Does Meezan Bank Deliver - The Search for Fair Returns in Islamic Banking Industry (A Study in Pakistan)

By

Muhammad Raheel Siddiqui
University Kuala Lumpur, Business School
Email: raheelsiddiqui107@yahoo.com

Abstract

This paper aims to examine whether banks treat their depositors fairly, by comparing the earnings received by depositors and those of shareholders of a bank, using historical data. Since there is considerable empirical evidence available that depositors are treated unfairly in conventional banks, i chose the largest Islamic bank in Pakistan for this purpose in order to observe whether the rates of return provided to depositors (investment account holders) in Islamic Banks are significantly different from those of conventional banks for the years 2005-2012. My results indicate that on the surface, the depositors were getting around 50% of the total Net Income of the bank that was available for distribution, as against 10.23% of the same given to shareholders; however, interestingly, these depositors constituted about 94.6% of the total amount available to the bank for financing, therefore effectively, depositors were on average receiving only about 16.51% of the profit on every Rupee invested in Meezan Bank, with the rest going to the shareholders – who had contributed only about 5.5% of the total available amount – a clear indication of highly unfair treatment meted out to depositors. In the end, i suggest an alternative ratio for the distribution of the Bank's earnings that would replace the current unfair return to the depositors.

1. Introduction

Why would man do anything at all if he could not benefit from it? This is this underlying question that has been the root of all competition and its purest answer is return.

Return, is the essence and primary motivation behind all economic activity. It is return that sees an investment realized, regardless of whether it came in the form of time, effort or money. It is its potential that drives innovation and pushes forward progress, springing to life new businesses, forcing the old to evolve and develop new models or venture into new territory.

It is return that has allowed the Islamic Banking Industry to begin and continue to develop. It is due to return that banking as a whole, whether Islamic or conventional, exists and continues to be necessary. But, does Islamic Banking in its current state justify the industry's existence? Are the industry's returns fair to all its stakeholders and in particular, do investment account holders and depositors receive in return (for entrusting their wealth to an Islamic institution) what is justly deserved to them? Does the industry's model for return differentiate itself enough from that of conventional banking and does this model truly exemplify fairness and justice, or is it simply just banking in a different skin?

The easy answer would be to hide behind the theory of Islamic banking and the principles of Shariah Law that form the foundation of its structure. Ask any well-informed Muslim (or even persons of other faiths) on the street about Islamic Banking and the first and foremost topic touched upon would be *Riba*[1] or usury. Usury, its benefits and facilitation are prohibited by the Quran and it is this prohibition of usury that Islamic banks try to define their selves by.

But are Islamic banks really *Riba*-free or maybe just as important, free from *Riba*? The former is a great debate of its own with contracts such as *Tawarruq2* forcing an uncomfortable grey in an industry that operates on Shariah rulings that are either black or white. More troubling, the debate hints at an abuse of the theory of Islamic finance and if proven as such, would show a divide widening between the theory and practice of Islamic finance that would support a greatly held public perception that Islamic banking is just conventional banking reskinned. The latter, however, is of more concern to this paper (and for the sake of clarity), by free from *Riba*, in this instance refers to whether the Islamic banking industry is free from the effects and influence of interest.

Al-ghunm bil ghurm, is an Islamic juristic principle that articulates the Islamic position on risk and translates to: "one is entitled to a gain if one agrees to bear the responsibility". There can be no return without risk, a principle that cannot be refuted within (or outside the sphere of influence that is attributed to) Islam. It can be greatly argued that the element of risk is the cornerstone of the practice of Islamic finance and a necessary ingredient in its instruments and products.

It is the view of Islam that financing contracts that make use of usury as a mode for profit are absent of the element of risk: "an extreme side of a financing contract, where the borrower bears the risk of bankruptcy, whereas the lender takes no risk at all. The lender is a risk avoider since he rejects taking risks with an expectation to gain in granting the loan. He desires to make money from the loan but refuses to face uncertainties of non-repayment." (Rosly & Zaini, 2008)

The element of risk in the creation of wealth in Islam is so fundamental that *Zakat* serves a further purpose than being a compulsory charitable donation based on one's wealth/property, it also "serves as a penalty to those who choose to keep idle balances for more than a year" (Rosly & Zaini, 2008), a deterrent to Muslims choosing to be risk averse or halting their pursuit for the bounties of the Creator.

Even the conventional financial system sees risk as a necessary element to the degree of return. The greater the risk, the higher the returns. The riskier the borrower, the greater the justification for a higher rate of interest charged, hence the greater the return for the conventional bank. Interest aside, it is the element of risk that has both differentiated the Islamic system from the conventional system and perhaps forced the Islamic system to compete in the same market as the conventional system.

Since the inception of the first Islamic bank in 1975, there has been an undeniable convergence of both the Islamic and conventional banking industries, as Islamic banks chose to directly compete within the same markets as conventional banks in an attempt to gain a respectable foothold in the global financial industry and to promote the Islamic system as the better alternative. This close competition made supportive regulators, such as the Bank Negara3 in Malaysia, enact regulations that would make Islamic Banks more attractive and competitive in a dual banking system. However, such support only saw to converge the two systems.

It could be argued that for the sake of practicality, this convergence was necessary to attract the self-interested 'economic man', who is ruled by a profit motive. How can an Islamic bank compete with conventional banks if its rate of return on a deposit or investment account was not in some respect or another guaranteed and guaranteed to a level equal or more than that of a conventional bank? Why would anyone deposit their money in an Islamic bank if their principal was not guaranteed? One could say that it is because the Islamic system is in line with their beliefs and that trumps their apprehension on risk of low returns

and loss of principal, but that would be too idealistic an argument and too unattractive when compared practically with the norm of the conventional system. The missed opportunity for Islamic finance to operate in a market of its own as a more holistic, approachable, interest-free, larger, institutionalized and socio-economic welfare centric venture capitalist hybrid has seen a great detriment imposed on the industry: Islamic finance is in no way free from *Riba*.

In a world where the conventional system is the norm, the compounding effects of interest on value and prices are carried over to goods and services bought by consumers. However, it is not so much its effects but more so its influence that has been imposed on Islamic banks due to their close competition with the conventional banks. It has been proven that the total amount of deposits in an Islamic bank has a strong negative relationship with the rate of interest, "during the rise of interest rates, returns on Islamic bank deposits are relatively lower which cause customers to switch to the conventional banks." (Meutia, 2016). Inversely, "decreasing rates of interest had a positive influence on Islamic banks", however, "it also suggested that Islamic banks were forced to increase deposit rates when rates of interest rose so as to keep competitive, which might imply a potential squeeze on the banks' income" (Meutia, 2016). Hence this clearly shows that the imposition of the conventional system and its status as a norm influences depositors who are naturally profit motive-driven to deposit their wealth where they have assessed it would 1) retain the most value and 2) offer the best returns, regardless of any risk-reward dynamic.

It should also be noted that research conducted in 1994 by the Bank Negara Malaysia, "revealed that the rate of return on deposits in Islamic banks have a high correlation with the market interest rate" (Meutia, 2016). This is yet another effect of the close competition and convergence of the Islamic and conventional industries, which also has the unfortunate added effect of giving the Islamic banking industry an image of being conventional banking guised in another skin.

It is not the objective of this paper to be unfairly critical to the current philosophical state of Islamic finance, an industry still developing its core policies and relatively new compared to its older conventional cousin. It is the objective of this paper to highlight the developments made by various Islamic financial institutions to push towards fair returns based on the level of risk committed to, justifying the existence of the industry as a whole. Hence this paper concerns itself with the fairness on the level of return received by depositors whose monies are used by Islamic banks to provide the majority of financing to its clientele, irrespective of the imposing influence of interest by the conventional system.

The true embodiment of risk and return or fairness in Islamic finance can be said to be found in its profit and loss sharing contracts – agreements such as *Mudaraba4* which are extended to depositors. These contracts, if implemented in their true essence and spirit, are revolutionary to say the least. However, the question that needs to be asked here is: can a Mudaraba contract between depositors and the Islamic bank be really implemented in true letter and spirit, given current banking practice and norms, and expectations of depositors and shareholders alike?

Taking the example of Pakistan, Islamic Banks largely accept unrestricted Mudaraba-based investment deposits as savings accounts and term deposits, which constitute a major part of their deposit mix. **The terms of the *Mudaraba* agreement require that the profit earned from the various financing and investment activities of the bank is shared between the depositors as (*Rabbul Maal*), and the bank (as *Mudarib*) according to a pre-agreed profit-sharing ratio.** As far as the loss is concerned, if any, it is borne by the depositors in proportion to their capital contribution, while the bank loses its expected reward

in such a loss or no-loss-no-profit situation. However, if the loss is caused by the negligence or wilful misconduct or breach of terms of the contract by the Bank, the entire loss thereof is borne by the latter. Notwithstanding the characteristics of the classical *Mudaraba*, the highlighted portion above is of particular significance to this paper. As far as the treatment of loss is concerned, especially in the context of depositor expectations in accordance with normal banking practices, the issue could be much debated – particularly with regard to the practicality of this stipulation – however, it is beyond the scope of this paper.

In consideration of this trust-based *Mudaraba* relationship between the Islamic bank and its depositors and with the need of upholding the Islamic principles of fairness, not just through return but also through transparency, it was imperative to have comprehensive policies for the calculation and distribution of profit & loss across the Islamic banking industry, which is why the State Bank of Pakistan (SBP)5 issued a set of "Instructions for Profit and Loss Distribution and Pool Management for Islamic Banking Institutions (IBIs)"6. These instructions are now supposed to be followed by Islamic banks in Pakistan as a rule, and the major highlights of the same are discussed later in this paper.

It is therefore my objective in this paper to assess whether the largest Islamic bank in Pakistan, Meezan Bank (the Bank), follows the provisions for the fair distribution of profit as prescribed by the Shariah and highlighted in the above-mentioned Instructions issued by the SBP, and seek to answer the following questions:

1. *Does Meezan Bank treat its depositors fairly?*
2. *To suggest an alternative ratio for the distribution of Meezan bank's earning that will replace the current unfair return to the depositors.*

The conventional system provides depositors with lower expected returns on their interest rate deposits in comparison with the return on equity received by their shareholders. This has been argued to be in all fairness, due to the lack of risk borne by depositors, who have their principal guaranteed with a fixed rate of return committed to them by the bank. As a result, the shareholders' equity takes on the burden of risk while depositors have more or less completely avoided it.

However, the current reality for Islamic banks in Pakistan, seems to be following the same trend – my premise is that depositors receive less return on their deposits than shareholders do on their equity, despite the former taking on the bulk of the risk, according to the terms of the *Mudaraba* contract. Furthermore, the returns on these deposits are flexible, as they are based on performance and are not fixed from the on-set. Hence, it would only be fair for these depositors to expect higher returns to those received by conventional deposits, but in reality, the returns are more or less similar. This is worrisome, as in theory, the amount of returns received by *Mudaraba* depositors should ideally be a clear indication of the performance of an Islamic bank.

As far as Malaysia is concerned, *Mudaraba* deposits constitute the largest portion of total deposits held by Islamic banks, leading to the leverage of such deposits being 7.56 times higher on average than capital provided by shareholders. However, returns on *Mudaraba* deposits are far lower than the return on equity received by shareholders. This is explained firstly by, 1) despite the fact that *Mudaraba* deposits are exposed to market risks, the same is not operationally recognized by Islamic banking regulators; whereas the Islamic bank's capital, absorbing both unsystematic and systematic risks, is recognized by the regulators. Secondly, 2) investments made by *Mubaraba* deposits earn small margins calling for a larger volume of transactions to yield greater profit (Rosly & Zaini, 2008).

Notwithstanding the above, one of the most salient features of Islamic banks is the prohibition of interest (Meutia, 2016). Allah SWT prohibits both the receipt and payment of interest in the Holy Qur'an, and the Sunnah of the Prophet PBUH contains detailed guidelines about the application of Riba in all related transactions. Profit and loss sharing in Islamic banks is therefore one of the many tools that has been used to replace the use of interest-based deposits – and is one of the key features of Islamic Banking that distinguishes it from conventional banking. However, like conventional banks, Islamic banks also face market segmentation, therefore the rate of return on deposits from banks are always a cause of concern for the public (Fayed & Ezzat, 2017; Kasri & Kassim, 2009). It is therefore a necessity for Islamic banks to offer competitive rates of return on deposits as compared to conventional banks, in order for obtaining a competitive advantage in the industry (Farook, Hassan, & Clinch, 2012).

In light of the above, I will therefore assess if the returns distributed by Meezan Bank to its depositors are fair to the latter. If not, however, suggestions for a new profit sharing ratio between the depositors and the Bank would be provided.

The remainder of this article is divided into six sections. Section 2 gives a brief historical overview of the Islamic Banking industry in Pakistan, with a short introduction about Meezan Bank; Section 3 outlines the basic profit distribution steps being followed in Pakistan; Section 4 describes the methodology followed and data obtained; Section 5 reports the results of the analysis; Section 6 thereafter discusses the limitations of this study; and finally i conclude in Section 7.

2. The Perspective from Pakistan

The intentions to introduce Islamic Banking in Pakistan can be said to have taken root in the mid-60s. After considerable work in this area by academics and Shariah scholars alike over the best part of two decades, a momentous struggle was made in the mid-80s to "Islamize" the banking system. During this period, 7 major amendments were made in the Constitution of the Islamic Republic of Pakistan under the name of Banking & Financial Services Ordinance, 1984. The full movement was, however, challenged in the Federal Shariat Court7 in early 1990, who declared some products and processes being used by the banking system as not in line with the conjunctions of the Shariah. As a result, efforts were started afresh to be able to realize the objective of full conversion to the Islamic banking system. This time, the involvement of Shariah scholars was spearheaded by Justice Retd. Mufti Muhammad Taqi Usmani, and with the help of banking, accounting and finance experts, significant progress was made in the development of a comprehensive Islamic banking model.

Prior to the launch of Islamic Banking in Pakistan, a delegation of Ministry of Finance (MOF) visited countries like Malaysia, Egypt and Saudi Arabia in 2001 for the exposure of Islamic Banking products and practices followed by Islamic Banks in these countries. Based on the delegation's recommendations and past experience of SBP, the policies of Islamic Banking were formulated and State Bank of Pakistan issued detailed criteria for setting up of Islamic banks in Dec 2001.

Consequently, Al-Meezan Investment Bank was the first Islamic Bank of Pakistan that got a license to operate from the State Bank of Pakistan and launched its operations in January 2002, with the clearly defined objective of introducing pure Islamic Banking or *Riba*-free banking. Today, Meezan Bank is the largest Islamic bank in Pakistan, and is a publicly listed company with a paid-up capital of Rs.10 billion. Being among the fastest growing financial

institutions in the banking sector of the country, the Bank offers a vast dimension of Islamic banking products and services in 140 cities, through its network of 570 well equipped retail banking branches.

Meezan Bank enjoys an impeccable reputation among the masses – it is perceived to be serving rigorously under the principles of Islamic Shariah and is renowned for its product development capability, Islamic banking research and advisory services. In order to ensure strict Shariah-compliance in all its products and services, the Bank has established the most well-staffed Product Development and Shariah Compliance department in the entire industry, that serves under the supervision of the Bank's in-house Resident Shariah Board Member and a Shariah Supervisory Board comprising of internationally renowned Shariah scholars. It would therefore be of interest to see how an Islamic bank with such an impeccable reputation, fares when it comes to fair profit distribution.

3. How Profit is distributed in Islamic Banks

In accordance with the requirements of the Instructions issued by SBP as highlighted in the preceding sections, the funds obtained from depositors under the Mudaraba contractual arrangement are invested in an investment pool called the Common Mudaraba Pool (CMP), while the Islamic bank is entitled to commingle any portions of its own funds or those funds obtained through current accounts, etc. in this CMP. In its capacity as the *Mudarib*, the Islamic bank treats the CMP as a fund under its management against an agreed share in the profit.

The depositors (fund providers), or *Arbaab ul Amwaal*8 are considered as partners amongst themselves, since there are many depositors entering into a Mudaraba arrangement with the Islamic bank. These depositors share their portion of the distributable profit on the basis of a weightage system, which are assigned to different tiers and classes of depositors based on certain objective criteria such as size and tenure of the fund9. As a result of this weightage system, larger portions of profits are allocated to bigger amounts committed for longer periods, on account of the size and tenure of the funds. The loss, if any, is borne pro-rata, in accordance with the requirements of the Mudaraba contract and as outlined above.

As far as income from financing activities is concerned, as a matter of principle, there should be clear differentiation between the transactions executed by the CMP10, and those entered into on behalf of the Islamic bank's shareholders. Consequently, the profit and loss of all the former transactions are considered for the account of the CMP, while the profit and loss of all transactions belonging to the latter category are for the account of the shareholders only.

Since actual liquidation of the CMP is not possible, a constructive liquidation of the same is carried out for profit computation and distribution purposes, and the net profit, if any, can be ascertained in the following manner:

1. Total income from the CMP's financing and investment activities is calculated.
2. The following items are then deducted from the total income:
    a. Direct expenses relating to financing & investment activities of the CMP;
    b. Provisions for bad and doubtful transactions/investments; and
    c. Depreciation of the fixed assets in the CMP.
3. The result of the above equation will be the net profit of the CMP available for distribution between the shareholders and the depositors.

From the net profit of the CMP, as shown in detail in Figure 1, the Islamic bank will first deduct the full share of its own funds invested in the Mudaraba pool (including current account balances). Of the remaining portion, the bank will then proceed to deduct its due share of the profit11 in its capacity as the *Mudarib*, and then the remaining portion of the distributable profit is disseminated amongst all the depositors as per the weightages assigned to their respective tiers or classes.

As far as the determination of net income available for distribution and the determination of expenses to be charged to the CMP are concerned, the following principles are followed:

1. All pre-operative expenses, including but not limited to equipping itself with all the necessary skills, infrastructure, manpower and systems, procurement of fixed assets including IT system etc. are borne by the bank (shareholders) in their capacity as a *Mudarib*.
2. All the indirect expenses, or the general expenses of the Islamic bank, its administrative expenses (including staff salaries, perks and other expenses), purchase and depreciation cost of assets and equipment, premises rentals, etc. are borne by the bank (shareholders).
3. Only direct expenses and costs of the CMP transactions, provisions for bad receivables/financing, and depreciation of CMP fixed assets, if any, are charged on the CMP12 (Qaseem, 2012).

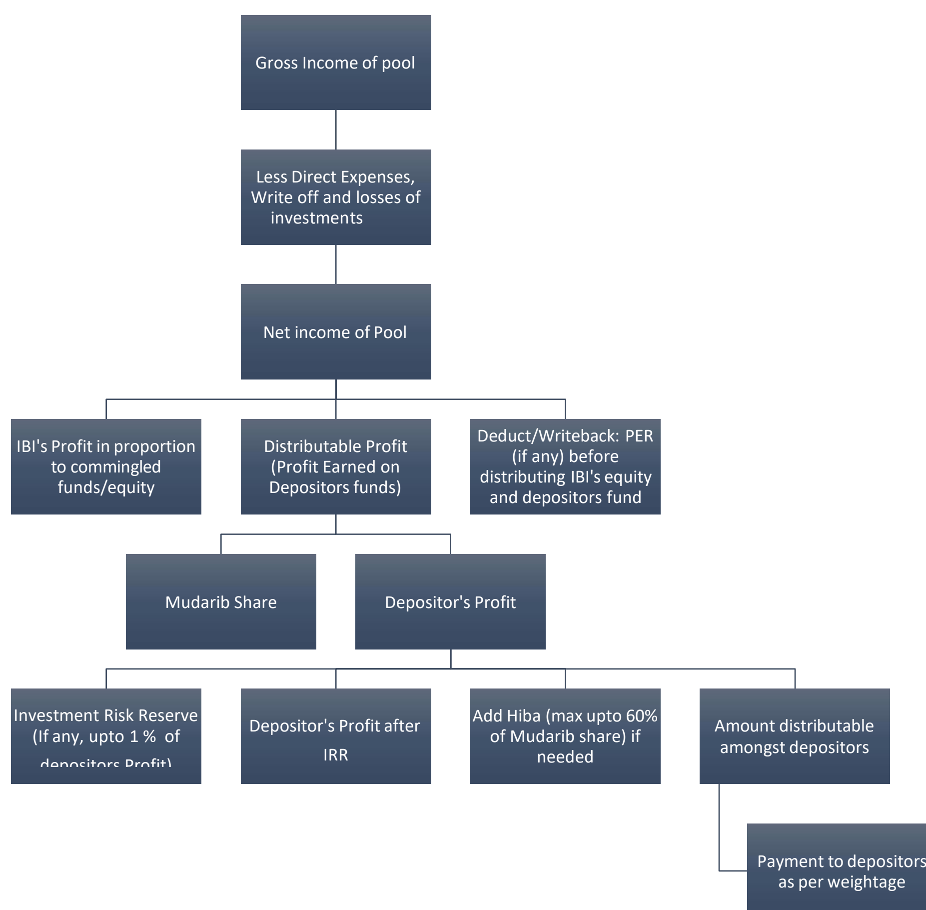

Figure 1 - Profit Computation and Distribution Process Flow, *as issued by the State Bank of Pakistan, January 1, 2013. Note that the Mudarib Share denotes the percentage share of Distributable Profit (profit earned on the depositors' funds) that the Bank receives in its capacity as the Mudarib, or fund manager, in the Mudaraba contract between the Bank and Depositors. IBI = Islamic Banking Institution; PER = Profit Equalization Reserve; IRR = Investment Risk Reserve. The latter two reserves are used for profit smoothening purposes.*

4. The Methodology and Data

In order to determine what percentage of the bank's earnings went to the depositors and shareholders, i primarily required data for the total profit paid out to depositors and shareholders separately, along with the total amount of funds/capital contributed by each, which I was able to obtain from the annual audited financial statements13 of Meezan Bank Ltd., for the years 2005 – 2016 (both years included). Using this data, i performed a ratio analysis, details of which follow.

For the computation of the *annual profit rate or Return on Investment (ROI)14* earned by depositors, i used the figures for the total profit paid out to depositors, as a fraction of the total amount of funds provided by them. The case for calculation of profit payout to shareholders was slightly more complex, however – since the primary method used for payment of profit to shareholders is through dividends, i used the total dividend payout, as a fraction of the total ordinary shareholder capital15. The dividend payout to Meezan Bank's shareholders was made in various forms over the years – stock only, cash only, or a combination of both.

The next step in my analysis involved computation of the percentage of net income from the financing activities that was distributed to depositors, for which i obtained the figures for the total return on financings, investments and placements, and then expressed the total return on deposits expensed as a fraction of the above16. For the shareholders, i computed the same percentage by dividing the total dividend paid to shareholders by the total return on financings, investments and placements17.

However, this percentage could prove misleading, as would be elaborated in the next section – therefore, in order to arrive at a more accurate picture; i proceeded to separately calculate the percentage contribution of both the depositors and shareholders to the total financing activities, or *total effective capital*18, of the bank. For the depositors, i expressed the total deposits as a fraction of the sum of total deposits and ordinary shareholders capital19, while for the shareholders; i substituted the total deposits by total ordinary shareholders capital in the numerator of the above-mentioned fraction20.

The next step in my analysis would be to examine the relationship between the percentage participation in the total financing activities for each of the depositors and shareholders and the percentage share of each in the net income from financing activities of the bank. To this end, i computed a statistic that gives rather interesting results21 – i divided the share of each category in the net income by their respective shares in total effective capital of the Bank22,23. Finally, in order to establish a ratio between the per Rupee24 profit earned by the depositors and shareholders, i divided the return on ordinary shareholder capital by the return on deposits25. Summing both figures up, and expressing each as a fraction of the total, gave us the required ratio.

Table 1 below provides the summary statistics for my data. The results show large differences between the treatment enjoyed by shareholders and that meted out to depositors. Despite the fact that depositors provided the lion's share of the total capital available for financing – on average about ***94.96%*** throughout the period concerned, they were only paid an average annual return of ***4.17%***, as compared to ***18.84%*** to the shareholders during the same period. This meant that effectively, for every Rupee invested by Meezan Bank during the period concerned, depositors only got a meagre ***16.51%*** of the ensuing profit. A thorough analysis of my results follows in the next section.

Table 1 – Summary of Main Statistics (2005-2016)

Statistics	Average
Return on Deposits (ROId)	4.17 %
Return on OSC (ROIs)	18.84 %
%age of Net Income paid to Depositors (Ad)	49.77 %
%age of Net Income paid to Shareholders (As)	10.23 %
%age Share in Total Financing Activities for Depositors (Bd)	94.96 %
%age Share in Total Financing Activities for Shareholders (Bs)	5.04 %
Proportion between Ad and Bd	0.52
Proportion between As and Bs	2.54
ROI for Shareholders vs ROI for Depositors (ROIs / ROId)	5.06
Percentage of Per Rupee Profit earned by Depositors	16.51 %
Percentage of Per Rupee Profit earned by Shareholders	83.49 %

5. The Results

Table 2 reports the detailed results of my analysis and provides a comparison between various statistics for both depositors (DEP) and shareholders (SH). **Column A** shows the return earned by depositors and shareholders on their capital – as can be seen, during the period 2005-2016, the depositors at Meezan Bank have earned a paltry average return of 4.17% per annum on their deposits (ROId), and this return has steadily declined over the years, falling to as low as 2.28% in 2016. In comparison, the shareholders of the Bank have been able to earn a healthy 18.84% return on their capital (ROIs) during the same period, with their returns depicting a sharp growth, especially after the year 2010 – their returns on investment doubled from 15% in 2010 to 30% in 2015, and stayed at the same level the subsequent year as well. Figure 2 shows the above-mentioned trends in ROId and ROIs.

Why did the Return on Investment for the shareholder's dip during 2006 and then 2008-09? This could be explained by the fact that up to the year 2008, the Bank was constantly raising share capital by issuing stock dividends; however, in 2008-09, there was no need to do the same since there was a very negligible increase in share capital. Moreover, the bulk of the Bank's profits were being retained.

Figure 2 - ROId and ROIs

Column B of Table 2 depicts the percentage of net income shared by the depositors and shareholders. As stated earlier, this could be a highly misleading figure if taken in isolation – my results show that on average, depositors received about 49.77% of the Net Income of the Bank from its financing activities during the period concerned, while the shareholders received about 10.23% of the same26. On the surface, this seems like quite a healthy share for the depositors on average, even though their share in the Net Income has been seen to have declined from about 54% in 2013, to 40.96% in 2016. However, when compared with the corresponding figures for percentage share in the total financing activities of the Bank, i get a completely different story. **Column C** depicts the percentage of total effective capital (total capital available for financing) contributed by the depositors and shareholders. As can be seen from the figures provided, depositors have provided an average of ***94.96%*** of the total capital available for financing during the entire period, their share in the total effective capital has never fallen below 90%, and this share has been steadily on the rise. In summary, therefore, despite ***having provided almost all the capital available for financing***, depositors get less than half of the Net Income available for distribution. Figure 3 below provides an adequate depiction of the situation.

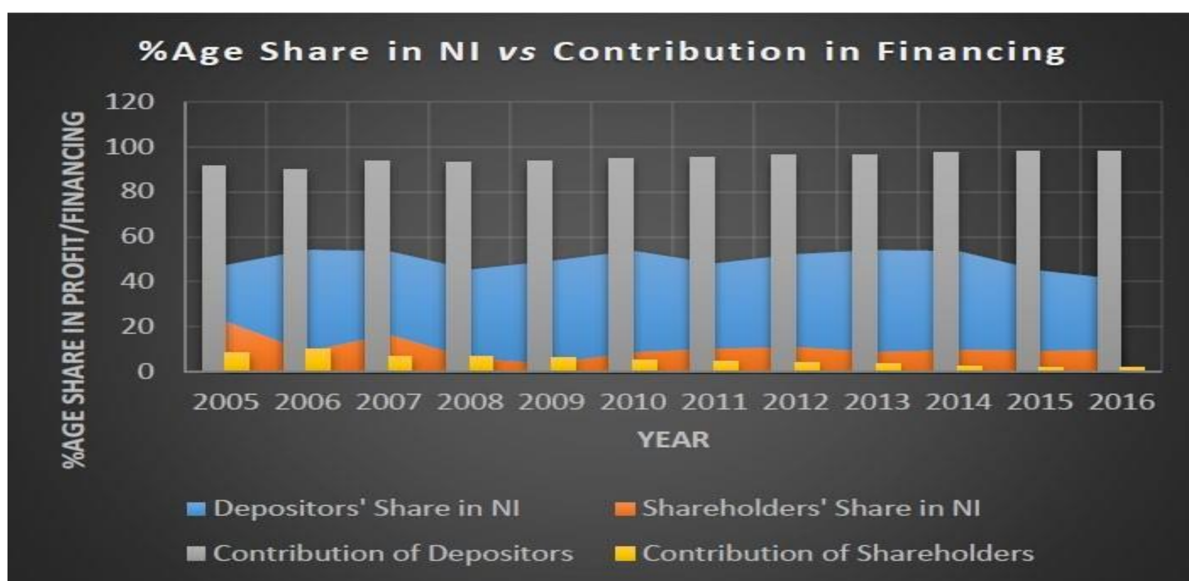

Figure 3 - Percentage Share in NI vs. Percentage Contribution in Financing Activities

Columns D and **E** summarize the plight of the depositors – the latter depicts the ratio between the depositors and shareholders in per Rupee earnings, while the former represents the percentage of per Rupee profit earned by each of the depositors and shareholders.

Effectively, **Column D** tells us that for every Rupee invested in Meezan Bank during 2005-2016, the average ratio between the earning of the depositors and shareholders has been **1 : 5.06**, meaning that on average, one part of the ensuing profit has gone to the former, while the shareholders have obtained ***5.06 times as much as the depositors***. Moreover, this disparity between the depositors and shareholders has skyrocketed in recent times, ***with the latter earning 13.14 times as much as the former*** in 2016!

This result is staggering to say the least, and is put into better perspective by the final part of my analysis. **Column E**, therefore, represents the respective percentage shares of both depositors and shareholders in the profit earned on each Rupee invested at the Bank. As can be expected, the depositors have received a mere 16.51% of this profit on average, after having contributed 94.96% of the financing capital, with the remaining obtained by the

shareholders. Moreover, the share of depositors in per Rupee profit has witnessed a sharp decline – falling to about 7.07% in 2016, with their corresponding contribution in total financing activities of the Bank standing **at a high of 98.25% in the same year**!

These results are better expressed in Figures 4 and 5 below. Figure 4 shows us the disparity between depositors' and shareholders' earnings – for every one part of profit earned by the depositors, the shareholders have on average earned about 5 times as much. Moreover, the astounding increase in this disparity in the past few years can also be seen from the rapid rise in the graph for shareholders' earnings.

Figure 4 - The Disparity between Depositors' and Shareholders' Earnings - for every one part of profit earned by the depositors, the shareholders have on average earned about 5 times as much

Similarly, Figure 5 portrays the percentage share of depositors and shareholders in the profit earned from each Rupee invested at the Bank – depositors have received about 16.51% on average, with the remaining received by shareholders. Furthermore, the minuscule share of the depositors in this profit in recent years can be seen by the rapidly diminishing yellow part of the graph below.

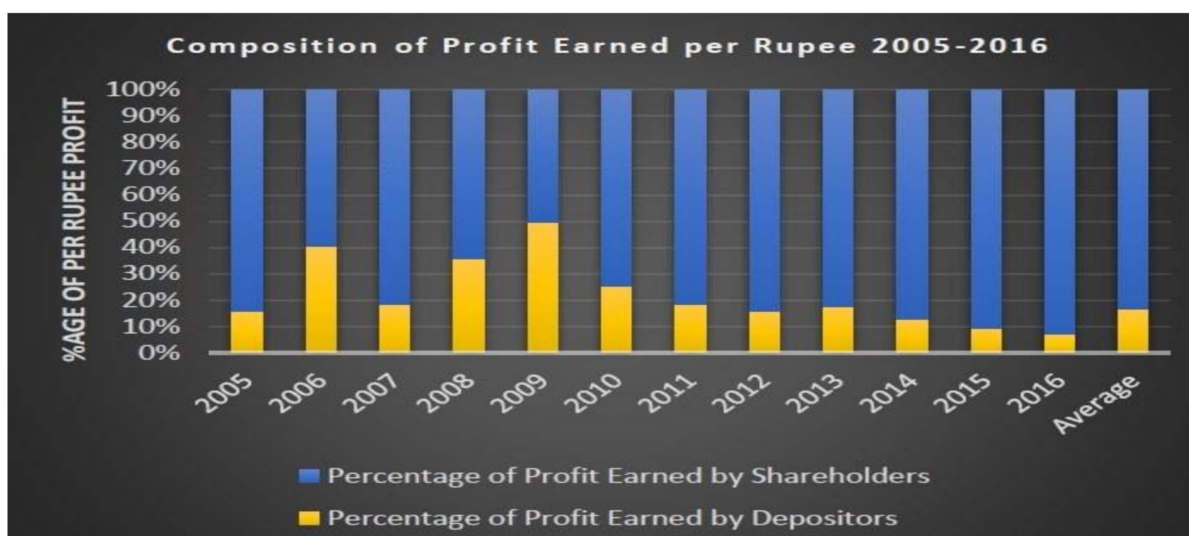

Figure 5 - The Percentage Share of Depositors and Shareholders in the Profit earned from each Rupee invested at the Bank - depositors have received about 16.51% on average, with the remaining pocketed by shareholders

The story does not end here – due to the presence of a few anomalous years in my data, where the shareholders were not paid substantial dividends due to a multitude of possible reasons, i suspect my results to be slightly biased in favor of the shareholders. Even though deprivation from the receipt of dividends does not mean that the shareholders were worse off – indeed they would have benefited immensely due to the increase in value of the firm – i have still proceeded to remove these "outliers" from my dataset and observe whether my results are substantially affected. Table 3 below represents the summary statistics of my results, after eliminating the first few years from my dataset and analyzing the data for the years 2010-2016 (both years inclusive).

Table 2 - This table shows a comparison between various statistics for both depositors (DEP) and shareholders (SH) for the years 2005-2016 – **Column A** shows the return earned by depositors and shareholders on their capital; **Column B** the percentage of net income shared by the depositors and shareholders; **Column C** the percentage of total effective capital contributed by each; **Column D** the proportion between the percentages of net income earned and the total effective capital contributed (B/C); & **Column E** depicts the percentage of per Rupee profit earned by each of the depositors and shareholders.

Year	Return on Deposit Vs Return on OSC (in % age)		% age of Net Income Shared (NI)		% age of Total Effective Capital (TEC)		Ratio b/w Depositors and Shareholders in Per Rupee Profit		% age of Per Rupee Profit Earned	
	A		B		C		D		E	
	DEP	SH	DEP	SH	DEP	SH	DEP	SH	DEP	SH
2005	3.03	16.00	47.31	22.33	91.79	8.21	1.00	5.28	15.93	84.07
2006	4.25	6.25	54.14	8.74	90.11	9.89	1.00	1.47	40.48	59.52
2007	4.49	20.00	53.61	16.53	93.52	6.48	1.00	4.45	18.34	81.66
2008	4.40	7.92	45.40	5.73	93.45	6.55	1.00	1.80	35.70	64.30
2009	4.95	5.00	49.20	3.29	93.78	6.22	1.00	1.01	49.77	50.23
2010	5.04	15.00	53.75	8.52	94.94	5.06	1.00	2.98	25.15	74.85
2011	5.10	22.49	48.06	10.01	95.49	4.51	1.00	4.41	18.48	81.52
2012	4.94	25.95	52.13	10.74	96.23	3.77	1.00	5.25	15.99	84.01
2013	4.32	20.02	54.06	8.66	96.66	3.34	1.00	4.63	17.76	82.24
2014	4.06	27.50	53.61	9.57	97.43	2.57	1.00	6.78	12.86	87.14
2015	3.16	30.00	44.99	9.08	97.92	2.08	1.00	9.50	9.52	90.48
2016	2.28	30.00	40.96	9.57	98.25	1.75	1.00	13.14	7.07	92.93
Avg.	**4.17**	**18.84**	**49.77**	**10.23**	**94.96**	**5.04**	**1.00**	**5.06**	**16.51**	**83.49**

As can be seen from the table below, after excluding the years where the dividend payout to shareholders was low, the percentage share of the shareholders in the per Rupee profit increases, while the disparity between both increases – the fraction ROIs / ROId has now increased to 6.67.

Table 3 - After excluding the years 2005-2009, the average percentage share of the shareholders in the per Rupee profit increases

Table 3 – Summary of Main Statistics (2010-2016)

Statistics	Average (%)
Return on Deposits (ROId)	4.13
Return on OSC (ROIs)	24.42
Earnings of Shareholders for every Rupee earned by Depositors (ROIs / ROId)	6.67
Percentage of Per Rupee Profit earned by Depositors	15.26 %
Percentage of Per Rupee Profit earned by Shareholders	84.74 %

Figure 6 provides another depiction of the result obtained above. As can be clearly seen, the removal of the years 2005-2009 has contributed to increasing the disparity between the shareholders' and depositors' earnings.

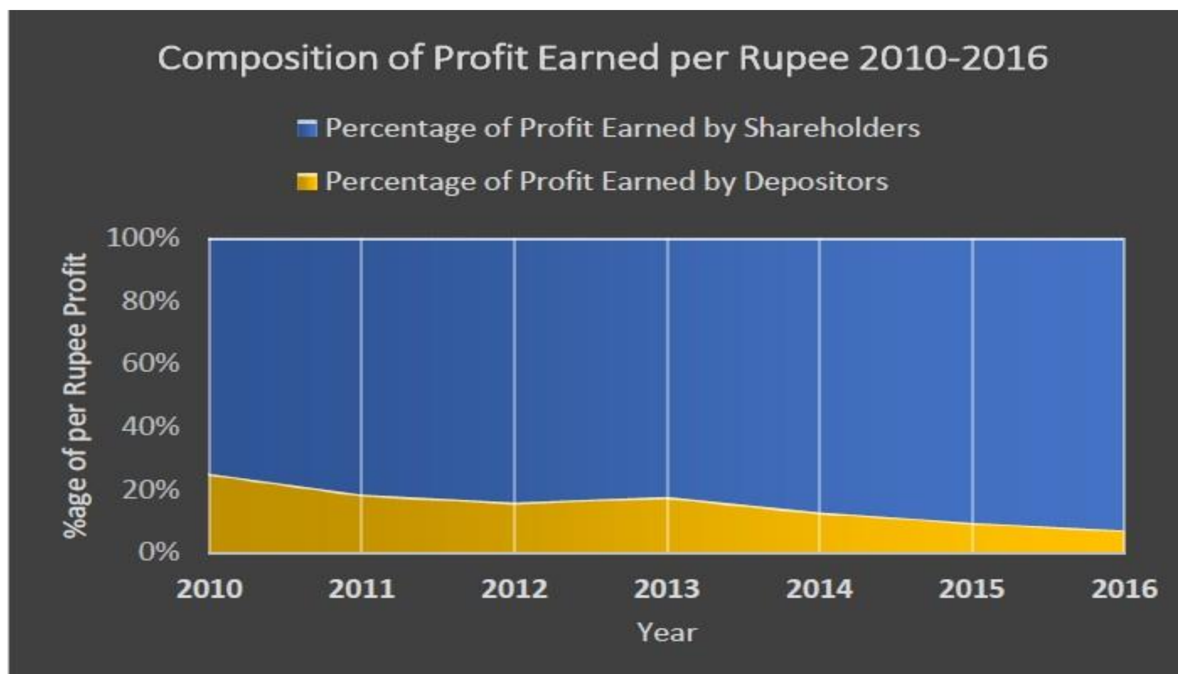

Figure 6 - Once the years 2005-2009 are removed from the dataset, the average percentage share of shareholders in per Rupee profit of the Bank increases

6. Limitations of the Study

Despite the fact that my study has been able to identify significant disparities between the earnings of shareholders and depositors, my results have their limitations, and in fact understate the extent of exploitation that depositors are being subjected to. Since profit amongst depositors is distributed according to weightages assigned to different categories and classes of depositors, and the maximum weightage to the *Mudaraba*-based deposit of any nature, tenor and amount can go up to 3 times of the weightages assigned to saving deposits (according to SBP instructions)27, there is a huge difference between the highest and lowest profit rates paid out to any bank's depositors. This essentially means that at any given point in time, there would be on average about a 300% difference between the profit rates realized by the largest and the smallest categories of depositors.

However, due to the unavailability of tier-wise data for profit distribution, this difference has not been captured in my study, and the total annual profit paid out to all the depositors has been taken. Furthermore, since this is an aggregate amount, and the contribution from High Net Worth (HNW) individuals and large Institutional Depositors normally constitutes a large portion of the total deposit base of any bank, it can be expected that my results would have been influenced by the profit paid out to such categories of deposits. An ideal situation would have been the bifurcation of annual profit payout between the HNW and Low Net Worth (LNW) individuals, which would have enabled us to study the inequality between shareholders and each category of depositors separately. Had sufficient amounts of data been available for the purpose of my study, i expect to have found that the average percentage share of the smallest and middle category depositors in the per Rupee profit of the Bank would have been much lower than the ratio that i have computed.

Despite the fact that the depositors are partners amongst themselves, and the Shari'a has prescribed strict rules for the just and equitable distribution of profit amongst partners in a *Musharaka*28, these rules do not seem to be followed to the letter in the allocation of weightages to different deposit categories. These weightages cannot be allocated in an arbitrary manner; nor is it allowed to allocate higher or lower weightages for any reasons other than a well-defined and objective criteria. However, in practice, Islamic banks have been observed to tinker with weightages without following any objective criteria as mentioned above – sometimes the weightage of a particular tier of deposits may be increased only for the benefit of a particular HNW customer, at the expense of the other tiers/depositors of the CMP29. This "subjectivity" in the allocation of weightages and the resultant deprivation of the lowest categories of depositors has also not been captured in my analysis.

It is common practice in the Islamic Banking industry that shareholders give up a portion of their own profit to the depositors in general or to a specific category of depositors as Hiba30, the need for which arises when the *expected* returns are lower than the *actual*, realized returns. In principle, the provision of Hiba, if at all, should be as part of the distributable profit – distributed across the board to all categories of depositors based on their weightages (Qaseem, 2012) 31. However, in practice, it has been observed that the practice of Hiba is used by some Islamic banks in order to be able to give a fixed rate of return to corporate or rate-conscious customers. This poses two problems:

1. The *actual return* earned by the depositors based on the *already unfair* profit sharing ratio agreed with the concerned bank are so low that they necessitate the provision of a *gift* to the former; and

2. The lowest categories of depositors are again discriminated against when HNW individuals are provided Hiba.

The implications of this practice are obvious – the profit sharing ratio agreed between the Islamic bank and its customers is highly inequitable, and the LNW customers of the bank are highly exploited. Unfortunately, my study is unable to account for the effects of these factors.

Furthermore, due to the fact that i have taken the figures for dividend payments to shareholders, i encounter a major dip in shareholders' earnings in some years during 2005-2009, which show very low dividend payments because of a multitude of possible reasons, some of which have been listed in the preceding section. This had caused to understate the average percentage share of shareholders in per Rupee profit, which was remedied by confining my analysis to the years 2010-2016. However, there is a need to study the reasons behind the low dividend payout in the years 2008-2009 in detail, and observe any possible effects that such a study might have on my results.

Moreover, by taking total capital available for financing in order to compute my required ratios detailed above, one of the major assumptions that i have made in this paper is that all available capital has been utilized for financing and investment activities. This is due to the fact that the proportion of total deposits from the total capital available for financing would have been prohibitively difficult to compute, given the available resources, and beyond the scope of this study. In case these figures had been available, my results might have been slightly different – the percentage share of depositors in per Rupee profit might have slightly increased. However, this increase is expected to have been negligible at best.

In addition to the above, another serious limitation of my study is the fact that I am unable to compare the shareholders and depositors on a level playing field. As detailed earlier in this paper, the shareholders are entitled to commingle their own equity with that of the depositors in the CMP. Consequently, from the ensuing profit, the shareholders obtain the *full share that could be attributed to their funds invested in the CMP*, while the share of the depositors is then distributed according to their respective weightages, after deduction of a another source of income for the bank – the Mudarib share – and required reserves. The justification provided for this preferential treatment is that shareholders' rights need to be protected – but whither disappeared the rights of the depositors?

7. Conclusion and Recommendations

Protecting and safeguarding the interests of the Investment Account Holders (IAHs) is a central theme of the Shari'a Governance Framework (SGF)32 purportedly followed by all Islamic banks in Pakistan - Clause 1-ii) of this document states:

"The BOD (Board of Directors) should also be fully aware of its fiduciary responsibility, particularly, towards Investment Account Holders (IAHs) /Profit and Loss Sharing depositors (PLS depositors) who accept risks that are almost similar to those of the shareholders but without having any voting rights and fora like Annual General Meetings (AGMs) to express their concerns on the IBI's performance. The IAHs expect IBIs to not only exercise prudence in deployment of their funds in different avenues but to also ensure Shari'ah conformity of returns to be earned and distributed to them. The BOD is thus expected to introduce the necessary mechanisms and risk management systems to safeguard the interests of IAHs/PLS depositors."

However, are the BOD really ensuring the same? my analysis above proves to the contrary. Based on data obtained for Meezan Bank Ltd. in Pakistan, for the years 2005-2012, i have observed that:

a) Depositors earned a paltry average return of **4.17%** per annum on their deposits, while the shareholders of the Bank have earned a healthy **18.84%** return on their capital.
b) Despite ***having provided almost all the capital available for financing***, they get less than half of the Net Income available for distribution.
c) For every Rupee invested in Meezan Bank during 2005-2016, on average, the percentage shares of the depositors and shareholders in the ensuing profit are ***16.51%*** and ***83.49%*** respectively.

When the above results are consolidated, the conclusion is clear – there is no acceptable justification that could be provided for paying a mere 16.51% of the share in per Rupee profit to depositors. This treatment is unfair to say the least, and as highlighted in the text reproduced from the SGF above – is an exploitation of the depositors, simply because they do not have any voting rights and are unable to express their concerns on the concerned bank's performance.

In the conventional banking system, depositors do not take any responsibility for assuming any kind of risk on their deposits, which the bank assumes for safekeeping of depositor's money. Even if one argues based on this principle, it is difficult to justify these results for a conventional bank, let alone Islamic banks – their case is entirely different, since the depositor in an Islamic bank is an Investment Account Holder, and bears the risk of loss on his deposit due to the nature of the *Mudaraba* contract.

So how to determine a fair ratio for sharing of the bank's earning between the two groups of shareholders and depositors? The answer to this question is yet to be provided by the Islamic Finance industry. One positive step in this regard has been suggested by Hasan (2010), that Islamic banks and conventional banks involved in Islamic finance be required to publish in their periodic financial statements the rate of profit which a bank makes on its equity, side by side with the rates agreed with depositors, in order to improve information and transparency33.

In my opinion, Islamic banks should not receive more than 5-10% of their total revenue as a management fee for acting as *Mudarib*, after adjusting all the expenses – only then can depositors at Islamic banks get their fair share of profit from financing activities. The determination of profit sharing ratio between the bank and its depositors should primarily be a function of the overall expected rate of profit on investment – therefore it should at least translate into an ROI for the latter that is commensurate with the returns that the Bank earns on its financing. The Financial Performance Index (FPI) developed by Abdul Rashid & Sana Jabeen, could also serve as a good basis for Islamic banks to use for the determination of a just and equitable profit sharing ratio, by identifying the determinants of financial performance and improving on them (Rashid & Jabeen, 2016) 34. Moreover, it might be prudent to set aside around 5-10% of the total profit as a reserve, with the remaining to be distributed amongst the investment account holders based on the weightages allocated to them.

Is this suggestion too harsh on banks? i don't think so, primarily because banks have many other sources of income, as outlined earlier in this paper. There is no valid justification for banks to take advantage of the relative helplessness of depositors to fill their coffers, *with other people's money*. Shareholders might argue that, depositors are not ready to accept the requirements of the *Mudaraba* contract for bearing risk, as evidenced by their behavior towards banking; consequently, it really is the shareholders who are the sole risk absorbers, which in turn justifies taking the lion's share of profit. However, these are shallow arguments – the requirements of a valid *Mudaraba* contract are clear. That said, depositors should be conditioned to accept responsibility for the possibility of loss on their deposits, rather than treating Islamic banking deposits like conventional ones, without which the true essence of Islamic Banking would remain a distant dream.

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