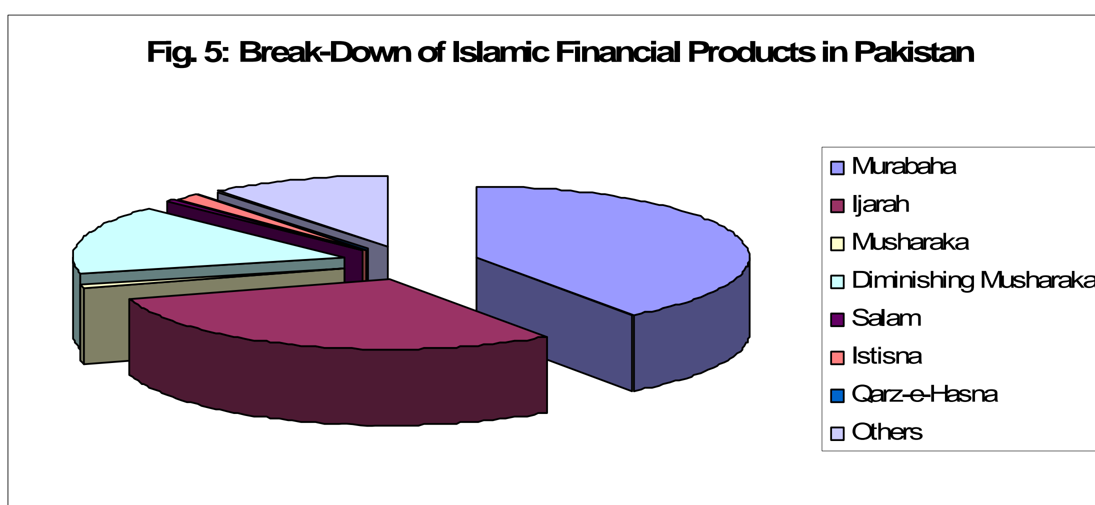
Indicator	Percent				
	Dec-03	***Dec-04***	***Dec-05***	***Jun-06***	***Sep-06***
NPFs to total financing	0.7	0.9	1.0	2.3	1.7
Net NPFs to net financing	0.0	0.2	0.2	1.4	0.7
Provision to NPFs	100.0	82.3	80.6	40.3	59.1
Net markup income to total assets	1.7	1.4	2.3	3.2	3.0
Non markup income to total assets	2.2	1.4	1.7	1.0	1.0
Operating expense to Gross income	54.6	65.3	49.9	55.9	64.3
ROA (average assets)	2.2	1.2	1.7	1.6	1.2
Growth in Assets	84.5	241.8	62.0	10.5	8.5
Growth in Deposits	64.6	259.5	65.4	11.2	10.6
Growth in Financing	147.0	218.2	66.3	5.9	2.0

Source: State Bank of Pakistan

The growing Islamic banking industry of Pakistan has become one of the priority destinations for the international banks like Citibank, Standard Chartered and

Japan Bank for International Cooperation (JBIC). JBIC has recently announced to launch Sharia-compliant Sukuk bonds in Pakistan to tap the potential for the growth of Islamic banking[xxvi]. Istithmar Bank, partnered with AIG Global Real Estate, has announced to invest in Pakistan and other emerging markets.[xxvii] Also, First Dawood Islamic Bank Limited is licensed as the sixth Islamic bank in Pakistan; sponsored by the First Dawood Group, Bank Islam Malaysia Berhad, Unicorn Investment Bank and Islamic Corporation of the Private Sector (ICP) - an arm of the Islamic Development Bank.[xxviii]

The distribution of Islamic banking products in Pakistan shows the same trend as in the global Islamic financial industry (Figure. 5): Murabaha has been the most prominent Islamic banking product in Pakistan which comprises of about 40% of the total financing products[xxix]. The second most promising product is Ijara; about 30%. The Non-Performing Loans (NPL) of the Islamic finance industry is only 1.2%[xxx] of the total advances which shows a very high quality of advances[xxxi] as compared to the conventional banks where the average NPLs are about 7.7% of the total advances.



3. Bridging the Two Financial Systems in Pakistan

Although a number of international CFIs have jumped into the Islamic finance market and started joint investment ventures - like large-size development projects- with IFIs, we still believe that this cooperation is limited not only in scope but also in geography, the Middle East. Given that Pakistan is the second largest populous Muslim country, getting money from the oil-rich Islamic countries through IFIs may prove not only a feasible but also a very promising alternative to fund further development of the Pakistani economy. In order to tap this market a number of Islamic banks from the gulf have started operations in Pakistan but it has turned out that they lack the necessary local market experience[xxxii].

Lee & Ullah

Lee and Ullah (2007) identified several deal structures that should help to promote potential cooperation between the conventional and the Islamic financial systems in countries where currently IFIs do not exist - for attracting petro-dollars into the fast-growing non-Muslim countries in Asia. Since Pakistan is a developing Muslim country where the financial market is still dominated by CFIs, we believe that the extension of the models to the local situation of Pakistan would prove to be highly beneficial not only for the country but also for the participating banks.

In what follows, we develop the deal structures that can facilitate the cooperation between Islamic and conventional banks in Pakistan while keeping the Sharia principles intact. There are not much instances of inter-bank cooperation between Islamic and conventional banks in Pakistan, but there can be ways for more productive cooperation particularly applicable to the growing economy. Key to successful cooperation between the two financial systems is developing risk sharing mechanism that can satisfy divergent risk appetites. Equipped with knowledge of the local market where the development potential is huge but capital is in shortage, domestic financial institutions – both Islamic and conventional – will find it easier to entice foreign capital from both the Muslim and non-Muslim countries through such deal structures.

Models developed in this paper are not only meant for attracting Islamic money from the Middle East but also for promoting cooperation between IFIs and CFIs inside the country. The Pakistani IFIs are very young and thus they have not been exposed to adequate market exposure. Local CFIs may be willing to share some of their investment opportunities with IFIs, and vice versa, because of the differences in the risk appetite of the two systems. Therefore, potential ways can be found for bringing the two financial systems together for better performance.

Project Financing Model:

Project financing has been a key area of investment for Islamic banks, and many Islamic banks have already been very active in this field. Lee and Ullah (2007) claimed that variations of the project financing model may serve as alternative channels of cooperation between Islamic and conventional banks.

As one can see in Table 2, the SME and consumer banking markets in Pakistan look quite attractive. Given the large Muslim population and fast expansion of the economy in Pakistan, demands for Sharia-compliant capital in these sectors far exceeds the supply capacity of domestic Islamic financial institutions. Domestic conventional banks may not be willing to provide Sharia-compliant funding to those sectors because the risk profile of Sharia-compliant lending is often not adequate for conventional bank assets due to equity-like risk the lender has to take[xxxiii]. The project financing model can function as conduit to provide funds to the SME sector or to the consumer financing sector.

To serve the Sharia-compliant lending market using funds raised partly from conventional banks, the role of the SPV in the project financing model should be to originate loans and to restructure cashflows from loans into three distinctive packages (Figure 7). The first package is Sharia-compliant in that payments to claimholders are proportional to the cash inflows. The second package is like preferred-stock in that stated payments to claimholders are fixed but can be reduced if the cash inflows were not enough to meet the stated payments. The preferred payment rate should be lower than the interest rate that should have been charged if there was no option for reduced payment when the cashflows were low. The preferred payment should be cumulative in order for the claimholders to whom payments were reduced when the cash inflow were low to be compensated later. The third package consists of the residual cashflows after paying to the claimholder of the first and the second packages.

The Islamic bank funds the SPV in return for claims of the first package and the part of the third package. The conventional bank takes the second and the remainder of the third package. In order for this deal structure to satisfy both the Islamic and the conventional banks involved, funding provided by the Islamic bank should be small compared to that by the conventional banks. The reason is that most of the equity-like risk should be taken by the Islamic bank. A large portion of the credit loss arising from the loan is first taken by the Islamic bank, providing buffer for the payments for the second package to be stabilized. This buffer, together with the cumulative nature of the preferred payments, would make the payments to the claimholders of the second package more debt-like than equity-like. By getting a relatively large share of the third package, the Islamic bank would be able to protect itself from suffering too much loss.

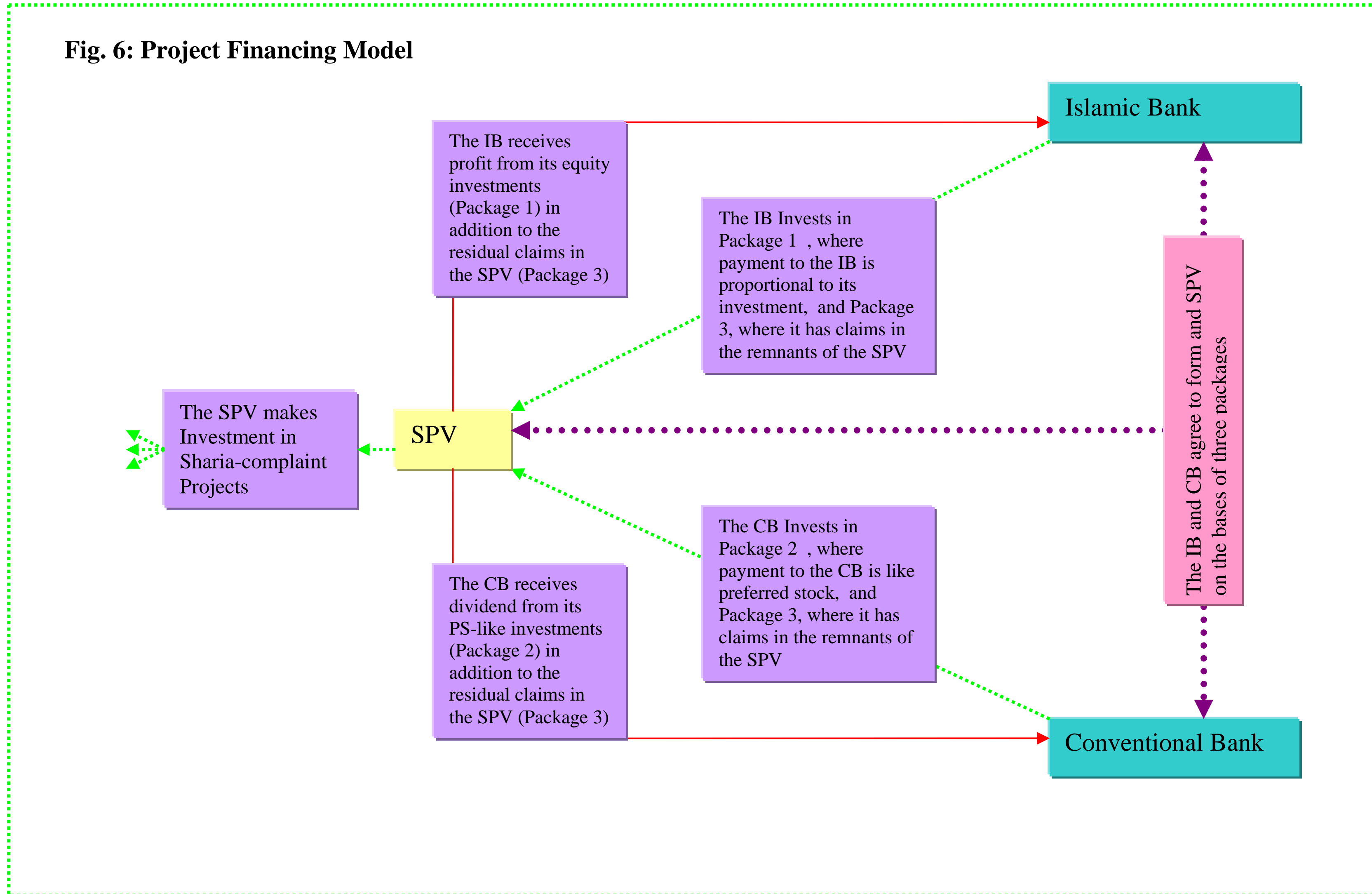


Fig. 6: Project Financing Model
Islamic Bank
The IB receives profit from its equity investments (Package 1) in addition to the residual claims in the SPV (Package 3)
The IB Invests in Package 1 , where payment to the IB is proportional to its investment, and Package 3, where it has claims in the remnants of the SPV
The SPV makes Investment in Sharia-complaint Projects
SPV
The IB and CB agree to form and SPV on the bases of three packages
The CB receives dividend from its PS-like investments (Package 2) in addition to the residual claims in the SPV (Package 3)
The CB Invests in Package 2 , where payment to the CB is like preferred stock, and Package 3, where it has claims in the remnants of the SPV
Conventional Bank

Motivation for such deal structure is as follows: Fig. 7 shows the probability structure of cashflows of a typical business funded jointly by debt and equity. Suppose the business is the SPV specializing in origination of Sharia-compliant SME and consumer loans. The conventional bank may be reluctant to fund the debt part because the probability of default is too high. On the other hand, an Islamic bank may also be reluctant to fund the equity part because the debt part of the SPV contradicts principles of Sharia.

Fig. 7: Cashflow Structure for a Business Funded Jointly by Debt and Equity

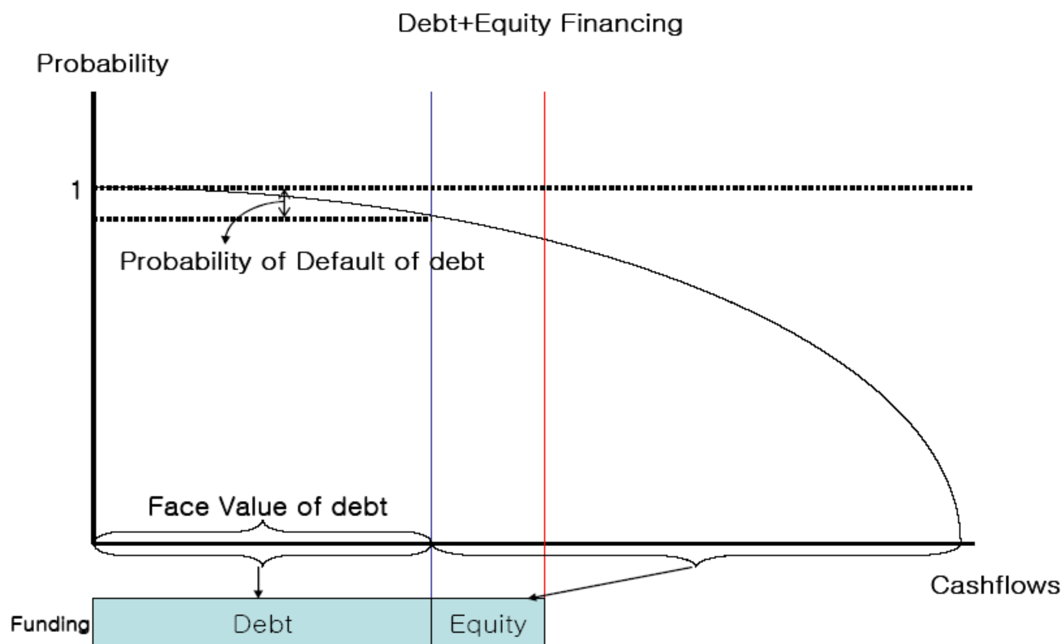
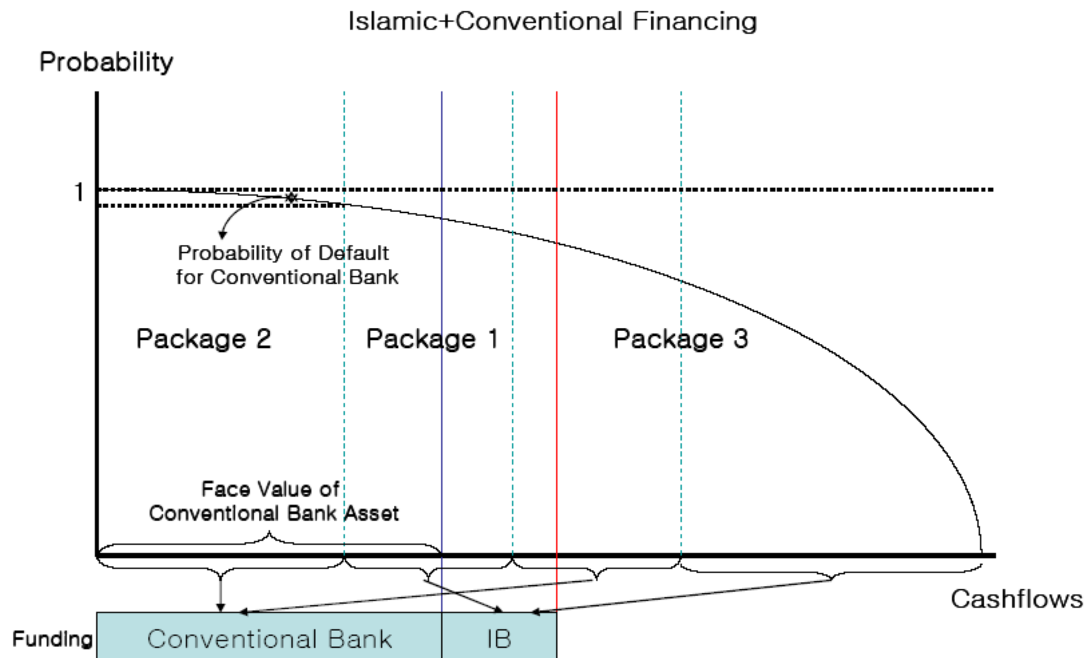


Figure 8 shows the probability structure of cashflows of the project financing model to fund the SPV. Now, the probability of default for the conventional bank is much lower than before due to the low preferred-payment rate.[xxxiv] The conventional bank is compensated for the loss in preferred-dividend-like income by the contingent cashflows from its share of the third package. Because of the low probability of default, the contract should be more acceptable to the conventional bank. The contract is riskier than conventional debt because cashflows from package 3 is equity-like. The contract is less risky than conventional equity, however, and it would not be impossible to divide package 3 so that the conventional bank gets enough compensation for additional risk of the equity-like part. The Islamic bank can agree on funding the remaining part more easily because now the contract for the conventional bank may not contradict Sharia.

Fig. 8: Cashflow Structure for a Business Funded Jointly by Islamic and Conventional Banks



Agency Model:

A more straightforward application of the project financing model is what Lee and Ullah (2007) called agency model. It is a project financing structure where a domestic bank functions as agent of a foreign bank. In this structure the domestic bank takes responsibility of managing the SPV, taking advantage of its superior knowledge of the local market. Such deal structures may help Pakistani banks in attracting funds from foreign financial institutions looking for investment opportunities in Pakistan.

For example, a Pakistani Islamic bank may find an attractive Sharia-complaint investment opportunity that the bank does not have enough capital to fund. The bank knows that there are foreign banks that want to invest in Pakistan but lack necessary local competencies. In this case the domestic bank can work as agent of a foreign bank in funding local development projects. By taking the equity portion of the SPV, the Pakistani bank could provide safety to the foreign bank that takes the bond portion of the SPV.

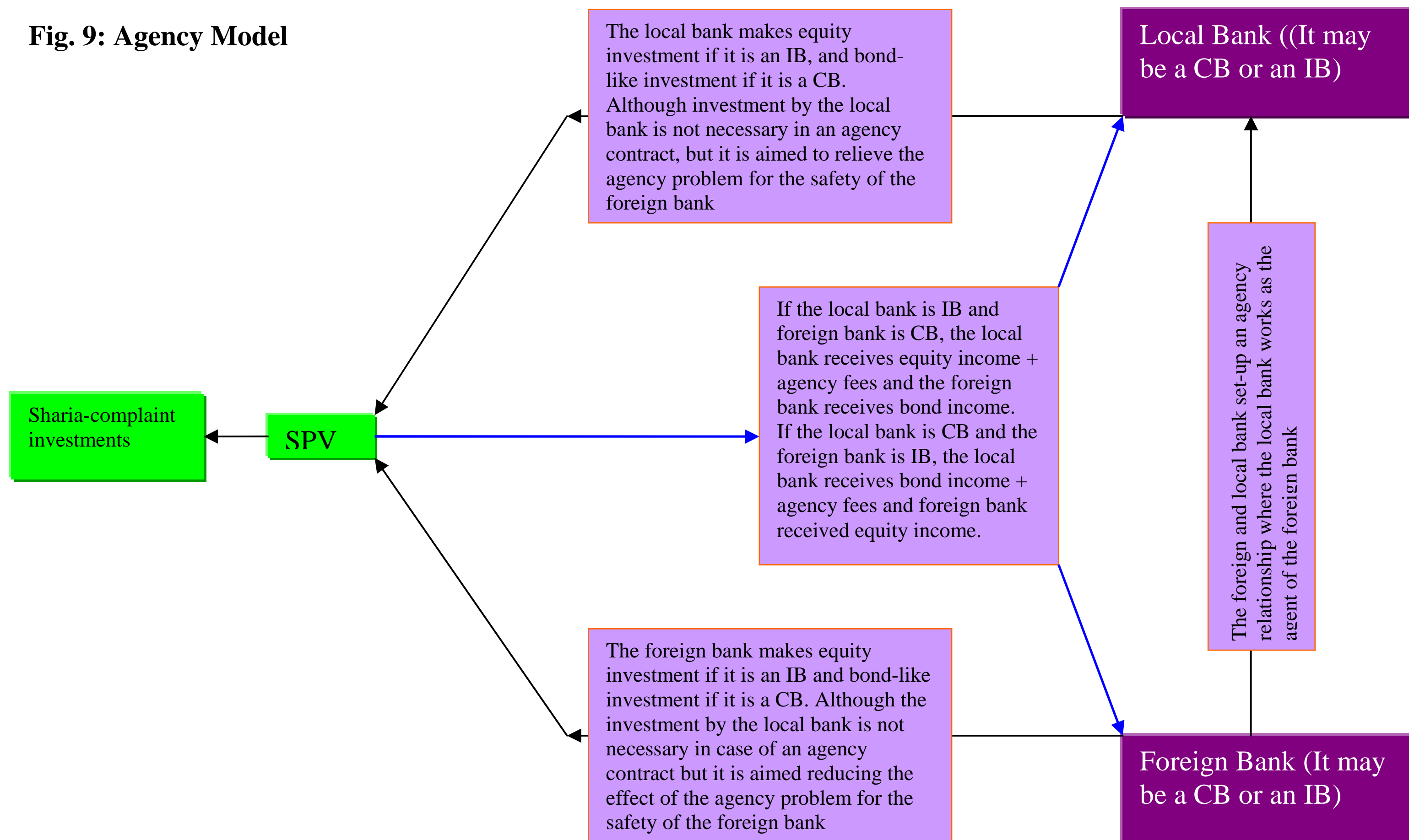
The structure may also work for a conventional Pakistani bank working as agent for a foreign Islamic bank. For example, an Islamic bank in the oil-rich Middle East

countries may want to invest in the Pakistani market. The Islamic bank is willing to take equity-like risk as long as the level of risk is not too high, but finds it lacks proper market acquaintance. In this case, the bank may find it better to look for a local Islamic partner but, given the small market share of Islamic banks in Pakistan, it would be easier to employ a local conventional bank as partner. A successful deal structure may arise where the foreign bank takes the equity part and the domestic bank takes the bond part.

In such deal structures where a foreign Islamic bank finds local conventional bank as partner that manages the SPV, three problems may arise. First, the project that the SPV invests in may not be Sharia-compliant. This problem can easily be handled by employing a Sharia-expert in the SPV. Second, the deal structure may not be Sharia-compliant because of the interest payments to the bond portion. This can be handled by making the bond portion relatively small. In the extreme, an agreement can be reached where the domestic bank collects its compensation only in the form of management fee. In this case, the bond portion of the SPV is more like collateral for possible negligence of the managing partner. Third, the deal structure may expose the foreign bank to too much risk because the equity part is only a residual claim to the cashflows of the project and as a result an agency problem is unavoidable. To handle this problem, it may be necessary to make the payments to the bond portion contingent upon the overall performance of the SPV. A three-trench structure, explained in the previous subsection, may help resolve this problem. By dividing the conventional bank's claims into two parts – the preferred stock and the residual – the foreign bank may force the local partner to abstain from any potential wrongdoings.

We believe that the agency structure would prove to be very flexible and as a result very convenient for a Muslim country to entice foreign capital to the fast expanding domestic market where potential investment opportunities are rich. It helps develop win-win relationships between foreign capital and domestic financial institutions by combining affluent capital with rich knowledge of the domestic market. The investment can be a large development project or simply portfolios of SME or consumer loans. Major role of the domestic institution is not in providing funds but in reducing uncertainty in the investment on behalf of the foreign institution. The three-trench structure on the payment side will turn out to be very instrumental in resolving most of the conflict of interest problems.

Fig. 9: Agency Model



Loan Restructuring Model:

As a result of the industrial expansion of Pakistan, many more new ventures are formed that have risky cash flows. Therefore the financial institutions, especially the Specialized Banks and Development Financial Institutions (DFIs)[xxxv] are sitting on non-performing loans. The overall non-performing loans of all banks account for 7.7 percent of there total advances, which is a huge amount. The specialized banks are suffering from a lot of NPLs which are about 39 percent of the total advances. Therefore, we feel that there is a need for restructuring the NPLs into a combination of equity and loan in order to have better feed the economy and give an ease to the financial institutions.

The Loan Restructuring Model of Lee and Ullah (2007) is a funding structure for a conventional bank to restructure nonperforming loans into an equity-like contract so that it could attract Sharia-complaint funding from Islamic banks.

The original loan restructuring model works as follows: A conventional bank believes that some of its borrowers would generate enough cashflows in the long run, but is not willing to sit on currently-nonperforming assets. The bank approaches an Islamic bank, and the two banks discuss the terms and conditions of loan restructuring. When they reach to a consensus, the portfolio of nonperforming loans of the conventional bank is restructured into two parts; equity and debt. The interest rate charged to the new debt should be much lower than the rate applied to the original loans. The equity portion is taken by the Islamic bank or shared by the two banks, and the conventional bank takes only the debt part.

It turns out that the deal structure is flexible enough so that an Islamic bank can also use to restructure its Sharia-compliant nonperforming loans and attract funds from conventional banks. In this case, the loans to be restructured are Sharia-compliant in that cashflows are not interest-like. Long-term prospects of the borrowers are good, but the bank does not want to sit on the loans because it needs current cashflows to make new loans. Again, the bank restructures the loan portfolio into two parts; equity and bond. Because the underlying assets do not currently generate cashflows, the bond portion consists of discount bonds. The Islamic bank takes the equity part and sells the bond part to conventional banks. The interest rates of the bonds should be high enough to justify its risk in order to attract funds from conventional banks.

In this structure, the Islamic bank is in fact selling the future cashflows from its loans at discounted prices. The bank gets cash from the sale of the bond, and uses them to make new loans. The conventional bank that purchases the bond gets better interest rate than it could get in the market. This is a win-win deal as long as both parties are sure of the long-term solvency of the borrowers. Information asymmetry, however, may threaten viability of such a deal structure.

It may be the case that the Islamic bank knows that long-term prospect of the loans are not really good but tries to take advantage of the ignorance of the conventional bank. Hence a very thorough due-diligence by the purchasing party may be required. One way to avoid the cost of intensive due-diligence may be to attach a put provision to the bond – that is, the seller should purchase the bond back in case the borrowers default.

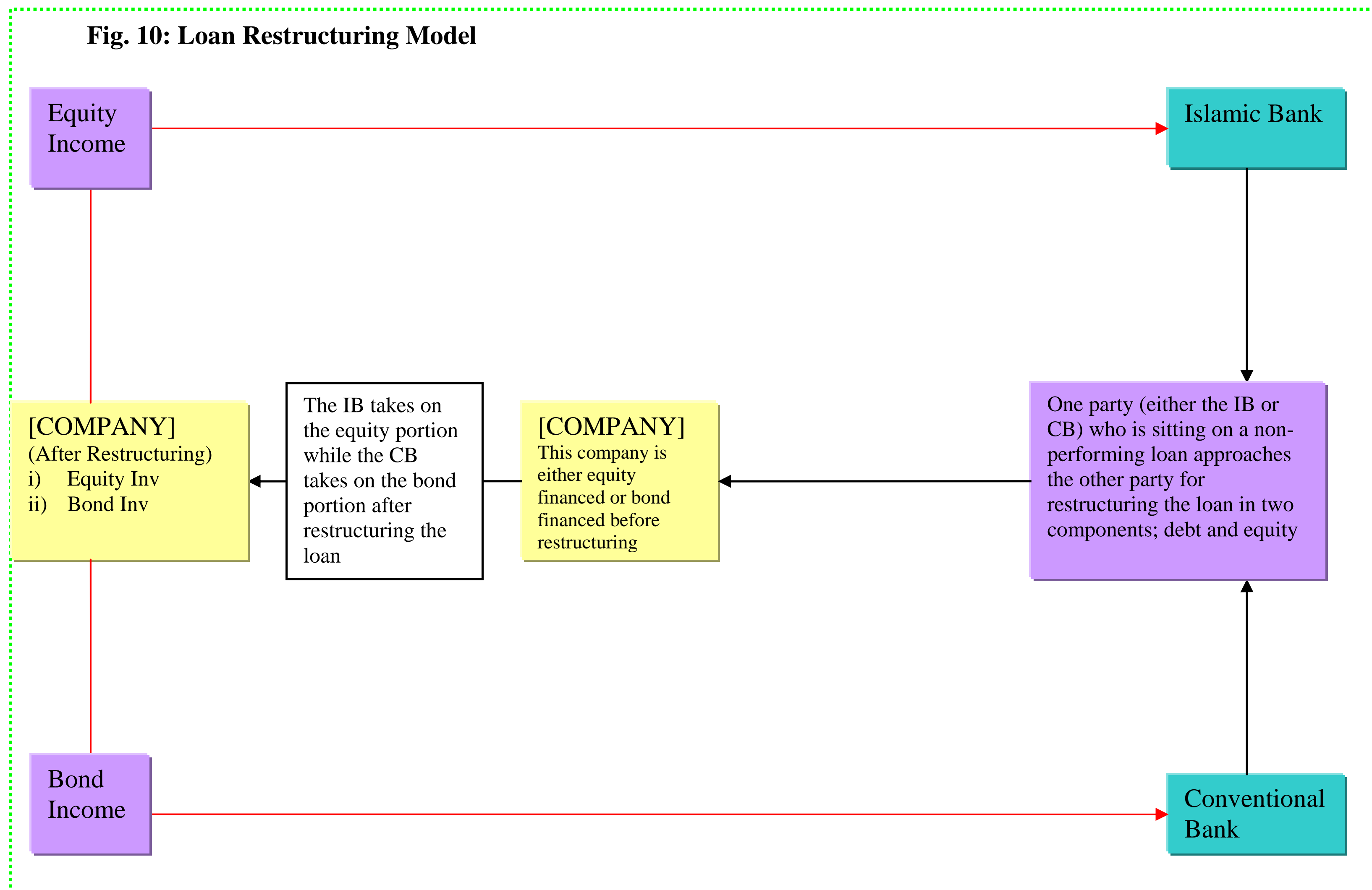


Fig. 10: Loan Restructuring Model
Equity Income
Islamic Bank
[COMPANY]
(After Restructuring)
i) Equity Inv
ii) Bond Inv
The IB takes on the equity portion while the CB takes on the bond portion after restructuring the loan
[COMPANY]
This company is either equity financed or bond financed before restructuring
One party (either the IB or CB) who is sitting on a non-performing loan approaches the other party for restructuring the loan in two components; debt and equity
Bond Income
Conventional Bank

4. Summary and Conclusion

The Islamic finance industry in Pakistan has grown tremendously in the past few years. This growth of the industry coincides with the economic developments of the country, mainly triggered by the persistent economic policies, privatization, stable political situation and many other factors. The economic growth has created huge investment opportunities and therefore the number of financial institutions has increased considerably. A number of foreign banks have started operations and 6 Islamic banks have been incorporated in the country since 2000.

Although the investment opportunities are large in number but still the cashflows from them are risky due to emerging entrepreneurships and the associated failure chances, and that's why the financial institutions have heavy non-performing loans on their balance sheets. This risk can be minimized if shared by the Islamic and conventional banks, which should be possible because of the differences in the risk appetites of the two institutions. Although Islamic and conventional banks are already cooperating with each other for availing such investment opportunities in a limited capacity in other parts of the world, such cooperation cannot be seen in Pakistan where there is a huge market potential for such joint efforts. There are potential ways that can bring Islamic and conventional banks together for availing the attractive investment opportunities in Pakistan.

This paper presented three ways for possible cooperation between Islamic and conventional banks in Pakistan. Although cooperation between the two systems in the area of project financing is already very active in some parts of the world but we have developed variations of the project finance structures which would trigger cooperation between the Islamic and the conventional financial systems in a broader sense, especially applicable to the growing economy of Pakistan where the domestic financial institutions can share their risk for availing good investment opportunities. The agency model can be used by both the Islamic and conventional banks where the domestic banks, Islamic or conventional, will work as the agents of foreign banks. The loan restructuring model can be used by the conventional banks to share non-performing loans with IFIs, and the IFIs can also share the long-term cashflows of currently non-paying loans with CFIs. We believe that these models can be used for filling the gap in risk tolerance between entrepreneurs and domestic bankers in Pakistan.

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End-notes

[i] Islamic window operations by CFIs are just Sharia-compliant businesses conducted by CFIs, and hence are not what we call cooperation between IFIs and CFIs in this paper.
[ii] See Khalid Mohammed Boodai (1980).
[iii] Ali (2002) and Archer and Ahmed (2003)
[iv] The Federal Sharia Court - formed in 1981 - declared all interest bearing transactions as repugnant to Islam. A number of companies filed suites against this decision in the Sharia Appellate Bench. SAB kept the decision of the Federal Sharia Court, and in its decision in 1999 devised a step-by-step process for the elimination of interest from the country.
[v] Islamic Banking Bullitton, State Bank of Pakistan, (Feb. 2007)
[vi] For example, young companies which focus on new technologies can easily face prohibitive costs in obtaining external capital from CFIs because they operate in a highly uncertain environment.
[vii] The risky nature of the investments and advances is also clear from the fact the scheduled banks of the Pakistan have a lot of non-performing loans on their balance sheet.
[viii] World Bank and IFC Report, "Doing Business in 2006"
[ix] See Chapra (1992 and 2000).
[x] See Muhammad Mazhar Iqbal (1995)
[xi] Pakistan was on the verge of default in 1998 because of the weak international liquidity position. The unstable political governments are said to be responsible for the worsened economic situation of the country in those days.
[xii] Karachi Stock Exchange (KSE) is the country's largest stock exchange situated in the biggest city, Karachi.
[xiii] According to the Ministry of communication of Pakistan, currently US$ 8 billion infrastructure projects are underway in Pakistan that will be completed by 2012.
[xiv] To date, IJM Corporation Bhd is the only Malaysian company involved in infrastructure construction in Pakistan. It is building an elevated expressway along Shahrah-E-Faisal from the Quaidabad Intersection to Jinnah Bridge in Karachi
[xv] The shaded slot in Table 3 indicates that young companies don't have easy access to credit which is one of the week points of the country
[xvi] Difficulty in access to credit by the SMEs is one of the motivating factor for writing this paper.

[xvii] PSCB stands for Public Sector Commercial Banks; LPB stands for Local Private Banks; FB for Foreign Banks and SB for Specialized Banks

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[xviii] The Islamization measures included the elimination of interest from the operations of specialized financial institutions including HBFC, ICP and NIT in July 1979 and that of the commercial banks during January 1981 to June 1985.

[xix] The legal framework of Pakistan's financial and corporate system was amended on June 26, 1980 to permit issuance of a new interest-free instrument of corporate financing named Participation Term Certificate (PTC). An Ordinance was promulgated to allow the establishment of Mudaraba companies and floatation of Mudaraba certificates for raising risk based capital. Amendments were also made in the Banking Companies Ordinance, 1962 (The BCO, 1962) and related laws to include provision of bank finance through PLS, mark-up in prices, leasing and hire purchase.

xx The procedure adopted by banks in Pakistan since July 1 1985, based largely on 'mark-up' technique with or without 'buy-back arrangement', was declared un-Islamic by FSC. The government and 67 companies filed appeals against this decision with the Sharia Appellate Bench (SAB) of the Supreme Court. The SAB consisted of 1) Mr. Justice Khalil-ur-Rahman, 2) Mr. Justice Munir A Shaikh, 3) Mr. Justice Wajeehuddin Ahmad, and 4) Maulana Justice Muhammad Taqi Usmani. The SAB gave its landmark decision banning interest in all its forms and by whatever name it may be called. The court also specified a step by step approach to rid the country of the evil of interest. As a consequence of this judgement, certain laws ceased to take effect from 31 March 2000, some other laws from 31 July 2000, and all other laws permitting or condoning interest from 30 June 2001.

[xxi] The Commission for Transformation of Financial System (CTFS) was constituted in January 2000 in the State Bank of Pakistan under the Chairmanship of Mr. I.A. Hanfi, a former Governor of State Bank of Pakistan. A Task Force was set up in the Ministry of Finance to suggest the ways to eliminate interest from Government financial transactions. Another Task Force was set up in the Ministry of Law to suggest amendments in legal framework to implement the Court's Judgment. The CTFS constituted a Committee for Development of Financial Instruments and Standardized Documents in the State Bank to prepare model agreements and financial instruments for new system.

[xxii] There was only one full-fledged Islamic bank and 3 conventional banks with Islamic banking window operations in December 2003.The total number of branches that offer Islamic finance facilities is 150. This number has grown from 17 in December 2003.

[xxiii] Islamic Banking Bullitton, State Bank of Pakistan, Feb, 2007

[xxiv] The 2006 Islamic Banking Bulleton of the State Bank of Pakistan shows that the share of Islamic Banks in total deposits of the banking industry of the country grew from 0.4% to 2.8% and share in financing grew from 0.5% to 2.4%. The average annual growth in the total deposits of the Islamic Banking industry in the period from January 2003 to December 2006 is 136% and the same growth in total financing and investments is 103%. The average annual growth in the total assets in the Islamic Finance Industry of Pakistan is 122% in the period from December 2003 to December 2006.

[xxv] PKR stands for Pakistani Rupees. The current exchange rate with dollar is PKR 60/$.

[xxvi] "The JBIC is looking for Islamic funds and they are planning to enter Pakistan in February next year," Dr Imran Usmani who is one of the counsels of the Sharia Board of the JBIC told. Saudi Arabia could be their first destination for launching of these bonds, he said and added Malaysia was also on their target and Pakistan could be third destination. For this purpose an MoU was signed between the two in Tokyo on May 25, 2006. The JBIC also appointed two other renowned Sharia scholars as members of its Sharia Counsel Group.

[xxvii] Khaleej Times, September 18, 2006

[xxviii] Daily Times, May 23, 2006

[xxix] The Mudaraba mode of financing is not present in Pakistan. Also Qarz-e-Hasna is almost 0%.

[xxx] Islamic Banking Bullitton, State Bank of Pakistan, February 2007

[xxxi] The other Asset-quality Ratios also show a very good position of the industry; Net NPL to Net Financings ratio is 0.3%, Net NPL to Total Assets ratio is 0.2% and Net NPL to Total Capital ration is 1.4%. These ratios are much better that the conventional financial industry of the country. See the February 2006 Islamic Banking Bulliton of the State Bank of Pakistan`

[xxxii] One example of such banks is the Dubai Islamic Bank that started operations in Pakistan in late 2006.

[xxxiii] Due to the high credit risk of SME and consumer loans in developing countries, the equity-like risk may become prohibitively high for a conventional bank to take.

[xxxiv] Technically, the SPV does not default because the payment can be reduced without announcing a default.

[xxxv] Specialized Banks are those that finance specific sectors of the economy e.g. Agricultural Development Bank provides finances to the agricultural sector of the country