

Faysal Asset Management

Research Note – Islamic Banks losing the charm

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Islamic Banks losing their Charm

It is widely known that a Shariah-inclined investor prefers an Islamic Bank due to the promise of Halal return, one that is free from Riba (Interest). In fact, the imposition of floor on the rate of return offered by Islamic banks on saving deposits gave these investors an additional motive to opt for Islamic Banking – i.e. a profit motive. A combination of these two motives and more has indeed allowed Islamic Banking to grow at a phenomenal rate to date. However, that might change going forward as the State Bank of Pakistan notified the following on November 20, 2012:

“the provisions of BPRD Circular No. 7* of 2008 regarding minimum rate of return on savings deposits shall be no more be applicable on Islamic Banking institutions.”

(Note: BPRD No. 7 had placed a 5% floor on all savings/PLS Savings deposits, which was later raised to 6%)

In light of this, Islamic Banks will not be the only ones to profit, as conventional banks with Islamic banking operations will also benefit from reduction in cost of funding. The rates offered on the deposit schemes are expected to slide down, though not so drastically. For instance, Bank Alfalah, which presently holds approximately 20% of the total Islamic deposit base, will witness a jump in bottom line by 3% to 5% for every 1% reduction in its PLS rate.

Interestingly, we reckon that the removal of floor rate will encourage investors to look for high yielding investment alternatives – in particular ones offered by other financial institutions including the likes of mutual funds.