

The Role of Modarabas in Pakistan's Financial Sector

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I am extremely pleased to be present here this afternoon to share my thoughts on the role of Modarabas in the financial system of Pakistan. As your association is in the process of soul searching let me add a few words of mine to this dialogue. I hope you will take my advice in good stride as constructive suggestions to strengthen and improve your sector.

Modaraba has established itself as a well understood Shariah compliant instrument of financing in Pakistan. It has been practised for the last 20 years and we have gained a lot of experience in its operations and management. We have developed an institutional framework which is acceptable to the scholars and also clarified the initial confusion regarding the regulatory responsibilities. The dual structure between SECP and SBP has given way to a single regulatory agency which is SECP. We had therefore logically expected that Modarba will provide a transit point in our path towards Islamic financial system. We thought we could apply the experience gained from this mode of financing and scale it up and replicate it throughout the system. But let me confess that I am disappointed that Modarabas haven't taken off so far in this country despite such a long standing and their contribution in the financial sector has been insignificant.

Assets held by Modarabas account for 0.2 % of the total assets held by the financial institutions in the country. The total market capitalization is still a tiny fraction of financial sector cap. They haven't been much successful in mobilization of savings or deposits either. Mr. Arif Habib has already presented a very systematic analysis of Modarbas' performance at the Karachi Stock Exchange with the aid of facts and figures. This picture is also not very pretty. Why has the performance of the Modaraba sector been so disappointing? I would like to offer, in all humility, a few hypotheses of my own which need to be considered, analysed and debated.

First,I would submit that the governance structure of the Modrabas has proved to be inadequate and the interests of the investors and certificate holders have not been adequately protected. The concentration of powers in the hands of managers particularly when the standards of transparency and disclosure are not that rigorous does leave a lot to be desired. It is high time that your Association should examine the whole governance structure ab initio in the light of the experience gained during the last two decades and move in a direction which gains the trust and confidence of the investors. To have only a paltry investor base of 165,000 individuals is not very satisfactory.

Second, as I have mentioned you need much greater transparency in your operations to inspire confidence. Liberal use of Central Depository and disclosure standards need to be improved and upgraded so that the ordinary

prospective investor is assured that his money is not only safe but is being managed in the most professionally desirable manner. At least you should strive to achieve and maintain the same standards of disclosure and transparency which are applicable to other financial institutions in Pakistan. This way you will be at par in terms of attracting investment to Modarabas.

Third, the Risk management practices in Modarabas should be reviewed to find out if the managers are optimizing the returns for the given level of risk. There is an urgent need to determine if the tools and techniques being adopted by them represent the best practice in the industry keeping the constraint of complying with shariah in place. The only credible way to expand this mode of financing is by demonstrating that the reward-risk relationship under Modaraba is not inferior compared to other instruments.

Fourth, although the regulatory dualism has been sorted out by giving the SECP the exclusive responsibility for regulation over the Modarabas I believe that the oversight has not always been exercised with utmost vigilance. The Registrar has too many powers and in my view too much discretion and I would like to question whether this is the right regulatory model. Shouldn't we at least consider some alternative such as some elements of market-based regulation combined with self regulation.

Fifth, the Modarabas have not been able to diversify their products or differentiate from other market players such as Leasing companies. Today 75% of their business is concentrated on leasing which does not provide any

market niche or comparative advantage to them. The leasing portfolio mostly covers traditional industries such as textiles, light engineering, cement etc. New activities have by-passed the leasing sector so far. Isn't it time to avoid this herd instinct and develop some other products and services which are uniquely the domain of the Modarabas and also tailored to the demand of the particular customer base which has so far not been able to access financial sector institutions.

Sixth, the Modrabas have to become more competitive in their cost of funding. If they continue to rely on the banks they would always remain at a cost disadvantage. As the tax rates on the banks are gradually reduced, the big banks are privatized and the drag of non performing assets is softened the banks will be able to outclass the Modarabas in cost of funding. You have to tap other sources which remain unrealized and do not flow to the banking sector. There are many savers who do not want to use the banking system and are looking for Shariah compliant products. You should try to attract them and thus add to the overall national savings pool of the country.

Seventh, the Modarabas have very little geographical dispersion outside the big cities such as Karachi, Lahore and Islamabad. Unless you establish presence in smaller towns and have a distribution network which is extensive, I am afraid that asset growth and deposit mobilization would remain lackluster. Small and medium enterprises are looking desperately for

finances and consumer financing is also in stage of infancy. This is an area which can augment your profitability by cross selling.

Finally, the minimum capital requirements of Modaraba sector should also be raised to levels which allow for more rapid asset growth. At the time other non-bank financial institutions are expanding their capital to do more business, it would be to your disadvantage if you are unable to keep pace with them in terms of capital adequacy.

I have been frank and candid in my observations but my motivation is simply to stir you up to harness the vast opportunities which lie ahead of you. The success of Modarabas will also show us the path to an orderly and smooth transition to the Islamic system of financing. I hope you will take my words in the right stride and in a constructive and positive manner. Let me conclude by apologizing to you if I have offended the sensibilities of any one present here.