

PRACTITIONERS' PERSPECTIVE

## The Premise of Islamic Banking, Disclosures, Transparency, and Investors' Confidence

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### INTRODUCTION

The Islamic Banking industry in Pakistan has experienced rapid growth since 2002- when the State Bank of Pakistan issued the first ever Islamic Banking license to Meezan Bank. Ever since, Meezan Bank has steadily been leading the way for the industry.

According to a recent study conducted on the Islamic Banking Industry in Pakistan by rating agency Moody's, Islamic deposits have grown 21 percent on a compound annual basis for the six-year period through June 2019, outpacing the 11 percent compound annual growth rate of all other deposit types. The study further highlighted the better performance of Islamic banks whereby return on assets for Islamic banking institutions was 2.3 percent at the end of June 2019 versus an average of 1.6 percent for all banks in the system. As of the latest data (end of September 2020), the IBI assets stand at Rs 3.81 trillion (16.0 percent) and Rs 3.03 trillion 17.3 percent, of overall banking industry.

The objective of Islamic finance is the well-being of the common men by avoiding exploitation and promoting fair distribution of wealth in the society. The central philosophy emerges from the divine guidelines allowing trade as an alternative of interest or usury. And Allah has permitted trade and prohibited interest. (Al-Baqarah,275)

In light of the guiding principle of Islamic finance it is clear that Islamic Banks are inherently different from the conventional banks. Following the basic premise of promoting real trade, risk-sharing, profit sharing and nurturing partnerships Islamic Banking institutions participate in the real economic sector rather than treating money as a commodity, lending on interest without any contribution in the real economy.

### Importance of Disclosure

Disclosures are crucial for banks as they ensure transparency, reduce uncertainty in the market, and allow investors to make informed decisions based on objective information. For Islamic banks, the importance of disclosures is even more significant as the annual reports serve more than their regulatory purpose. The disclosures communicate compliance to the

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regulatory requirements, but moreover it is a means to strengthen Sharī'ah compliance. Islamic banks have a fundamentally distinct business-model, the Islamic Banks actively engage in trade and investment activities which sets them apart from their conventional counterparts. The disclosures, therefore, become a crucial tool not only to build depositor and overall stakeholder confidence but also to highlight the unique risk-taking trade-based business model of an Islamic bank. Furthermore, since Islamic economic and financial systems aim to establish a fair and equitable financial system disclosures of Islamic Banks should also objectively communicate the value created and distributed to various segments of the society.

Islamic Banking Institutions should go an extra mile to ensure that their Annual Reports (being the most common and widely available form of disclosures) provide value-added, transparent and objective information as per the need and demand of various segments of their stakeholders. In Pakistan, Meezan Bank is the trend setter for introducing various value-added and transparent disclosures that educate and empower various groups of stakeholders, catering to their information needs. Meezan Bank's Annual Reports have set a precedent for not only local but international banks and regulators as well. The industry has recognized this contribution and Meezan Bank has been lauded with multiple prestigious awards from the banking and corporate sector.

Meezan Bank Annual Reports for the FY 2015 and FY 2006 achieved the 2nd position by "Best Corporate Report Awards (Jointly by ICAP & ICMAP)" in the Banking sector. The Annual Reports for FY 2013, FY 2014, FY 2016 and FY 2017 got 3rd position while the Annual Report for FY 2011 bagged the 4th position.

The following section will elaborate some examples of innovative and informative value-added disclosures in the Annual Reports of Meezan Bank.

## **Strengthen Sharī'ah compliance**

### ***Sharī'ah Supervisory Board Report***

This section is the summary of all major activities performed in the Bank and Sharī'ah Board's view on the Sharī'ah compliance status of all segments of the bank. MBL started to include the Sharī'ah Supervisory Board Report from 2003, this was way before it was made a compulsory regulatory requirement for all Islamic banking institutions in 2010 when the State Bank of Pakistan's Islamic Banking Department instructed IBIs to prepare a report regarding Sharī'ah compliance, to be published in the IBIs annual report.

Till date, MBL has the most detailed SSB Report in Pakistan which is available in both languages: Urdu and English. The SSB Report presents objective and transparent endorsement of the qualified and respectable Sharī'ah scholars on all matters related to Meezan Bank's operations. This builds the investor and depositor confidence as they can access detailed opinion of qualified scholars.

## **Highlight different Business Model**

### ***Statement of Inventory***

This section shows bank's exposure to real risk, thereby highlighting the actual difference between Islamic and conventional banks. The business model of Islamic Banks is based on

trade, consequently they carry inventory at different stages of transactions. MBL includes a sector-wise breakup of inventory to show the diversification of its portfolio. This section increases the confidence of investors with regards to the unique risk-sharing nature of Islamic banks as well as with regards to the prudent risk management of the bank.

### **Financing Portfolio**

Contrary to the common belief that Islamic Banks rely heavily on debt-based modes of financing, this disclosure shows that equity-based modes of financing constitute 53% of the MBL's total financing. The Financing Portfolio section shows that the Bank has moved towards diversification in the usage of various financing products and has reduced the reliance on *murābahah* (debt-based mode of finance). The year on year analysis of the various modes of financing shows that there is a growth of 16.79% in diminishing *mushārahah* from 2018. Bank has mainly focused on financing through equity modes, including Diminishing *mushārahah* and running *mushārahah*. Furthermore, MBL also discloses the break-up of its income generated from various modes of finance in the Statement of Financing Portfolio Income. This shows the income of each financing mode and also depicts a well-balanced and diversified portfolio. This Statement provides breakup of financing and shows the deployment of funds in each mode of Islamic finance at different stages of transactions rather than the conventional accounting treatment which categorizes all under one heading, "financial receivables".

### **Transparency**

#### ***Allocation of Income & Expenses to Remunerative Depositors' Pool***

In Islamic Banking Institutions, the depositors-bank relationship is that of partners, due to the underlying contract of *muḍārahah*. This disclosure presents objective and detailed information, in easy to understand manner, to the depositors about the utilization and income of their funds. Various information like the *hiba* from *muḍārib* and Bank's earning as the *muḍārib* are presented in a transparent manner.

### **Pool Management**

The Pool Management note gives the stakeholders a brief overview of structure and management of different pools. It is an effort to make impartial information available to the depositors of Meezan Bank about details of the securities where their deposits/ investments are deployed to generate returns. Through such statements, the stakeholders feel more confident that all their investment and/or deposits are deployed in fully Sharī'ah compliant securities.

### **Statement of Charity**

Charity is another key differentiating aspect between the operations of an Islamic bank and conventional bank. This statement is an important disclosure with regards to the collection (breakdown of the various sources of collection) and disbursement of the charity fund throughout the year. This disclosure is very important for the customer confidence that the charity amount collected from them (because of delayed payments) is channeled to the

under-served segments of society. A detailed list of the various organizations is also provided for further transparency. It should be noted that as per Sharī'ah guidelines this charity is not used to fund MBL's CSR in any way.

## **Value Distribution**

### ***Distribution of Created Value***

In fulfilling our promise to our stakeholders, Meezan Bank distributes the value created in relevant and meaningful ways. MBL strives to 'Establish Islamic Banking as banking of first choice...' stakeholders receive intangible benefits ranging from employee upskilling programs to diverse avenues of alternate Sharī'ah-compliant investments & financings.

This section highlights the role of Meezan Bank in improving different spheres of the society. Meezan Bank adopts a 360-degree approach in distributing value to all stakeholders including the economy and under-served segments of society.

## **Contribution to UN SDGs**

Islamic economic and financial system aims to establish a just society. Consequently, Islamic Banks have a responsibility that is beyond their own profit maximization. Meezan Bank's Annual Reports have a dedicated section that discusses Meezan Bank's contribution towards achieving UN SDGs. The four areas on which Meezan Bank focused on in 2019 were;

1. *Quality Education*: MBL is making a substantial contribution in increasing the relevant skills for employment and entrepreneurship of youth in the country.
2. *Affordable and Clean Energy*: MBL is committed to promote and lead green energy initiatives. This is in line with the objective of Islamic Finance, to preserve the environment and resources granted by Allah Almighty.
3. *Decent Work and Economic Growth*: MBL promotes healthy work environment and strengthens the country's economy by expanding the access of individuals to Islamic banking through awareness sessions across Pakistan.
4. *Partnerships for the goal*: Being the prime digital innovation endorser in banking, MBL is playing a key role in bolstering domestic resource mobilization and mobilizing financial resources for SMEs in the country

## **Auxiliary Information**

### ***Did You Know***

"Did you know?" boxes started appearing in the Meezan Bank Annual Report from year 2017. The purpose of this section is to enhance the knowledge of our stakeholders and to develop interest by creating such miscellaneous pockets of information in the Annual Report. These boxes also serve the purpose of presenting readers with facts which can counter the prevalent misperception about Islamic banks.

In the Annual Report 2018, the "Did you know?" box presented Running *mushārakah*, a *sharikaï al-'aqd* based financing product, which was introduced for the first time in Pakistan. Through these boxes, stakeholders are communicated the continued commitment of Meezan bank to encourage equity-based financing. Another misperception is that since Islamic

banking is governed by the same laws as conventional banks and therefore the difference is just on paper. The "Did you know?" box explained the role played by the competent Shari'ah Advisory Committee of State Bank's Islamic Banking Department in supervising and facilitating the Islamic banking industry. The "Did you know?" boxes featured in Annual Report 2019 educated readers about the Shari'ah compliant nature of all deposits maintained by Islamic banks at SBP. Another box highlighted that Meezan bank invests their funds only in shares of Shari'ah compliant companies. The box also informs readers about Shari'ah compliant share indices available on the PSX.

### **Product Glossary**

This section is another informative piece added to the annual reports that explains basic features of each financing product to provide understanding of each product to all stakeholders.

### **Conclusion**

The above mentioned innovative and informative approaches of Meezan Bank should be adopted by the Islamic Banks of Pakistan. Adopting these practices will ensure transparency, avoid economic and financial losses, enable investors to make informed decisions, and reduce the market uncertainty. Furthermore, an industry-wide implementation of these innovative disclosures will educate and empower stakeholders with confidence that Islamic banks are indeed different from merely money lending institutions. Consequently, value added disclosures play an important role in establishing Islamic banking as the banking of first choice.

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