

Customers' Financing Needs Vis-À-Vis Financial Products Offered by Islamic Banks in Pakistan: A Case Study of Khyber Pakhtoonkhwa Province

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Abstract

The profit and loss sharing and mark-up financing products are the two parent principles of Islamic financing. Profit and loss sharing products are equity based products while mark-up (*Murabaha*) and lease (*Ijara*) are debt based financing products. Ironically, the theory of Islamic finance entirely relies on the profit and loss sharing products, while the practice is dominated by the mark-up or deferred sale. This paper analyses the products (either equity based or debt based) offered by Islamic banks in Khyber Pakhtoonkhwa (KPK) province Pakistan. It was found that there is a dichotomy between the theory of Islamic banking and what is actually practiced by Islamic banks. An analysis of this dichotomy, with special reference to investors and customers (being the main stakeholders of Islamic banks) is important for understanding the basis of Islamic financing, the future of Islamic financial institutions and the contribution which these institutions may make to individual Muslim economies as well as to the global economic scene.

Keywords: Equity-based and debt-based financing products; Islamic banking; Islamic banks in Pakistan.

1. Introduction

For the first time when the idea of Islamic banking was placed into practice, there was no initial working model to act upon, except the belief that interest based banking might be replaced by banking based on profit-and-loss sharing. In fact, this effort took place when the entire banking system was based on Interest or *riba*. Meanwhile, the establishment of a separate regulatory system for Islamic banks was also a critical issue.

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With the help and efforts of the prominent Muslim economists and jurists, the initial idea led to the practical reality. Islamic banking is now set to reach new horizon and these practices are not only welcomed in Muslim countries, but also in those countries where people have little knowledge or no knowledge of Islam at all. This global trend in fact contributed to the growth of Islamic banking across the world.

The impressive growth of Islamic banking over the last few years has created high expectations for the stakeholders and has compelled the major players of the banking industry, investors as well as regulators and governments, to view it as a separate segment in the banking industry. Islamic banks are successful in attracting millions of Muslims around the globe to participate in this particular venture. Observing the huge potential for such banking system, Islamic banking windows are opening up in conventional banks. Unlike conventional banks, the primary function of Islamic banks is not the provision of loans backed by collaterals. Islamic banks are involved in trading of real assets based on the financing needs of the customers. Moreover; Islamic banks are supposed to use funds primarily for investment in productive assets and add to the wealth of real economy. Islamic banks with an aim of bringing revolution to the economy with interest free ethical banking were expected to be able to invent product out of the box with different structures. In fact, all so-called Islamic banks have been offering debt based financing products for replacing interest [1].

1.1 Research Problem

The customers approach to Islamic banks and ask for financing a project, business, manufacturing...etc. This demand has direct relationship with the availability of the funds and the methods or products available to satisfy the customers' requirements.

It is not known whether Islamic banks in Khyber Pakhtoonkhwa province Pakistan provide a complete range of financial products or not, And whether the available range of products fulfill the real needs of their customers. Therefore, to identify what the customers of Islamic banks in Pakistan want and what Islamic banks really offer is the main aim of this research paper.

2. Literature Review

2.1 Equity-based Financing Products of Islamic Banks

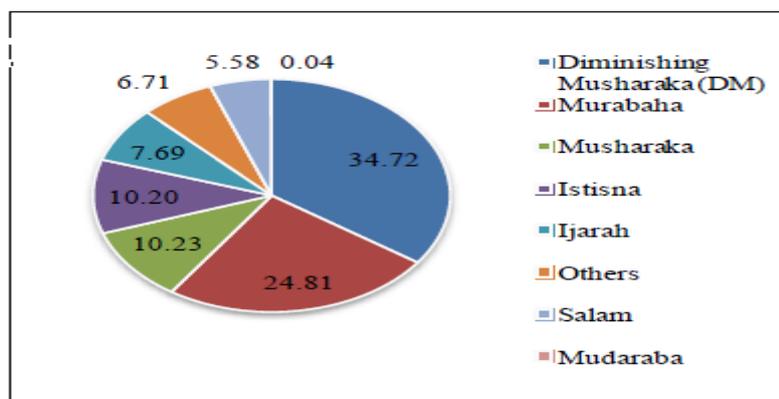
Equity financing is the process of bringing in investors or partners who provide capital in exchange for a share of ownership of the business. According to Muhammad Obaidullah [2] there are two main equity- based financing products such as *Mudaraba and Musharaka* that Islamic banks offer. These are trustee project finance and joint venture project finance respectively. In asset or equity-based financial instruments, the proceeds can take various forms such as building, vehicles, equipments and usufruct. The main concern in this case is that the dominant part of the total assets should be in tangible form [3]. Muhammad Ayub [4] argues that the deployment of funds is still a major issue because Islamic banks do not have Vanilla products for fulfilling their customers' needs.

Islamic banks are therefore required to offer financing products that truly meet the requirements of its

customers. In the spirit of Islamic finance, participatory modes of financing such as *Mudarabah* and *Musharaka* are the most *Shari'ah* compliant products [5]. These two modes of financing are very close to the model of partnership limited by shares. As a result of these participatory modes of financing, the capital holders (investors) and entrepreneurs (customers) join up for commercial or productive activities carried for the interest of all. Risk sharing is one of the fundamental principles of Islamic finance and is highly recommended in business based on partnership and joint venture. Because interest is prohibited, pure debt based financing is eliminated from the banking and therefore suppliers of funds become investors, rather than creditors. In fact, the provider of financial capital and entrepreneur share business risks in return for share in profit and losses. As for as financing based on a real asset is concerned, the prohibition of interest and risk sharing suggest a financial system where there is a direct link between the real and financial sector.

In other words, the system introduces a materiality aspect that links financing directly with the underlying asset so that the financing activity is clearly and closely identified with the real sector activity [6]. These equity based financing products are unique to Islamic banking and account for superiority over conventional banking on grounds of ethics and efficiency [2].

The reasons of why Islamic banks do not offer equity based financing products such as *Mudaraba* and *Musharaka* is one of the main arguments of this paper. One obvious reason that Islamic banks referred to for not offering equity-based financing products is the risk factor. Debt based financing products on the other hand are less risky for Islamic banks. Moreover, the only way the banks can satisfy depositor's demand is to liquidate loans [7]. Given the assumption that premature loans liquidation is costly and loans are illiquid- they cannot be sold in the market- it follows that the bank can run adverse impact on the real sector. Islamic law rejects the concept of a predetermined interest rate and permits an uncertain rate of return based on trade and profits. Theoretically speaking, banks in an Islamic economy can strictly operate only on some type of profit and loss sharing basis [8]. According to the Islamic banking bulletin state bank of Pakistan, equity based financing products of Islamic banks constitute only 17 % of the total portfolio of these banks [9]. This is strikingly different from the initial foundation of Islamic banks laid by the pioneers of Islamic banking in early 1963[10].



Source: State bank of Pakistan

Figure 1: Share of equity-based products in overall portfolio of Islamic Banks in Pakistan

2.2 Debt-based financing products of Islamic banks

Debt-based financing is the process of borrowing money to fund a business. Islamic banks, in general, are governed by *Shari'ah* which prohibits interest, gambling, risky sales, and investment in forbidden items such as alcohol [11].

Dislike conventional interest-based banking, in Islamic banking the profits and losses on a physical investment are shared between the investor and the customer according to a formula that reflects their respective levels of participation. While in practice, more than 90 percent of the portfolio of Islamic banking products are debt based [12].

There are a variety of debt-based financing products such as deferred payment (*Bai-Bithamane-Ajil*), cost plus sale (*Murabaha*), leasing (*Ijara*), deferred delivery sale (*Salam*), manufacture sale (*Istisn'a*) and recurring sale (*Istijrar*) offered by Islamic banks [2]. All these modes of financing create debt [12]. Contrary to the theory, Islamic financial institutions adopted mark-up type, interest substituting and risk avoiding modes of financing and marginalized financing products based on profit and loss [14]. In fact, Islamic system of finance emphasizes risk sharing with Islamic financial products like *Mudarabah* and *Musharaka*. These products are based on the Islamic principles derived from the *Qur'an* and *Sunnah* to eventually facilitate trade and business in the society and to consequently bring economic well being and prosperity [15].

The main advantage to the customers of Islamic banks is equity-based financing products which help them establish their own business using their knowledge, skills and energy. And then distribute the profit generated as a result of the business operations.

On practical grounds, it is not the case (at least in Pakistan) that the customers of Islamic banks be provided capital for a business in partnership with Islamic Bank. This research found that the customers were very interested for entering into a participatory or equity based financing with Islamic banks. Investors, too, were keen to allow the bank invest in profit and loss sharing business partnership and joint ventures based on profit and loss sharing.

Islamic finance and banking refers to all areas of activities in the financial system that is not in contradiction with Islamic commercial law [16]. Islamic commercial law thus has a distinct set of contracts and product structures for financing operations. Each of these financial products have a variety of risks as found by Khan and Ahmed [17], among all the financing products banks (both equity based and debt based) offered by Islamic banks, profit and loss sharing financing products are the most risky in terms of credit risk, mark-up risk and operational risk. But the least risky are they in terms of liquidity which surely helps the bank in financial crisis when there is shortage of liquid funds. According to Sajjad Zaheer and Moazzam Farooq [18] during liquidity crunch, Islamic banks are less prone to the risk of withdrawal during the bouts of liquidity stress.

3. Materials and Methods

This is a research based on survey study that seeks to determine the customers' perspective on availability of

equity-based financing products by Islamic banks. The research is based on the primary data generated from the survey conducted on the investment account holders and customers of financing products. A number of literature sources are used for developing the theoretical framework. There are five full-fledged Islamic banks that are effectively operating in Pakistan. Those are Dubai Islamic bank, Al Baraka bank, Meezan bank limited, Burj bank and bank Islami Pakistan. A total of 200 customers (40 from each bank) were asked from these five Islamic Banks in Khyber Pakhtoonkhwa province to express their views on their needs and the financial products availability from the banks. A variety of questions were asked from the customers. Out of them, only those questions are discussed which relates to the debt-based and equity-based financing products. Moreover; to understand the view point of these Islamic banks on offering either debt-based or equity-based financing products, interviews were held with the branch managers of these Islamic banks. The data in this research was collected from June 2014 till March 2015.

4. Analysis

The view point of customers is discussed first, followed by the responses of the banks' branch managers.

4.1 The Customers' Financing Needs

For what purposes do you need funds from the bank?

Table 1: Customers' financing needs (number of respondents 183)

Responses	Frequency	Percentage
Partnership business with profit and loss being shared with the bank	117	63.93
House financing	25	13.66
Car financing	32	17.49
Others	9	4.92

As shown above, the greater percentage (63.93 percent) of Islamic banks' customers suggested that they needed funds for the business purposes and being partner with the bank in sharing profits and losses. This demand can be fulfilled by offering equity-based financing product namely *Musharaka*.

On the other hand, 13.66 percent and 17.49 percent of the respondents replied with their needs for house financing and car financing respectively. Such needs can be fulfilled by offering debt-based financing products like *Ijara* (lease) and *Diminishing Musharaka*. According to Habib Ahmad [19] using profit and loss sharing principle to reward depositors is a unique feature of Islamic banks. It is not only the depositors who, according to *Sharia'h*, are subject to this principle but also the bank in keeping a fair balance between offering both

equity-based and debt-based financing products. These views disprove the work done by Faycal Amrani [20] who argued that the banishment of profit and loss sharing contract is due to demand factor.

4.2. Products Offered by Islamic Banks

The branch managers were interviewed about the availability of financing products. Their responses are presented below:

What financing products does your bank offer?

Table 2: Financing products offered by Islamic bank (respondents: 5 banks*)

Financing Product	Frequency	Percentage
Dminishing Musharaka	4	80
Murabaha	2	40
Istisn'a	1	20

* Dubai Islamic Bank, Albaraka Bank, Bank Islami Pakistan, Burj Bank and Meezan Islamic Bank.

In your view, what are the reasons for not offering profit and loss sharing products such as *Musharaka* and *Mudarabah*?

This was an open-ended question to the bank managers with responses mentioned below:

- The customers cannot fulfill the documentation requirements of the profit and loss sharing products.
- We do not want to face the risk associated with profit and loss sharing products.

Does any number of your investment account holders want to invest their money based on profit and loss sharing?

The response to this question was very different than what Islamic banks actually do. All of the investment account holders wanted their money be invested in financing products based on profit and loss sharing.

Why your bank does not invest the funds in the same financing product(s) identified by the investment account holders?

The managers responded with the following reasons:

- When the investors sign the undertaking form, they allow the bank to invest their funds in any *Shari'a* compliant product whether it be equity based (profit and loss sharing) or debt-based.
- The eligibility requirements for buying equity based products (e.g; *Mudaraba* and *Musharaka*) are so huge that the client could not ever meet them. For example, in *Mudarabah* based financing the client should keep collateral with the bank, and should also prove he/she will pay the principal as well as an

agreed profit ratio/percentage.

These responses are supported by a survey conducted by Mehboob ul Hassan [21] on the perceptions of investment account holders of Meezan Bank (a full-fledged Islamic Bank in Pakistan) in 2007. In response to the question of would the investment account holders of the bank continue to deal with the bank even the risk on investment is higher than conventional bank? , 88.48 percent of the respondents replied with yes. The argument of the management of five Islamic banks sampled in this research is that the knowledge, skills and commitment of a customer being partner in business with bank is very difficult to measure and to make sure that the customer will effectively and efficiently operate the business for which the bank had provided funds.

On the other hand, if Islamic banks would offer debt based financing products only, then they would have focused on wealth accumulation not wealth distribution. One of the main objectives of Islamic financial system is wealth circulation; this can best be achieved by offering equity-based financing products. Had the banks been offering both debt-based and equity-based financing products proportionately, the growth of Islamic banks will be both vertical and horizontal. In other words, Islamic banks would not only have increased their assets, but helped poor people in financing for businesses and hence uplifting their living standards.

5. Limitations of the study

- Small sample size: results may not be indicative for the target respondents at large.
- Some respondents, who had limited knowledge of Islamic banking or no knowledge about the financing products of Islamic banks, hence the replies of some questions, may be based on their own imaginations or thoughts.

It is therefore important to note that the results should be taken only as indicative and perceptive rather than conclusive.

6. Conclusion and Recommendations

As suggested by the pioneers of Islamic banking, the system of offering profit and loss sharing financing products should be the main and primary operational characteristics of Islamic banks. In theory, profit and loss sharing or equity-based products are the main distinguishing feature of an ideal Islamic bank.

While in practice, debt-based financing products offered by Islamic banks in Pakistan dominates equity based financing products. Furthermore, profit and loss sharing products constitute a negligible percentage in the portfolio of Islamic banks in Khyber Pakhtoonkhwa province of Pakistan. The reasons given by the managers of Islamic banks for not offering equity-based financing products do not justify customers' financing needs for profit and loss sharing products; neither have they justified the investment account holders' perspective on their preferences towards investing in profit and loss sharing products. Consequently, it is suggested that products of Islamic banks should not be offered with respect to the extent of risk associated with these products, but according to the needs of its customers. Moreover; although offering debt-based financing products such as *Murabaha* (cost plus sale) and *Ijara* (leasing) are permissible by Islamic *Sharia'h*, these products should not

constitute the major business activity of Islamic banks. In fact, for Islamic banks to have operated on high ethic and moral principles and to have alleviated poverty, Islamic banks should maintain a fair balance between offering both equity-based and debt-based financing product for their maximum impact.

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