



# Guidelines on Islamic Financing for Agriculture



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# The Team

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# 1. Introduction

Pakistan is an agricultural country. Agriculture constitutes almost one-fourth of the country's GDP, contributes around 60% of exports and employs 44% of the labor force.

SBP, in collaboration with banks, has taken several initiatives that paid dividend in the form of significant increase in meeting the financing needs of this sector. Most of the banks have established separate agri / rural credit departments and are eager to adopt agri / rural credit as viable business line.

Islamic Banking has also taken a very good start and currently almost all major conventional banks have opened their stand-alone Islamic Banking Branches (IBBs) in addition to six full fledged Islamic banks operating in the country. There has always been a great demand from agricultural customers to have Islamic financing products for agriculture sector. The Islamic banks and IBBs have also shown great interest in adopting Shariah Compliant agriculture finance as a viable business line. However, there was lack of awareness of Islamic Modes of Financing among traditional agri financing bankers and Islamic Banks were naive to the requirements and business cycles of farm and non-farm sectors in the country. Therefore, a Task Force for Agri Financing was constituted by SBP, comprising of experts in agriculture & Islamic banking, and Shariah Advisors of IBIs. It was aimed to prepare guidelines to facilitate IBIs to develop their own Shariah compliant products for financing to agriculture sector. Task Force has prepared these Guidelines for Islamic Financing for Agriculture for Islamic Banks and conventional banks with Islamic Banking Branches/Windows (ref: IBD Circular No. 3 of 2007).

## 2. Islamic Financial Transactions

The conceptual framework of Islamic Finance sketches out a financial system where real exchange of goods or services takes place or the investment is done through investing in profitable ventures. Salient features of commonly used Islamic Financial Transactions are given below. Details of these modes of financing are available in IBD Circular # 2 of 2008 regarding Instructions and Guidelines for Shariah Compliance for IBIs. The definitions and essentials for Musaqat, Muzara'a and Mugharasa are under review by SBP Shariah Board, however, the provisional definitions of these modes have been incorporated as per Accounting and Auditing Organization for Islamic Financial Institutions' (AAOIFI) Shariah standards.

### 2.1.1. Trade-Based Modes of Financing

Trade-based modes of financing means providing finance through trading of goods and commodities. Under these modes, an IBI acts as trader and supplies goods on demand of the customer after purchasing the required goods/commodities from open market/vendor/supplier, either directly or through an agent. IBIs need to be proactive in dealing with this type of financing and ensure that the actions portray real roles of IBI as a trader of goods rather than mere lender of money. The IBI should ensure its involvement in trading and exchange of the subject goods/commodities through certain ways, like actual exchange of goods/commodities, taking ownership of the goods, possession of the subject goods/commodities and determination of price and subject matter of the sale in exact manners.

Major types of financing under trade-based financing are:

- MURABAHA
- MUSAWAMA
- SALAM
- ISTISNA

### **2.1.2. Issues in Trade-Based modes of financing:**

There are certain issues and problems in implementing the trade model of Islamic finance in Islamic banking industry, which can be addressed through adherence to the rules of Islamic financing. In order to facilitate proper implementation of trade based transactions, some of the critical concepts are explained as under: -

#### **a. Agency**

IBIs may not be efficient in purchasing the required goods from open market due to lack of trading experience, limited knowledge, wide range exposures, diversified demands, customer-specific needs and regulatory issues, therefore, under the Shariah rules, IBIs are allowed to hire the services of a third person like Macadam or an agency or an employee of the IBI whom this task can be assigned. The customer himself may also act as an agent of the IBI (in case of non-availability of an experienced and familiar person / agency with the business) who will conduct the sale on its behalf. The actions of an agent are as lawful as of the assigner and, therefore, all risks and benefits relating to the task assigned will be borne by the IBI.

#### **b. Physical Inspection & Possession**

To meet Shariah requirement for trade and assurance of practical application of trade, the concept of physical inspection of the subject commodities and goods has been recommended by Ulema and contemporary Shariah scholars. As it is necessary for the purchaser to know as to what he is going to purchase, and for the seller as to what he is going to sell, and also taking possession of the subject matter is an essential part in the trade based modes; physical inspection serves both the purposes. This physical inspection should be done ideally for every transaction but it may be a tedious process, therefore, inspection intervals may be decided by Shariah Advisor/department in a way the Shariah objective is achieved.

#### **c. Direct Payment**

This concept also strengthens the essence of trade. Under this concept, the price of goods / commodities purchased on request of customers is paid directly to the supplier, and IBI obtains any evidence or proof from the supplier that may confirm the actual sale. If direct payment to the supplier by the IBI is not feasible for valid reasons, such reasons shall be recorded by the IBI for making payment to the supplier through the agent for purchase of goods. However, proper utilization of funds and timely submission of documentary evidence for purchase of goods by the agent shall be ensured by the IBI.

#### **d. Timely execution of Offer and Acceptance**

Under Murabaha IBIs generally acquire ownership of the required goods through agent who can also be the customer himself. In such cases, if the goods are consumed before execution of offer and acceptance, the Murabaha transaction becomes void. Therefore, IBIs should ensure timely execution of offer and acceptance.

### **2.1.3. Rental Based Mode of Financing:**

Under rental based mode of financing, IBI purchases an asset and hands it over to the customer on rental basis. Ijarah (Leasing) is the only type of rental based mode of financing.

#### 2.1.4. Participatory Modes of Financing:

Participatory modes of financing are based on the basic theme of participation in profit and loss. Under the participatory financing, IBI provides funds for the activities and is entitled to share profit or loss in the business as per already agreed terms and conditions. Major modes of financing under participatory financing are as under:

- MUSHARAKA
- DIMINISHING MUSHARAKA
- MUDARABA
- MUSAQAT
- MUZARA'A
- MUGHARASA

### 3. Islamic Financing for Agriculture

Agriculture is broadly classified into crop and non-crop sectors. The two sectors are quite different in terms of financing requirements and cash flows. IBIs are involved in agriculture financing for both the sectors. Details are as under.

#### 3.1. Crop Sector

Financing for raising crops or horticulture by the farming community is classified under the crop sector credit. There are two main cropping seasons: Rabi and Kharif. The period for Kharif crops starts from March to August. Crops are sown in summer and harvested in late summer or early winter. The important Kharif crops are cotton, rice, sugarcane, Maize, Jawar and Bajra. The period from September to February is Rabi' season and main crops of the season are wheat, Barley, Gram, Rape/Mustard seeds and Tobacco.

Banks provide credit facility in crop/farm sector for (i) production i.e. financing for purchase of inputs or working capital, and (ii) development purposes i.e. financing for the purchase of equipments or other long term investments at the farm.

#### 3.2. Non Crop Sector

Financing for non-crop farming activities like livestock, fisheries, poultry, sericulture, apiculture etc. is classified under non-crop sector credit. Banks provide finance to farmers to meet financing needs of production as well as development under this category.

#### 3.3. Financing Needs

Farming community needs money to meet their day to day expenses i.e. working capital as well as medium and long term investments or term finance to effectively run their businesses. In addition to the financing needs, as given hereunder, IBIs may refer to SBP guidelines and instructions for crop and non crop sector activities like guidelines on livestock, fisheries, poultry, horticulture, etc. ([www.sbp.org.pk](http://www.sbp.org.pk))

##### 3.3.1. Working Capital

Financing to meet short term or day to day expense requirements of farmers for both crop and non-crop activities are classified under working capital. Repayment of working capital is usually linked with the cropping cycle and becomes due around harvesting of the crop. The major purposes under

working capital are financing for purchase of seeds, fertilizers, pesticides, labor, water, electricity, etc.

**Table 3.1: Suggested Islamic Modes of Financing for Working Capital**

Sr. #	Purpose	Suggested Islamic Modes of Financing
1	<p>Purchase of inputs for <i>crop production</i> i.e. seeds, fertilizers, insecticides, pesticides, herbicides, weedicides, manual sprayers etc.</p> <p><b>Poultry farming</b> which includes Purchase of feed, birds/ day old chicks, feed raw material, vaccination, vitamin and other medication for poultry birds, saw dust, wood, coal, water filter cartages, utensils for poultry bird feed, etc.</p> <p><b>Dairy Farming</b> which includes purchase and plantation of animal fodder and feeds, feed grinders, tokas, feed mixing machines and feed or milk containers; vaccinations, vitamins and other medications for animals; utensils for animal feeding, calf feeders, bangles, rope/iron chains, etc.</p> <p><b>Fish farming</b> includes purchase of fuel, ration and ice, packing/ processing/ cleaning items required for export of fish. Consumable items for curing and drying. Procurement of insulated boxes, purchase of plastic fish crates and plastic baskets.</p>	<p><b>Murabaha / Musawamah/ Salam/ Muzara'a</b></p> <p><i>Under Murabaha and Musawamah, the Islamic Banking Institution (IBI) buys these inputs from market and sells them to farmer on cost + profit basis. Preferably, this should be a direct sale and purchase i.e. the .IBI purchases it from open market and sells it to customer. This may be done through arrangement with suppliers of the input. In case of difficulties in direct sale and purchase, the Agency arrangement can be made under which the farmer (or any other person) will act as an agent of the IBI for purchasing the required goods.</i></p> <p><i>In case of Salam financing for Crop Production purposes, IBIs can also use Salam as a buyer of output.</i></p> <p><i>In case of Muzara'a financing for crop production purposes, IBI can also have an arrangement of Muzara'a with farmer.</i></p>
2	<p><b>Maintenance</b> of farm, machinery, implements and other working capital needs in terms of labor charges, water charges, utility charges, etc.</p>	<p><b>Salam</b></p> <p><i>Since these are running expenses and IBI may not be able to finance these directly, therefore, one of the possible modes is Salam. Under this mode, IBI buys the output to be deliverable in future against the full spot payment of the price which may be utilized by the farmer to meet his financing needs.</i></p>

### 3.3.2. Term Financing

Financing to meet medium to long term financial requirements of farmers for both crop and non-crop activities are classified under the term financing. Major purposes under term financing are financing for purchase of fixed assets viz. machinery, equipment, tractors, vans, etc. to be used by farmers. It also includes financing for the construction of sheds, farms, hatcheries and other investment on farm land by farmers. Mapping of various purposes of agricultural credit requirements with suggested Islamic modes of financing are given in the following table.

**Table 3.2: Suggested Islamic Modes of Financing for Term Financing**

Sr. #	Purpose	Suggested Islamic Modes of Financing
1	<p><b>Farm mechanization financing</b> i.e. Purchase of agri. implements, equipments i.e. trailers &amp; threshers, power tiller, power &amp; boom sprayers, plough, cultivators, rigrs/ drills, rotavators, driggers, cotton picker, saw machines for crate making, press machines for wheat straw and dry fodder, chiesel ploughs, potato planter, sugarcane planter, rice trance planter, self propelled reaper for harvesting wheat and rice crops, etc.</p>	<p><b>Murabaha / Ijarah/ Diminishing Musharaka (DM)</b>  <i>Financing for these requirements can be provided under Murabaha (for small / light equipments or for short-term financing and Ijarah/DM for big / heavy equipments or long-term financing). IBI, in case of Murabaha purchases, these equipments from market and sells it to farmer on cost + profit basis.</i>  <i>In case of Ijarah, IBI acquires the required asset and rents it out to the farmer. The ownership remains vested with IBI during the currency of Ijarah agreement besides ownership related risks and rewards.</i>  <i>In case of DM, IBI and farmer participate in the ownership of the required asset. The farmer contributes certain % of total price and the rest would be paid by IBI. IBI afterwards rents its share out to the farmer. Both parties share the risks on pro rata basis.</i></p>
2	<p><b>Transport Financing</b> includes: Purchase of tractors, refrigeration vans, farm cooling tanks, motorcycles for milkmen, small pickups, mini trucks and chiller carriers, etc.</p>	<p><b>Ijarah/ Diminishing Musharaka (DM)/ Murabaha</b>  <i>IBI acquires the required asset and rents it out to the farmer. The ownership related risks and rewards will be of the IBI.</i>  <i>In case of DM, IBI and farmer participate in the ownership of the required asset. The farmer contributes certain % of total price and the rest would be paid by IBI. IBI afterwards rents its share out to the farmer. Both parties share the risks on pro rata basis.</i>  <i>Murabaha can also be used for these assets IBI, in case of Murabaha purchases the required equipments from market and sells it to farmer on cost + profit basis.</i></p>
3	<p><b>Livestock Financing</b> includes: Purchase of mature milk yielding buffaloes or cows, replacement of existing buffaloes or cows, purchase of young buffaloes, cows, sheep and goats for rearing for meat production, milk storage chilling tanks, refrigeration plants and milk carrying containers, refrigerated meat storages and refrigerated containers, distribution vehicles such as motorcycles, pickups, refrigerated vans, etc.            Construction or procurement of permanent sheds, water tanks, water pumps, tube wells &amp;</p>	<p><b>Murabaha/ Diminishing Musharaka (DM)/ Istisna</b>  <i>Financing for these requirements can be provided under Murabaha (for small / light equipments or for short-term financing and Ijarah/DM for big / heavy equipments or long-term financing). IBI, in case of Murabaha purchases, these equipments from market and sells it to farmer on cost + profit basis.</i>  <i>In case of DM, IBI and farmer participate in the ownership of the required asset. The farmer</i></p>



Sr. #	Purpose	Suggested Islamic Modes of Financing
	generators, fencing & enclosures, establishment of slaughter houses (abattoirs), etc.	<p><i>contributes certain % of total price and the rest would be paid by IBI. IBI afterwards rents its share out to the farmer. Both parties share the risks on pro rata basis.</i></p> <p><i>In case of Istisna financing for assets (excluding livestock), IBI will be a seller/manufacture of the required assets (building, shed, storeroom etc.) and may appoint a builder/supplier to construct/supply the required asset for onward sale to the farmer.</i></p>
4	<b>Installation</b> of Tube wells/Turbine, Sprinkle/Drip irrigation system, water management, solar energy plants, pumps for irrigation system, etc.	<b>Ijarah/ Murabaha/ Diminishing Musharaka/ Ijarah-al-Ashkhaas (Services Ijarah)</b> <i>may be used depending upon the nature of financing needs of the farmer.</i>
5	<b>Lining</b> of water courses cost of land leveling/development, etc.	<b>Salam/ Istisna</b> <i>To meet these running expenses, Salam is a suitable Islamic modes of financing, whereby the IBI will buy the output deliverable in future against the full spot payment of the price. The amount received by the farmer as price for his produce/ output may be used to fulfill his financing requirements.</i>  <i>Istisna is also possible for financing the construction/lining of water courses.</i>
6	<b>Forest development and enhancement.</b>	<b>Diminishing Musharaka/ Murabaha</b> <i>DM is suitable if the customer needs financing for purchase of land to develop forest. In case of DM, IBI and farmer participate in the ownership of the required asset. The farmer contributes certain % of total price and the rest would be paid by IBI. IBI afterwards rents its share out to the farmer. Both parties share the risks on pro rata basis.</i>  <i>DM on Sale and lease back basis should be approved specifically by the Shariah Advisor.</i>  <i>Murabaha can be used for financing of plants for growing forest and other inputs.</i>
7	<b>Poultry Farming</b> which includes construction of broiler, layer, breeder & hatchery farms and feed mills, control sheds, automatic drinkers /tube feeders, generators, ventilators, table/ breeder eggs storage refrigeration plants, purchase of machinery/ equipment for poultry farm/	<b>Diminishing Musharaka</b> <i>For construction and acquisition of physical assets, DM is a suitable mode of financing.</i> <b>Murabaha/ Ijarah/ Istisna</b> <i>For physical assets' financing.</i>

Sr. #	Purpose	Suggested Islamic Modes of Financing
	hatchery/ feed mill, transport vans - eggs and poultry carrying van, distribution vehicles such as motorcycles &, pickups, deep freezers, slaughtering & de- feathering machine, etc.	
8	<b>Fish Farming</b> includes Purchase of motor boats/fishing trawlers. Purchase of marine engines (outboard and inboard), replacement of engines and spare parts, construction of cold storage by fishermen with the use of insulation material/sheets for walls/ roof, purchase of other deck equipments like winch, wire rope, gallows, net handler, navigational lights, communication equipments, radar, life jackets, life boats, anchors, direction finders (compasses), echo sounded (fish finders), life buoys, insulation materials, purchase of nets – trawlers net/purse-seine/grill nets, purchase of chilling/freezing plants, fish storage centre (distribution centre). Fish/shrimp hatcheries, purchase of mobile insulated, pickups/vehicles etc.	<b>Diminishing Musharaka/ Murabaha/ Ijarah/ Istisna</b> <i>All these are possible modes of financing of physical assets.</i>
9	<b>Dairy Farming.</b> (Milk Processing Plants, other machineries, etc.)	<b>Ijarah/ Diminishing Musharaka/ Murabaha/ Istisna</b> <i>All these are possible modes of financing of physical assets.</i>
10	Establishing Green Houses.	<b>Ijarah/ Diminishing Musharaka/ Murabaha/ Istisna</b>
11	Construction of godowns and cold storages.	<i>All these are possible modes of financing of physical assets.</i>
12	Development of Dairy and livestock farms.	
13	Construction and improvement of livestock laboratories.	
14	Setting up seeds processing and milk chilling units.	
15	Installation of fruit and vegetable machinery.	

## 4. Implementation

Implementation of Islamic Modes of Financing into Agriculture Sector would require knowledge of their application and procedure. Following table illustrates the same.

**Table 4.1: Islamic Modes of Financing, Application and Procedure**

Islamic Mode of Financing	Application	Procedure
<p><b>MURABAHA:</b>  <i>Murabaha (مرا بحة) means a sale of goods by a person to another under an arrangement whereby the seller is obliged to disclose to the buyer the cost of goods sold either on cash basis or deferred payment basis and a margin of profit included in the sale price of goods agreed to be sold.</i></p>	<p>Murabaha is used for Credit Sale by the IBIs. The subject matter i.e. goods/assets are selected by customer and purchased by IBI and then sold to customer on deferred payment basis.</p> <p>The concept of agency is used in Murabaha. A third party or the customer is appointed as an agent to act on behalf of the IBI.</p>	<ol style="list-style-type: none"> <li>1. Signing of Master Agreement for Murabaha Financing between the client and the IBI.</li> <li>2. Appointing an agent to purchase commodities on IBIs behalf by executing Agency Agreement, if required.</li> <li>3. Client gives Purchase Requisition to the IBI whenever a commodity is required.</li> <li>4. The IBI or the agent, as the case may be, purchases the commodity and takes possession.</li> <li>5. In case of the agent, the agent informs the IBI after purchase that he has purchased the commodity on its behalf.</li> <li>6. Physical inspection (if possible) by the IBI of the commodities.</li> <li>7. The client makes an offer to purchase the commodity from the IBI or the IBI offers to sell the same at an agreed price (i.e. Cost +Profit).</li> <li>8. Acceptance by the IBI/client and the sale is concluded. The ownership plus the risk of the commodity is transferred from the IBI to the client.</li> <li>9. The customer pays the price as per the agreed upon schedule of payment</li> </ol>
<p><b>MUSAWAMAH:</b>  <i>Musawamah (مساو مة) is a general kind of sale in which price of the commodity to be traded is stipulated between seller and the buyer without any reference to the price paid or cost incurred by the former.</i></p>	<p>The application of Musawamah is almost similar to Murabaha. This mode is normally used in cases where it is difficult to determine the actual cost of the subject matter.</p>	<ol style="list-style-type: none"> <li>1. Signing of Master Agreement for Musawamah Financing between the client and the IBI.</li> <li>2. Appointing an agent to purchase commodities on IBIs behalf by executing Agency Agreement, if required.</li> <li>3. Client gives Purchase Requisition to the IBI when a specific commodity is required.</li> <li>4. The IBI or the agent, as the case may be, purchases the commodity and takes possession.</li> <li>5. In case of the agent, the agent informs the IBI after purchase that</li> </ol>

Islamic Mode of Financing	Application	Procedure
		<p>he has purchased the commodity on its behalf.</p> <ol style="list-style-type: none"> <li>6. Physical inspection (if possible) by the IBI of the commodities.</li> <li>7. The client makes an offer to purchase the commodity from the IBI or the IBI offers to sell the same at a mutually agreed price.</li> <li>8. Acceptance by the IBI/client and the sale is concluded. The ownership plus the risk of the commodity is transferred from the IBI to the client.</li> <li>9. The customer pays the price as per the agreed upon schedule of payment.</li> </ol>
<p><b>SALAM:</b> <i>Salam</i> (سلم) (advance payment against deferred delivery of goods) means a kind of sale whereby the seller undertakes to supply specific goods to a buyer at a future date in consideration of a price fully paid in advance at the time the contract of sale is made.</p>	<p>Salam can be used for facilitating farmer customers who need working capital/ running finance. The purchaser has an advantage of purchasing particular commodity at a relatively lower price. On the other hand, the seller gets early price of those items / commodities which have not been produced yet. This may help him meet the working capital requirements, etc.</p>	<ol style="list-style-type: none"> <li>1. The Salam Agreement is executed between the client as a seller of commodities and the IBI as a buyer of these commodities.</li> <li>2. The agreement describes complete specifications of the commodity, sale price and date and place of delivery.</li> <li>3. IBI pays the full sale price to client.</li> <li>4. Client after receiving advance price can utilize the amount for his needs.</li> <li>5. At maturity, client delivers the commodities as per agreement.</li> </ol>
<p><b>ISTISNA:</b> - <i>Istisna</i> (استصناع) is a mode of sale, at an agreed price, whereby the buyer places an order to manufacture, assemble or construct, or cause so to do anything to be delivered at a future date.</p>	<p>Istisna is a mode of financing that may be used for assets/goods which require processing/ value addition. It may be used for financing for farm buildings, machinery, fabrication and other types of assets that are used in agriculture sector. The payment of price will be as per mutual agreement e.g. full in advance, fully deferred to delivery, partially advance and partially at delivery, in tranches or full payment after delivery.</p>	<ol style="list-style-type: none"> <li>1. The Istisna Agreement is executed between two parties, one as a seller/manufacturer of goods and the other as a buyer of these goods.</li> <li>2. The agreement describes complete specifications of the goods/assets or manufactured items sale price, date and place of delivery.</li> <li>3. IBI pays price as per mutual agreement.</li> <li>4. At maturity, client delivers commodities as per agreement.</li> </ol>

Islamic Mode of Financing	Application	Procedure
<p><b>IJARAH:</b> - <i>Ijarah ( اجاره ) is a contract whereby the owner of an asset, other than consumables, transfers its usufruct to another person for an agreed period for an agreed consideration.</i></p>	<p>Contrary to trade-based modes of financing, Ijarah is an ongoing contract which has flexibility of increase in rental amount during the tenure. Ijarah is a very useful mode of financing specially for long term financing with the option to change the rental as per rules of Ijarah. Usually long-term assets are not feasible for trade based modes since the bench-mark changing scenarios do not affect the price in any manner, while it can be taken in consideration in Ijarah. In agri sector, the instrument of Ijarah can be used for almost all types of machinery and equipments financing needs like tube-well; tractor or building and land financing, etc.</p>	<ol style="list-style-type: none"> <li>1. Signing of Undertaking to Ijarah according to which the client undertakes to take certain asset on lease from the institution upon arrival of the asset.</li> <li>2. If required, the IBI and the client may enter into an agency agreement according to which the client would purchase asset on behalf of IBI.</li> <li>3. After purchasing of a particular asset, the IBI and client execute an Ijarah Agreement in which they agree on rental and tenure.</li> <li>4. The IBI, after agreement delivers the asset to the client for use.</li> <li>5. At the end of lease period, normally the IBI and the client enter into a separate agreement of sale through which the leased asset is sold to the client against an agreed price.</li> </ol>
<p><b>MUSHARAKA:-</b> <i>Musharaka means relationship established under a contract by the mutual consent of the parties for sharing of profits and losses arising from a joint enterprise or venture.</i></p>	<p>Musharaka can be used for financing needs from working capital to project finance, and from short term financing to term finance. Issuance of certificates and other kinds of financial needs can also be structured under this mode.</p>	<ol style="list-style-type: none"> <li>1. One or more entrepreneurs approach an IBI for the required finance for a project.</li> <li>2. The IBI, along with other partners, provides complete or partial finance.</li> <li>3. All partners, including the IBI, have the right to participate in the management of project.</li> <li>4. Profits are to be distributed according to the agreed profit distribution ratio/formula, which needs not be the same as per their capital proportions.</li> <li>5. Losses, however, are to be shared on pro rata basis.</li> <li>6. At the end of the period, the principal with profit proceeds is to be distributed among the partners.</li> </ol>
<p><b>MUDARABA:-</b> <i>Mudaraba means an arrangement in which a person participates with his money (called Rabbulmal) and another with his efforts (called Mudarib) for sharing in profit from investment of these</i></p>	<p>Mudarba like Musharaka can be used for most of the financing needs.</p>	<ol style="list-style-type: none"> <li>1. Two parties execute Mudaraba Agreement by way of which they decide that one party will provide Mudaraba capital and other party manages the capital for a particular period.</li> <li>2. Profit rate is to be decided as</li> </ol>

Islamic Mode of Financing	Application	Procedure
<p><i>funds in an agreed manner.</i></p>		<p>agreed between them.</p> <ol style="list-style-type: none"> <li>3. Mudarib has management rights and, therefore, he will utilize the partnership capital in an agreed manner.</li> <li>4. At the end of the tenor, Mudarib will return principal and pre-agreed share of the profit to the Rabb-ul-Maal.</li> <li>5. If the business incurs a loss, it will be borne by Rabb-ul-Maal if there happens no negligence on the part of Mudarib.</li> <li>6. Investor is not liable for the losses beyond the capital he has contributed.</li> </ol>
<p><b>MUSAQAT* (Irrigation):-</b>  <i>Musaqat (Irrigation) partnership is a partnership that depends on one party presenting designated plants/trees that produce usable products/items/goods/output to another in order to work on their irrigation in consideration for a common defined share in fruits.</i></p>	<p>This mode is applicable in agriculture sector in a very effective manner, especially for orchard financing. A specific or predetermined share of the enterprise output (e.g. a third or a half, etc.) will go to the provider for labor and enterprise. This will be clearly positioned in the contract.</p>	<p>Under this mode, multiple options are available based on the ownership of land/orchard, rental arrangements, labor, etc. Therefore, defining particular steps would require inputs from the stakeholders.</p>
<p><b>MUZARA'A* (Sharecropping):-</b>  <i>Muzara'a (Sharecropping) is partnership in crops in which one party presents land to another for cultivation and maintenance in consideration for a common defined share in the crop.</i></p>	<p>Muzara'a is an acceptable legal contract suitable for financing agricultural operations. It can take several forms. For instance, contract based arrangement can specify that land and other physical factors of production for the enterprise could come from one party while labor could be provided by the other party.</p> <p>Incidence of a three-party Muzara'a partnership in which the first party provides land, the second provides a combination of required physical inputs, and the third provides labor.</p>	<p>For Muzara'a contracts to be legally viable, several critical conditions must be spelled out. They are as under:</p> <ol style="list-style-type: none"> <li>1. The functions and obligations of each individual or party in the contract must be clearly and unambiguously defined.</li> <li>2. The location and characteristics of the land to be cultivated under Muzara'a must be clearly identified and submitted to the party that is to implement the operation.</li> <li>3. The production goal of the enterprise must be defined in terms of end products i.e. crops or live stock to be grown.</li> <li>4. The period in which the Muzara'a contract is to be effective must be defined.</li> </ol>

Islamic Mode of Financing	Application	Procedure
		Method of distribution of output must be stated clearly in the contract.
<p><b>MUGHARASA*</b> (Agriculture): - <i>Mugharasa (agricultural) partnership is a partnership in which one party presents a treeless piece of land to another to plant trees on it on the condition that they share the trees and fruits in accordance with a defined percentage.</i></p>	<p>Mugharasa is a legal contract suitable for financing development of orchards/ trees. Under the arrangement, it is specified that land and other physical factors of production can come from one party while labor can be provided by the other party.</p>	<p>Mugharasa contract requires following conditions to be followed:</p> <ol style="list-style-type: none"> <li>1. The functions and obligations of each individual or party in the contract must be clearly and unambiguously defined.</li> <li>2. The location and characteristics of the land to be cultivated under Mugharasa must be clearly identified.</li> <li>3. The production goal of the arrangement must be defined in terms of end products.</li> <li>4. The period in which the Mugharasa contract is to be effective must be defined.</li> <li>5. Method of distribution of output must be stated clearly in the contract.</li> </ol>

\* The definitions and essentials for Musaqat, Muzara'a and Mugharasa are under review by SBP Shariah Board, however, the provisional definitions of these modes have been incorporated as per Accounting and Auditing Organization for Islamic Financial Institutions' (AAOIFI) Shariah standards.

## 5. Eligibility of Customer

Individuals/ partnership concerns and all types of legal entities engaged in agriculture related activities, having sufficient knowledge and relevant experience are eligible to get financing under the Islamic financing scheme. As per Prudential Regulations for agriculture financing, subject guidelines shall not include financing to traders and intermediaries engaged in trading/ processing/ grading/packaging/marketing of agricultural commodities. Such financing will fall under Corporate/ Commercial or SME financing and will be subjected to compliance of corporate/ commercial/ SME regulations. However, financing under the guidelines can be extended to entities ( including corporate firms, partnerships, and individuals) engaged in farming activities as well as processing, grading, packaging and marketing of mainly 75% of their own horticulture produce. Financing facilities may be extended, provided IBI is satisfied with the capacity of the customer /sponsor to manage and run the horticulture activities subject to the following conditions:-

- Customer should be a holder of computerized NIC while usual requirements for corporate clients would apply.
- Customer should not be a defaulter of any IBI / financial institution. This condition may be relaxed in case the IBI is satisfied with creditworthiness of the customer and that earlier default was circumstantial and not willful.
- IBI is satisfied and feels comfortable with the farmer and guarantors (where applicable) identity character, reputation and creditworthiness.

It is advisable that IBI should have detailed understanding and information about the customer,

his/her capacity to effectively use and repay the debt from the projected cash flow, and/ or any other possible income streams.

## 6. Profits and Incomes

Under Islamic Modes of financing IBIs are prohibited to charge any riba or interest on their financing. However, it can share the profit/loss being an investor in the business or can charge rentals and other service charges at pre agreed rates on case to case basis. Such incomes are based on financing policy of the IBIs and regulations of SBP.

## 7. Security and Collateral

IBIs should secure their financing/investments by accepting security and collateral as per their financing policies which may include the following: -

- Charge on agricultural land through passbook system.
- Mortgage of rural, urban or commercial property.
- Hypothecation/mortgage of assets e.g. processing, grading and packaging machinery, generator & refrigerators, etc.
- Lien on IBI deposit, IBI guarantee and/or;
- Individual/Group Guarantee.
- Any other tangible collateral security acceptable to IBI.

## 8. Insurance/Takaful and other Documentation

IBIs can secure their financing by obtaining documents as per their financing policies and SBP regulations/ guidelines. For the convenience of IBIs, model agreements for Islamic modes of financing are also available at SBP website (<http://www.sbp.org.pk/press/essentials/Essentials-Mod-Agreement.htm>). Completion of documentation formalities shall be the responsibility of the IBI. Further, insurance/Takaful cover should be obtained for the assets to safeguard the interest of the IBI and the customer from risks of losses due to circumstances beyond the control of the customer. It is advisable that IBIs should sensitize and educate their customers about the importance of having an insurance/Takaful cover in this regard.

## 9. Monitoring and Recovery System

Effective monitoring and recovery system are critical for ensuring quality of financing portfolios. The first recourse for the IBI to recover its financed amount is the customer and his/her cash flows. An effective monitoring system, follow-up and frequent interactions with the customers are critical for ensuring recovery of agricultural financing. In addition to the traditional correspondence and letter/notice based recovery mechanism, IBIs may also initiate following recovery process against the delinquent borrowers:

- Persuading customers / guarantors through personal contacts.
- Issuance of legal notices.
- Recovery through Tehsildar/ Mukhtiarkar/ after declaration of financed amount as Arrears of Land Revenue in accordance with Section 4(7) of Loans for Agriculture Purposes Act 1973 by the Collector / Asstt. Collector / Deputy Commissioner in case of financing against passbook.



- Filing recovery suits in Banking Courts of competent jurisdiction.
- Recovery in accordance with Financial Institutions (Recovery of Finances) Ordinance 2001.
- Any other legal remedies available to the IBI.

Banks are required to develop sound and reliable monitoring and tracking system to ensure proper utilization & quality of financing and its timely repayments.

## **10. Compliance with SBP Regulations**

Bank shall ensure that financing to agriculture sector under the subject guidelines will be made in compliance with SBP's regulations and approval of the products from their Shariah Advisors.

**Instructions for Profit & Loss  
Distribution and Pool Management  
for Islamic Banking Institutions  
(IBIs)**



**State Bank of Pakistan**  
Islamic Banking Department  
[www.sbp.org.pk](http://www.sbp.org.pk)

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## **INTRODUCTION**

The Mudaraba based deposits constitute a major part of Islamic banking institutions' (IBIs) deposit mix. The contractual arrangement of such deposits with the IBI requires sharing of profits in financings, investments and placements etc. funded by such deposits between the IBI as Mudarib and the depositors as Rabbulmal, as per pre-agreed profit-sharing ratio. In case of loss, the same is borne by the depositors in proportion of their investments unless caused by the negligence and misconduct by the IBI in managing the depositors' funds. Considering this peculiar relationship where income earned by the IBI through financing investment and placement has a direct impact on depositors' return; there is a need to have well defined, transparent and standardized policies and practices for profit & loss computation and distribution across the Islamic banking industry.

As the depositors' funds are deployed in one or more pools, each having distinct risk and reward features, the IBIs' pool management<sup>1</sup> policies and practices significantly impact the profit and loss distribution. Each pool is like a virtual enterprise having explicitly demarcated sources of funds, ownership of specific assets and income and expenses. At present, different pool management practices are prevalent in the industry, which coupled with limited disclosures on the practices give rise to reputational risk for the Islamic banking industry. Considering the need to bring standardization and improve transparency in profit & loss distribution and pool management practices, the following instructions have been developed, which are applicable on IBIs with immediate effect.

### **1. CREATION OF POOLS**

- 1.1. IBIs shall have a well-defined profit and loss distribution and pool management framework for creation of one or more pools of assets to be financed by different types of Mudaraba-based (individual, corporate or financial institutions) deposits. The framework shall interalia specify the objectives, investment strategy, and risk characteristics of each pool. It shall also explicitly define the basis for (i) allocating different types of deposits to different pools (ii) assigning weightages to each deposit category of a particular pool. The framework shall be approved by the Shariah Advisor and Board of Directors (BOD) of the IBI and a duly approved copy of the same shall be submitted to Islamic Banking Department, SBP within three months of issuance of these instructions. Further, changes (if any), warranted in the framework shall also be approved by Shariah Advisor and BOD under intimation to SBP within 15 days of such change(s).
- 1.2. All the pools to be created by the IBI shall be in conformity with the aforementioned framework and shall be created through a memorandum signed by the authorized senior executive to be defined in the framework documenting the objectives, investment strategy, tenor (if any), the risk and reward features, Profit Sharing Ratio (PSR), weightages and basis thereof. Till the finalization of the framework in light of these instructions, the pools may be created through the memo with the approval of the president or relevant senior executive authorized by him/ her. In case of Islamic Banking Division (IBD) of conventional banks, the memo may be approved by Head IBD in the interim period.
- 1.3. The pool to which a deposit is to be allocated shall be identified at the time of accepting the deposit and allocation of such deposit to the respective pool on the same day shall be ensured.

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<sup>1</sup> The pool management in IBIs refers to systematic creation of one or more pools for different categories of Mudaraba deposits, as per risk and reward expectations of such depositors.

- 1.4. The IBIs shall have in place an adequate IT based system which interalia suitably caters to the requirements of allocation of (a) deposits, (b) financing, investments and placements, (c) income and expenses and (d) movement of assets to/from different pools. The system limitations, if any, shall be addressed within one year of issuance of these instructions. The pools till such time shall be managed through proper chart of accounts or cost centers. The relatively smaller sized IBIs may however approach SBP for relaxation/extension in time frame for development of the IT system.
- 1.5. The Mudaraba based deposits shall be invested in earning assets like financing, investment etc. Such deposits shall not be invested in non-trading fixed and other assets like land, building, furniture fixtures, computers and IT systems etc. The IBI as Mudarib is responsible to finance all such costs/assets from its own sources/equity.
- 1.6. The Cash Reserve Requirement (CRR) as prescribed by SBP from time to time shall be part of the pool financed through deposits attracting CRR.
- 1.7. The IBIs may commingle its own equity (available in liquid/cash form) with the depositor's funds in a pool. As IBI assumes all the risks of current deposits (mobilized on Qarz basis), it can use such deposits as its equity for the purpose of profit and loss computation and distribution.
- 1.8. The account opening form for Mudaraba based deposits or any other document for the purpose shall include depositor's explicit permission to IBI to commingle its funds or the funds of other depositors including the current deposits within the Mudaraba pool as and when required.
- 1.9. To honor redemption/withdrawal requests, the pool(s) shall constitute at least 20% tangible/tradable assets such as Ijarah assets, Ijarah Sukuk, Diminishing Musharaka assets, etc. However, this benchmark may be brought down to a minimum of 10% of the pool's assets subject to approval of the Shariah Advisor of the IBI.
- 1.10. Each pool to be created and managed by an IBI shall be treated as a virtual enterprise having its own assets, liabilities, income and expenses, which are identifiable, balanced and verifiable at all time. Further, transaction records for each pool shall be maintained separately. It shall also be ensured that IBI's equity in different pools is reconciled with the total equity appearing in accounting records.
- 1.11. The inter pool transfers of assets shall be made through a memorandum which shall interalia include the need and objective of inter pool sale/purchase of assets and shall be authorized by committee of least two relevant senior executives.
- 1.12. IBIs may create treasury pools for interbank transactions through necessary authorization level as defined in the pool management framework. These pools however need to be maintained separately due to its peculiar nature i.e. liquidity management.
- 1.13. Subsidized financing facilities extended to IBI's employees shall be funded from bank's own resources including current deposits. Mudaraba based deposits other than remunerative current account deposits shall not be used for extending any subsidized financing to employees i.e. staff loans and other funded facilities given to staff under IBIs' HR policies.
- 1.14. It is preferable to create separate pools for Foreign Currency (FCY) deposits. The FCY deposits will be managed as per existing instructions of SBP Foreign Exchange Manual.

## **2. IDENTIFICATION AND ALLOCATION OF POOL RELATED INCOME & EXPENSES**

- 2.1. The allocation of income and expenses to different pools shall be made based on pre-defined basis and accounting principles / standards.
- 2.2. The direct expenses shall be charged to respective pool, while indirect expenses including the establishment cost shall be borne by IBIs as Mudarib. The direct expenses to be charged to the pool may include depreciation of Ijarah assets, cost of sales of inventories, insurance / Takaful expenses of pool assets, stamp fee or documentation charges, brokerage fee for purchase of securities/commodities etc, impairment / losses due to physical damages to specific assets in pools etc. However, this is not an exhaustive list; IBI pool management framework and the respective pool creation memo may identify and specify these and any other similar expenses to be charged to the pool.

### **2.3. Investment & Financing Losses:**

- 2.3.1. The general and specific provisions created against non-performing financings and diminution in the value of investments as under prudential regulations and other SBP directives shall be borne by the IBIs as Mudarib. However, write-offs of financings and loss on sale of investments shall be charged to respective pool along with other direct expenses.
- 2.3.2. The losses on financings and investments due to misconduct/negligence/breach of contract by IBI shall not be charged to the pool; the IBI as Mudarib shall be responsible for absorbing such losses. The financing approved and disbursed and investment made in contravention to the prudential regulations or the IBI's own policies, procedures and processes as determined by internal auditor, external auditor and/or SBP inspection team will be treated as the negligence on the part of the IBI.

## **3. PROFIT/LOSS ALLOCATION BETWEEN DEPOSITORS' FUND AND IBI'S EQUITY**

- 3.1. In case of comingling of IBI's equity with depositors' fund in a pool, the Net Income/ loss of Pool shall be allocated between IBI's equity and the depositors' fund in proportion to their respective share in pool.
- 3.2. Profit and loss on the Mudaraba based deposits shall be computed and distributed on the basis of average balance in the depositor's account during the profit computation period.

## **4. PROFIT SHARING RATIO & WEIGHTAGES**

### **4.1. Profit Sharing Ratio (PSR)**

- 4.1.1. The Profit Sharing Ratio (PSR) between depositors (Rabbulmal) and IBIs (Mudarib) shall be decided and announced at least 3 working days before the beginning of period concerned. Further, no downward revision in the PSR agreed with the depositors (particularly the term depositors) at the time of acceptance of deposit shall be made during the deposit tenor. In case such a revision is necessary the depositors shall be allowed to withdraw their investments without any deduction / forfeiture of profits /penalties etc.
- 4.1.2. The Mudarib share shall be admissible only on profit allocated to depositors' funds from the pool's net income (please see the Profit Computation and Distribution Process Flow at Annexure-I). Further, the Mudarib share shall not exceed 50% of the Distributable Profit.

#### 4.2. Weightages

- 4.2.1. The weightages to different categories of deposits in a pool shall be assigned based on parameters / criteria defined in the pool management framework.
- 4.2.2. The weightages shall be announced at least 3 working days before the beginning of period concerned and shall not be changed during the period.
- 4.2.3. The maximum weightage to the Mudaraba based deposit of any nature, tenor and amount shall not exceed 3 times of the weightages assigned to saving deposits.<sup>2</sup> The remunerative current accounts shall not form part of Mudaraba based deposits for the purpose of this clause.
- 4.2.4. IBIs shall explicitly mention in their profit distribution and pool management framework, the treatment and remuneration basis for premature / early encashment of term deposits during the period concerned. This shall however be ensured that the profits distributed and allocated as a result of constructive liquidation of the pool shall not be called back / forfeited in any situation.

### 5. PROFIT SMOOTHENING

#### 5.1. Profit Equalization Reserve (PER):

- 5.1.1. IBIs may maintain Profit Equalization Reserve (PER) from Net Income of Pool i.e. the gross income less direct expenses and losses if any.
- 5.1.2. The monthly contribution into PER will not exceed 2% of Net Income, and the accumulated balance of PER shall not exceed 30% of Islamic Bank's Equity or Islamic Banking Fund (IBF) of Islamic Banking Division of Conventional banks
- 5.1.3. 50% of the balance available in PER shall be reflected as liability and remaining 50 % as reserve in the books of the IBI.
- 5.1.4. The funds of PER shall only be invested in Shariah compliant SLR eligible securities and the returns earned on these funds will also be credited into the PER account. The profit sharing ratio for IBI as Mudarib shall not be more than 10% for managing PER.
- 5.1.5. The IBIs may fully or partly utilize/the amount of PER to improve the returns to the depositors during periods when the pool's profits are below market expectations.
- 5.1.6. The clauses related to PER (if any) shall be made part of account opening form or any other document for this purpose.

#### 5.2. Transfers from Mudarib Share:

- 5.2.1. IBI may forego up to 60 percent of its Mudarib share as Hiba to meet the market expectation in case of lower than expected/market returns earned by the pool. However, the IBIs maintaining PER will reduce their Mudarib share only if the PER is insufficient to improve the profit payouts to the depositors.

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<sup>2</sup> The deposits that used to attract SBP instructions for payment of minimum returns

- 5.2.2. This Hiba by the IBI shall however, be distributed across the board to all the deposit categories in a pool.
- 5.3. IBIs will gradually phase-out the practice of offering special or individual Hiba to the priority customers. Therefore, special or individual Hiba for CY 2012 will be frozen to previous year's level in absolute terms i.e. upto the actual amount of special or individual Hiba during CY 2011, upto 50% in 2013, upto 25% in 2014 and 0% in 2015. Further, special Hiba if any, to be offered shall not be more than 2% over and above the actual return earned by the depositor based on performance of the pool and respective weightages and the reasons for allowing such special Hiba shall be documented, and shall be subject to specific and explicit approval of the Shariah Advisor . The actual amount of special or individual Hiba given during CY 2011 shall be submitted to Islamic Banking Department along with the Shariah Advisor and BoD approved Framework as required in clause (1.1).

## **6. INVESTMENT RISK RESERVE (IRR)**

- 6.1. As the credit and market risk of the financing and investment portfolio is to be borne by depositors being Rabbulmal in the Mudaraba arrangement with the IBI, there may be scenarios where the pool may incur losses primarily due to unusually large write-offs and/or significant losses on sale of the pool's investments. Thus to absorb/off-set such losses IBIs may create the Investment Risk Reserve (IRR) to cover the future investment losses and develop models and basis to determine the size of the IRR and the periodic contributions to be made to build up the IRR. Till the development of the model, IBIs may contribute towards IRR an amount up to 1.0 percent of the profit available for distribution amongst the pool's depositors after deduction of mudarib share in every profit period.
- 6.2. The IRR, if any created and maintained shall be reflected as liability by IBIs.
- 6.3. The funds of IRR shall only be invested in Shariah compliant SLR eligible securities and the returns earned on these funds will also be credited in the IRR account. The profit sharing ratio for IBI as Mudarib shall not be more than 10% for managing IRR.
- 6.4. The losses, if any, incurred by the pool shall be covered from the balance available in IRR.
- 6.5. The clauses related to IRR shall be made part of account opening form or any other document for this purpose.

## **7. VERIFICATION/AUDIT**

The distribution of profit and loss to the depositors on the basis of these instructions shall be subject to verification/audit jointly by the Shariah Advisor and External Auditor.

## **8. DISCLOSURES**

### **8.1. Disclosures in Notes to Financial Statements:**

- 8.1.1. The number and nature of pools maintained by the IBI along with their key features and risk & reward characteristics.
- 8.1.2. Avenues/sectors of economy/business where Mudaraba based deposits have been deployed.



- 8.1.3. Parameters used for allocation of profit, charging expenses and provisions etc. along with a brief description of their major components.
- 8.1.4. Mudarib Share (in amount and Percentage of Distributable income).
- 8.1.5. Amount and percentage of Mudarib share transferred to the depositors through Hiba (if any).
- 8.1.6. Profit rate earned vs. profit rate distributed to the depositors during the year.

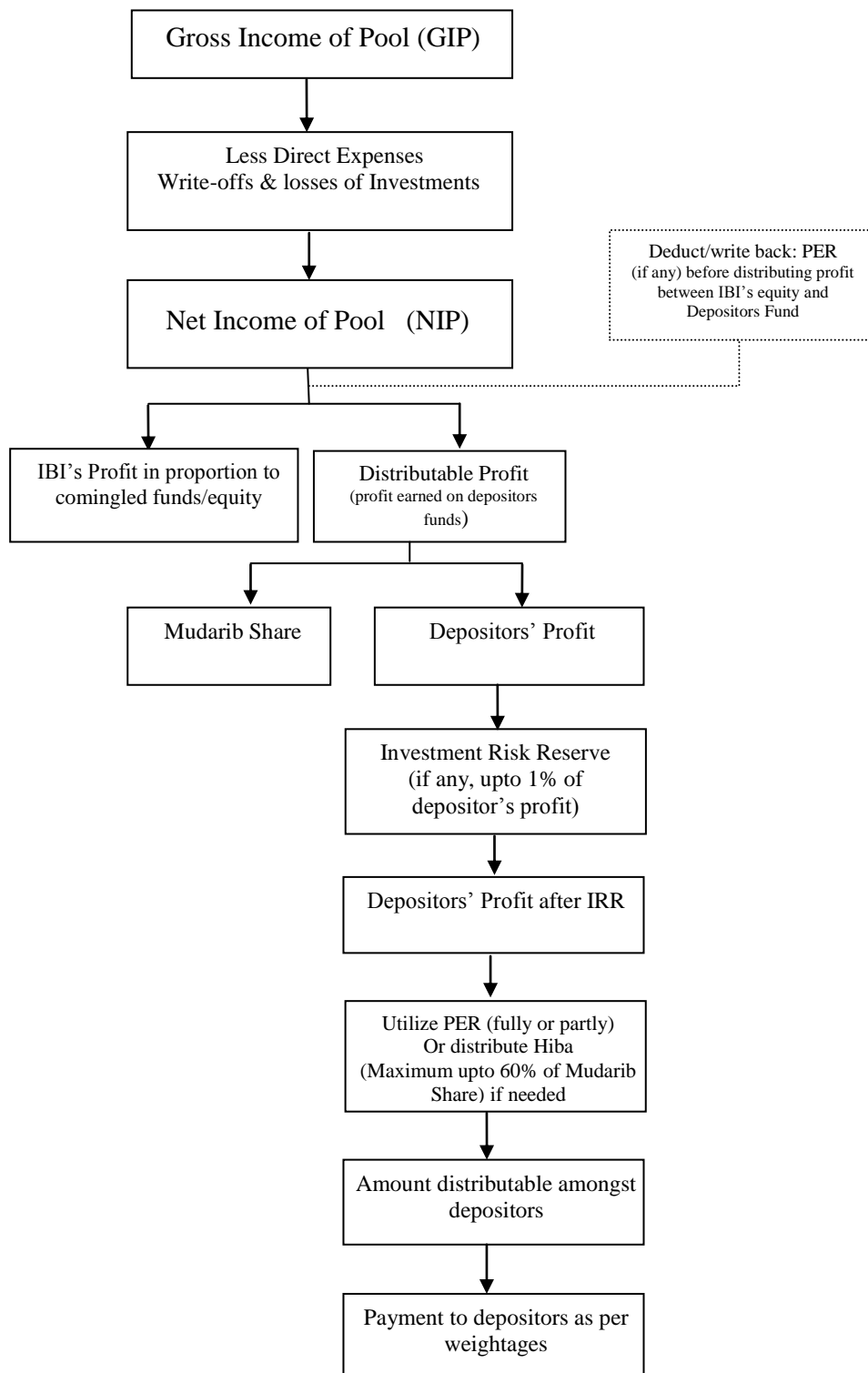
**8.2. Disclosures on IBI's website and notice board of each branch:**

- 8.2.1. Percentage of Mudarib Share for period concerned and at least two previous periods in each category of deposits.
- 8.2.2. Weightages assigned to each category of deposits for period concerned and at least two previous periods.
- 8.2.3. The actual monthly/periodic profit/loss distributed to each category of deposits during last 2 years.
- 8.2.4. PER and IRR policies (if in place).

**XXXXXXXX**

Profit Computation and Distribution Process Flow:

Appendix-I



**GUIDELINES FOR OPENING OF STAND ALONE BRANCHES  
FOR ISLAMIC BANKING BY EXISTING BANKS**

With the objective of promoting Islamic banking in Pakistan, the following Guidelines for opening of Stand-alone branches for Islamic Banking by existing commercial banks have been prepared by State Bank of Pakistan. The banks desirous of offering Shariah compliant products and services are required to apply to the State Bank for issuance of a license under these Guidelines.

**1. Definitions**

The following terms, as used in these Guidelines, shall have the following meanings:-

- i) "banks" means commercial banks, including branches of foreign banks operating in Pakistan, which desire to offer Shariah compliant products and services;
- ii) "IBB" or "branch" means the Islamic Banking Branches of commercial banks, which offer the Shariah compliant products and services only;
- iii) "Shariah compliant products and services" means banking products and services offered by banks to their clients duly approved by their Shariah adviser/Shariah Supervisory Committee;
- iv) "IBF" means the Islamic Banking Fund set up by the banks to fund the operations of their Islamic Banking Branches;
- v) "IBD" means the Islamic Banking Division set up at the head office of the banks/ country offices in Pakistan to administer, supervise and regulate all matters pertaining to IBB.
- vi) "deposit" means deposits mobilized under section 26A of the Banking Companies Ordinance, 1962.

**LICENSING REQUIREMENTS FOR ISLAMIC BANKING BRANCH(ES)**

**2. Eligibility Criteria**

The eligibility of a bank to open Islamic banking branch(es) shall be considered by the State Bank keeping in view, among others, the financial strength of the bank as evident from its capital base(net capital free of actual and potential losses), adequacy of its capital structure, record of earning capabilities, future earning prospects of the bank, managerial capabilities, bank's liquidity position, track record of the bank's adherence to prudential regulations, credit discipline, quality of customer services and the convenience and the needs of the population of the area to be served by the proposed branch. In addition, the following considerations will also be taken in the grant of the license:-

- (i) Banks having CAMELS rating of 1, 2 and 3 in the last ON-SITE inspection shall be eligible for opening Islamic Banking Branches.
- (ii) There should not be major adverse inspection findings against the bank.
- (iii) The bank shall identify experienced and trained key staff to handle the IBB operations.

**3. Working Paper/Proposal**

The applying bank is required to submit a proposal to the Islamic Banking Department of the State Bank of Pakistan, outlining the following details:-

- i) Number of branches alongwith name of city where the IBB is to be offered within the next financial year.
- ii) Products and services to be offered by the IBB including deposits, financing, investment, etc.
- iii) Method of segregating the funds of IBB from the funds of commercial banking of the applying bank.
- iv) Infrastructure and logistic requirements, including manpower and training programs.
- v) The name, qualification and experience of Shariah Adviser(s).
- vi) Accounting aspects, such as accounting policies to be followed, profit and loss sharing mechanism, etc.

The banks will be required to submit such further information as required by State Bank while processing the case.

#### **4. Issuance of License**

- i) State Bank will evaluate the proposal of the bank keeping in view merits of the case and upon its satisfaction, will grant an approval in principle to the bank for opening of branch(es) upon such terms and conditions as it deems fit. However, license for individual branch opening shall be issued on receipt of formal application on prescribed format under the provisions of Section 28 of the Banking Companies Ordinance, 1962 (Application Form). This will be issued when requirements of para 5 hereof are complied with and evidence is provided that adequate security arrangements have been provided at the proposed place of business and the Town Planning Regulations are not violated.
- ii) In subsequent years, if the bank wishes to open more branches, the bank shall submit to State Bank of Pakistan for approval, an Annual Islamic Banking Branch Expansion Plan (the Plan) at least 30 days before the commencement of each calendar year (January-December) during which it plans to open branches. The plan would, inter alia, indicate the number of the new branches proposed to be opened in urban and rural areas, location of each of the proposed branch and the area which it would serve, branches proposed to be closed (if any), the number of existing branches incurring losses consecutively for the last three years, arrangements for managerial and other staff members and information technology access and linkage for the proposed branches and arrangements for housing each of the proposed branch. State Bank will consider the Plan for new branches keeping in view the need of the system and grant approval in principle for number of new branch(es) that bank will be allowed to open during the given calendar year within 30 days from the date of receipt of the Plan complete in all respect. The approval in principle granted under a particular Plan shall lapse in case bank fails to submit a formal application for issuance of license at least 30 days before the expiry of that particular year. Similarly license issued under the respective Plan shall expire where a bank fails to open the branch before 31<sup>st</sup> December of that year.
- iii) Request for a new branch in Azad Kashmir will have to be supported by the AJ&K Government.
- iv) The branch(es) shall be subject to the prevalent banking and other laws, rules and directives issued by SBP from time to time.
- v) Banks will be free to shift or reallocate their branches within the same city/town/village without prior approval of State Bank. Intimation of shifting of a branch will be sent by the bank concerned to the State Bank within 15 days from the date of its shifting on prescribed performa (Annexure 'A').

- vi) The license may be revoked in case it subsequently transpires that the bank had made material misrepresentation of facts or concealment of material information and the responsible official(s) shall personally be liable for action under the relevant laws.

## **5. Commencement of Business**

Before commencement of business, the bank will ensure that all the Documents and agreements pertaining to each type of products and services alongwith Risk management guidelines, Plans for Internal control and Information Technology systems are in place. All relevant documents/agreements and guidelines should be duly certified by their Shariah Adviser/Committee and a certificate in this regard will be submitted to the State Bank alongwith the Application Form. All these documents should be made readily available to the SBP Inspection Team during inspection of the bank.

## **6. Islamic Banking Division**

- (i) The bank will be required to set up an Islamic Banking Division (“IBD”) at the Head Office/Country Office in Pakistan.
- (ii) The bank will submit the organizational structure of the IBD alongwith details of key persons of the division (qualification and years and type of experience) to Islamic Banking Department of the State Bank of Pakistan alongwith the Application Form.
- (iii) The responsibilities of the IBD shall be as follows:-
  - (a) To manage and be responsible for the operations of IBB(s), including policy and procedural matters;
  - (b) To liaise with other departments in the bank and Shariah Adviser/Committee to ensure smooth operations of IBB(s);
  - (c) To ensure that all funds pooled into the IBF are channeled into Shariah compliant financing and investment activities;
  - (d) To arrange training of staff on Islamic banking;
  - (e) To arrange for compilation and submission of such returns, as may be required to be submitted to State Bank from time to time;
  - (f) To ensure that all directives and guidelines, particularly those applicable to Islamic banking, issued by State Bank are strictly complied with;
  - (g) To maintain the Statutory Cash Reserve and Liquidity Requirement with State Bank as prescribed by State Bank from time to time.
  - (h) Other roles and responsibilities as determined by the bank or State Bank from time to time.
- (iv) The IBD shall be headed by a senior and experienced officer directly reporting to the Chief Executive (in case of foreign banks, the Country Manager) and manned by qualified staff.

## **7. Islamic Banking Fund**

- (i) The bank shall be required to maintain a minimum fund of Rs 50 million or 8% of the risk weighted assets of IBB(s), whichever is higher.

- (ii) The IBF shall be funded by way of an allocation by the head office of the bank or in case of foreign bank, its country office.
- (iii) The IBF shall be placed under the control of IBD to fund the operations of the IBB(s).

#### **8. Physical set-up**

Every licensed branch of a bank shall carry a name, and shall invariably be required to prominently display the name of the branch as stipulated in the license.

#### **9. Shariah Compliance**

A Shariah Advisor has to be appointed in the light of SBP Shariah Board's "Fit and Proper Criteria" and the approval of SBP. However, Banks are free to appoint a Shariah Committee at their own discretion and not as part of SBP regulation.

#### **10. Systems and Control**

The bank shall ensure that proper systems and controls are in place in order to ensure segregation of funds and protect the interest of depositors, including but not limited to the followings:-

- i) The bank shall be required to prepare procedure manuals for the IBD and IBB operations duly approved by their Shariah Adviser/Shariah Supervisory Committee as well as the Board of Directors or in case of branches of foreign banks operating in Pakistan, by their Head Office.
- ii) The bank shall prepare a full set of documents pertaining to the deposit, investment and financing products pertaining to IBB operations.
- iii) The full set of the documents duly vetted by their Shariah Adviser/Shariah Supervisory Committee shall be maintained by the IBD. Similarly, all documents in respect of new schemes offered by IBB(s) shall also be prepared and maintained by IBD before launching of the scheme.
- iv) All documents (including ledgers, registers, pay-in-slips, cheques, receipts, passbooks, etc.) used in the IBD and IBB(s) shall be appropriately marked, so as to easily distinguish them from the documents pertaining to commercial banking.
- v) In order to efficiently utilize the existing branch network, the bank may authorize some of its branches to sell the Islamic banking deposit schemes. However, in such cases proper systems and control should be in place to ensure that the fund transfer takes place on the same day to/from the IBB. The authorized branches shall not, in any manner whatsoever, receive/pay interest on such services. The authorized branches may charge a reasonable fee/commission on sale of such deposit schemes under a policy to be approved by the Board of Directors or in case of branches of foreign banks, their Head Office. Proper training in Islamic banking should also be provided to the staff of authorized branches dealing with such deposit schemes.
- vi) The bank shall be required to undertake comprehensive internal audit including internal Shariah Review on the operations of the IBB(s) and IBF at least once in a year.

#### **11. Accounting Records and Disclosure**

- (i) The banks shall keep separate book of accounts in respect of Islamic banking operations and ensure proper maintenance of records for all transactions for segregation of funds.
- (ii) The banks shall prepare a separate daily trial balance of the operations arising from the IBB(s).

- (iii) Based on the balances of all the items (assets, liabilities, expenses and income) relating to the operations of the IBD/IBB(s), the bank shall prepare and submit separate annual as well as quarterly financial statements for its IBB operations alongwith its periodical financial statements on the format prescribed by State Bank from time to time.

**12. Statutory Liquidity and Cash Reserve Requirements**

In order to maintain the Statutory Cash Reserve and Liquidity requirement in respect of IBB operations, the IBD will open a separate current account with State Bank. In this account, IBD will maintain the Cash Reserve with State Bank in the manner prescribed for commercial banks (at present @ 5% of time and demand liabilities). For Statutory Liquidity Requirement (SLR), till the development of Shariah compliant approved securities, they will for the present, maintain an additional cash amount equivalent to 6% of their TDL in the same current account with State Bank in lieu of SLR (i.e., 40% of 15% SLR at present). Therefore, in all, IBD will maintain 11% of time and demand liabilities (TDL) of the Islamic banking branches in this current account with State Bank on weekly average basis and 10% of TDL on daily basis in lieu of CRR and SLR for IBB operations of the bank.

**13. Reporting to State Bank**

- i) In the Weekly Statement of Position submitted to the State Bank, the banks shall submit separately the position of IBB operations.
- ii) The banks shall also be required to submit such other statements regarding their Islamic banking operations as prescribed from time to time.

**14. Processing Fee**

A processing fee @ Rs. 25,000/- per branch applied in the Proposal/Plan has been fixed. The banks while submitting the Proposal/Plan shall invariably enclose a cheque in the name of State Bank of Pakistan as processing fee. The Proposal/Plan without the amount of processing fee shall not be entertained. The processing fee will be non-refundable.

\*\*\*\*\*

**PARTICULARS OF THE ISLAMIC BANKING BRANCH SHIFTED**

1. Name of the Bank \_\_\_\_\_
2. Name of the Branch shifted \_\_\_\_\_
3. Licence No. \_\_\_\_\_ Dated \_\_\_\_\_
4. Premises from which shifted \_\_\_\_\_
5. Exact location of the premises to which shifted \_\_\_\_\_
6. Distance between the old and new branch/booth premises \_\_\_\_\_
7. Date of shifting \_\_\_\_\_
8. Reasons necessitating the shifting (in detail) \_\_\_\_\_  
 \_\_\_\_\_  
 \_\_\_\_\_

9. Working results of the branch/booth at the old place, i.e. deposits advances and profit & loss accounts for the last three financial years

10. No of Accounts (category-wise) as at the end of last financial year and on the date of shifting.

11. Distance (in meters/kilo meters) of the old premises with nearest branches of other banks.

S. No.	Name of Bank	Name of Branch	Distance

12. Distance (in meters/kilo meters) of the new premises from the nearest branches of other banks.

S. No.	Name of Bank	Name of Branch	Distance

12. Certified that location of new premises does not violate the Town Planning Regulations of the concerned authority.



13. Certificate from the **competent authorities** that both the existing and proposed premises are: (a) within the same locality (in case of branches at banked places including big cities); (b) within the same territorial limits of the same village (in case of branches at un-banked places).

\_\_\_\_\_  
(Counter Signature of an Officer not  
below the rank of Sr. Vice President of  
the Head Office or equivalent with date)

\_\_\_\_\_  
(Signature of Officer Incharge  
of the Branch with date)

**Guidelines for**  
**Islamic Microfinance Business by**  
**Financial Institutions**



**State Bank of Pakistan**  
Islamic Banking Department  
[www.sbp.org.pk](http://www.sbp.org.pk)

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# Guidelines for Islamic Microfinance Business by Financial Institutions

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**GUIDELINES FOR ISLAMIC MICROFINANCE BUSINESS  
BY FINANCIAL INSTITUTIONS**

**Prologue:**

State Bank of Pakistan has provided comprehensive regulatory framework for establishment and operations of Microfinance Banks and provision of microfinance services by financial institutions to poor and low income people. It is expected that provision of finance to the deprived and under-privileged segment of the society will help them coming out of the poverty. With the growing popularity of Islamic Banking in the country as well as microfinance, there is a need to prescribe guidelines for Islamic microfinance services by microfinance and commercial banks as well as allowing full fledged Islamic microfinance banks in the country. The following guidelines are aimed at providing enabling environment for introduction of microfinance products and services on Shariah compliant basis in the country through various channels mentioned in the guidelines.

**Provision for offering Islamic Microfinance by Financial Institutions:**

Islamic microfinance services and products can be offered by various types of financial institutions, in different forms. Each type of financial institution has been separately discussed under the following headings in these guidelines:

1. Full-fledged Islamic Microfinance Banks (IMFBs)
2. Islamic Microfinance Services by Full-fledged Islamic Banks
3. Islamic Microfinance Services by Conventional Banks
4. Islamic Microfinance Services by Conventional Microfinance Banks (MFBs)

These guidelines are not intended to replace the regulations and guidelines already issued by SBP from time to time. It must be recognized that the under-mentioned criteria shall be *in addition to* the parameters already defined by SBP for each category of financial institutions.

**Option 1.      Establishing Full Fledged Islamic Microfinance Banks (IMFB):**

**Licensing Requirements:**

Sponsors desirous of establishing full fledged Islamic microfinance banks shall be required to obtain a licence from State Bank of Pakistan under the Microfinance Institutions (MFI) Ordinance, 2001. This ordinance allows establishment of four categories of microfinance banks in the country viz:

1. Nation wide Microfinance Banks;
2. Province wide Microfinance Banks;
3. Region wise Microfinance Banks; and
4. District wide Microfinance Banks.

## Guidelines for Islamic Microfinance Business by Financial Institutions

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For obtaining a licence for Islamic MFB, the criteria and conditions for grant of license for establishing microfinance banks/institutions notified under the MFIs Ordinance 2001, shall apply which are available at: <http://www.sbp.org.pk/about/micro/criteria.htm>. Additionally, the following criteria shall also be observed by persons/entities applying for a full fledged Islamic microfinance bank license:

- i) All financial transactions of Islamic MFB shall be in accordance with the injunctions of Shariah.
- ii) Every Islamic MFB shall be required to appoint a Shariah Advisor who should meet the “Fit and Proper Criteria” for Shariah Advisors, issued vide IBD Circular 2 of 2007 as amended from time to time. Appointment of Shariah Advisor shall require prior written approval from State Bank of Pakistan for which information about Shariah Advisor should be submitted to the State Bank on Form SAP, provided in the aforementioned circular.
- iii) The application shall indicate the modes of finance and product structures proposed to be used for raising resources and extending financial assistance to the clients.
- iv) The applicant shall also indicate expertise and other facilities available with them for ensuring compliance of their microfinance banking business with Shariah.
- v) All the deposits accepted by the MFB shall be accepted either on demand or on profit and loss sharing basis.

In addition to the documents required under the above-mentioned criteria, the applicant shall also submit the following documents along with the request:-

- Shariah compliance mechanism, apart from Shariah Advisor
- Manpower and training programs
- Detailed CV of proposed Shariah Advisor
- Policies, manuals and procedures of products and services duly vetted by the Shariah Advisor

The applicant shall deposit a pay order or demand draft of Rs.500,000/- (Rupees five hundred thousand) favouring State Bank of Pakistan along with the application as processing fee. The fee so deposited shall be non-refundable.

### **Application Forms**

Application forms for MFBs have been placed on SBP website and can be accessed at the link [www.sbp.org.pk/about/micro/index.htm](http://www.sbp.org.pk/about/micro/index.htm) or obtained directly from Director, Banking Policy and Regulations Department.

### **Compliance with Legal Framework & Prudential Regulations for MFBs**

The company granted license to operate, as Islamic MFB shall comply with the provisions of Microfinance Institutions Ordinance 2001, Rules/Prudential Regulations framed under it and SBP directives issued from time to time.

**Option 2. Islamic Microfinance Services by Full-Fledged Islamic Banks:**

Islamic Banks are encouraged to offer Islamic microfinance (IsMF) products through various channels which can not only bring additional value streams to IBIs but also help in building their image of fulfilling the social responsibility and working for the cause of poverty alleviation.

Full fledged Islamic banks are allowed to use the same institutional arrangements allowed to commercial banks vide SMED Circular No. 10 dated June, 27, 2006 which include establishing IsMF Counters in the existing branches, opening of standalone IsMF branches, establishing independent IsMF subsidiaries with independent and professional board and management, developing linkages with MFBs licensed by SBP and NGO-MFIs that are not licensed by SBP to extend wholesale funds in a Shariah compliant manner. Full fledged Islamic banks interested in building IsMF portfolios should review the different institutional/ organizational arrangements and select the mode based on their organizational culture, capacity and overall objectives. The following modes may be used by full fledged Islamic banks, the guidelines for which have been prescribed in the SMED Circular No. 10 of 2006.

***Mode 1- Islamic Microfinance Counters at Existing Branches***

Separate counters offering Islamic microfinance products may be opened in the existing branches and it should be prominently displayed in the premises that Islamic microfinance products are being offered in the branch. Before launching the scheme, the information required in above-mentioned SMED Circular shall be submitted to Islamic Banking Department and SME and Microfinance Department alongwith its vetting from the Shariah Advisor. Islamic microfinance operations under this mode shall be subject to the Prudential Regulations issued vide SMED Circular No. 11 dated June 27, 2006, under the powers vested in Banking Companies Ordinance, 1962.

***Mode II- Standalone Islamic Microfinance Branches & Mobile Banking***

Similar to the license for new branch for banking business, Islamic banks may open microfinance branches as per procedure prescribed in SMED Circular No. 10 of 2006. The license shall be issued subject to the MFI branch licensing policy and on receipt of evidence about adequate security arrangements at the proposed place of business and meeting the town planning regulations. The Islamic microfinance operations under this mode shall be subject to Prudential Regulations issued vide SMED Circular No. 11 dated June 27, 2006, under the powers vested in Banking Companies Ordinance, 1962.

***Mode III- Establishing Independent IMFBS as Subsidiaries of Banks***

The Islamic bank(s) interested in sponsoring an Islamic microfinance subsidiary may apply to SBP for issuance of a license to establish the Islamic microfinance bank under MFIs Ordinance 2001. Islamic bank shall be required to submit the information and documents required under SMED Circular 10 of 2006 as well as requirements for Islamic Microfinance

banks mentioned in Option 1 above. However, the subsidiary may use the services of Shariah Advisor of their parent Islamic bank. Microfinance operations under this mode shall be subject to the Microfinance Institutions Ordinance 2001 and Prudential Regulations for Microfinance Banks.

***Mode IV- Developing Linkages with Islamic MFBS/MFIs***

Islamic Banks can enter into financing arrangements with IMFBS/MFIs on the basis of Islamic modes of finance. Before entering into any such arrangement, Islamic banks shall be required to get the products and their mechanisms vetted from their Shariah Advisor. Islamic banks shall be allowed to enter into financing arrangements with only such MFIs whose own model is in conformity with Shariah or which are interested in building Shariah compliant portfolio. It should be taken into account that most of the NGO-MFIs don't have formal ownership structure and collaterals to secure the financing to be extended by the banks. Islamic modes of Mudaraba and Musharaka can provide a viable mechanism to cater to this kind of financing by Islamic banks. Nevertheless, innovative thinking shall be required to address the issues of documentation and record keeping by the MFIs as well as method of providing finance to IMFBS/MFIs in Shariah compliant manner.

In addition to the information required to be submitted to SME and Microfinance Department of SBP under the Mode-IV of SMED Circular 10 of 2006, Islamic banks shall also be required to submit approval of Shariah Advisor regarding product, mechanism and agreements of the Islamic Bank for providing finance to IMFBS/MFI. Similarly approval of Shariah Advisor shall also be submitted confirming that MFI has a system in place by which microfinance products and services shall be provided to customers in a Shariah compliant manner. Microfinance operations under this mode shall be subject to the Prudential Regulations issued vide SMED Circular No. 11 dated June 27, 2006, under the powers vested in Banking Companies Ordinance' 1962.

**Option 3. Islamic Microfinance Services by Conventional Banks:**

Keeping in view the issues attached with Shariah compliance like segregation of funds, availability of services and advice of Shariah Advisor on regular basis and internal Shariah compliance mechanism etc., only such conventional banks can offer Islamic microfinance products which have been issued license for Islamic banking branches.

Islamic Microfinance products in existing branches as well as in full fledged Islamic microfinance branches (Mode 1 and Mode 2 below) shall be monitored by Islamic Banking Division of the bank, whether a separate Microfinance Division exists in the bank or not because Islamic microfinance assets have to be booked in Islamic Banking Division.

In case, bank has a separate Microfinance Division, it should provide appropriate support and facilitate Islamic Banking Division in development and launch of Islamic Microfinance products.



Conventional Banks, having Islamic Banking Branches can offer Islamic microfinance services through following modes:

### ***Mode 1- Microfinance Counters at Existing Branches***

The Islamic microfinance products and services can be offered at both Islamic Banking and conventional branches. All the Islamic microfinance products and services shall be duly vetted by Shariah Advisor of the bank. There should be separate counter in the branch offering Islamic microfinance products and it should be prominently displayed in the premises that Islamic microfinance products are being offered in the branch. However, if the Islamic microfinance products are to be offered in conventional branches, all the documents including ledgers, registers, pay-in-slips, cheques, receipts, passbooks, etc. used for Islamic microfinance shall be appropriately marked, so as to easily distinguish them from the documents pertaining to conventional banking. Moreover, proper systems and control shall be in place to ensure that the fund transfer takes place on the same day to/from the nearest Islamic microfinance branch or if there is no Islamic microfinance branch in the nearest Islamic Banking Branch. The authorized branch(es) shall not, in any manner whatsoever, receive/pay interest on such services. The authorized branch(es) may charge a reasonable fee/commission on sale of such deposit/financing schemes under a policy to be approved by the management. Proper training in Islamic microfinance should also be provided to the staff of authorized conventional branches dealing with such products. Before launching the scheme, the information required in SMED Circular No. 10 of 2006 shall be submitted to Islamic Banking Department and SME and Microfinance Department alongwith its vetting from the Shariah Advisor.

### ***Mode II- Standalone Islamic Microfinance Branches & Mobile banking***

As already mentioned, if a conventional bank with Islamic banking branches opts for opening standalone Islamic microfinance branches, same shall be monitored by Islamic Banking Division of the bank. All the products and services shall be duly vetted by Shariah Advisor of the bank. All assets and liabilities of Islamic microfinance branches shall be consolidated in Islamic banking operations of the bank. In case the bank does not have a Microfinance Division, the functions of Microfinance Division as prescribed in SMED Circular No. 10 of 2006 shall be performed by Islamic Banking Division of the bank. The Islamic microfinance operations under this mode shall be subject to Prudential Regulations issued vide SMED Circular No. 11 dated June 27, 2006, under the powers vested in Banking Companies Ordinance, 1962.

### ***Mode III- Establishing Independent Islamic MFBs as Subsidiaries of conventional Banks***

The conventional banks having Islamic Banking Branches interested in sponsoring an Islamic microfinance subsidiary may apply to SBP for issuance of a license to establish the Islamic microfinance bank under MFIs Ordinance 2001. The bank shall be required to submit the information and documents required under SMED Circular 10 of 2006 as well as

requirements for Islamic Microfinance banks mentioned above. However, the subsidiary may use the services of Shariah Advisor of their parent bank. Other requirement of establishing Islamic MFB shall be same as discussed under aforementioned heading “Establishing full-fledged Islamic microfinance bank”.

***Mode IV- Developing Linkages with Islamic MFBs/MFIs***

Islamic Banking Division of conventional bank can enter into financing arrangements with IMFBS/MFIs on the basis of Islamic modes of finance. Before entering into any such arrangement, Islamic Banking Division shall be required to get the products and their mechanisms vetted from their Shariah Advisor. These banks shall be allowed to enter into financing arrangements with only such MFIs whose own model is in conformity with Shariah or which are interested in building Shariah compliant portfolio. It should be taken into account that most of the NGO-MFIs do not have formal ownership structure and the collaterals to secure the financing to be extended by the banks. Islamic modes of Mudaraba and Musharaka can provide a viable mechanism to cater this kind of financing by such banks. Nevertheless, innovative thinking would be required to address the issues of documentation and record keeping by the MFIs as well as method of providing finance to IMFBS/MFIs in Shariah compliant manner.

In addition to the information required to be submitted to SME and Microfinance Department of SBP under Mode-IV of SMED Circular 10 of 2006, banks shall also be required to submit approval of Shariah Advisor regarding product, mechanism and agreements for providing finance to IMFBS/MFI. Similarly approval of Shariah Advisor shall also be submitted to Islamic Banking Department and SME and Microfinance Department confirming that MFI has a system in place by which microfinance products and services shall be provided to customers in a Shariah compliant manner.

**Option 4. Islamic Microfinance Services by Conventional Microfinance Banks:**

Conventional MFBs are also allowed to offer Islamic microfinance products and services subject to the following conditions.

Any MFB desirous of offering Islamic microfinance products and services shall be required to apply to the State Bank for permission to start Islamic microfinance.

***Eligibility Criteria***

The eligibility of a MFB to offer Islamic microfinance services shall be considered by the State Bank keeping in view, among others, the financial strength of the MFB as evident from its capital base (net capital free of actual and potential losses), adequacy of its capital structure, record of earning capabilities, future earning prospects of the MFB, managerial capabilities, liquidity position, track record of the MFB’s adherence to prudential and other regulations, credit discipline, quality of customer services and availability of experienced and trained key staff to handle the Islamic microfinance operations. Similarly there should not

be major adverse inspection findings against the bank.

The applying MFB shall submit a proposal to the State Bank of Pakistan, outlining the following details:-

- i) Duly completed Shariah Advisor's particulars (SAP) form for the Shariah Advisor to be appointed in the light of SBP's "Fit and Proper Criteria".
- ii) Shariah compliant products and services to be offered including deposits, financing, investment, etc.
- iii) Method of segregating the Islamic microfinance funds from the funds of conventional microfinance of the applying bank.
- iv) Infrastructure and logistic requirements, including manpower and training programs.
- v) Changes in Memorandum and Articles of Association of the MFB for the enabling clauses to accept deposits on PLS basis and provide financing on the basis of Islamic modes of financing, if not covered earlier in their Memorandum and Articles of Association.

The bank shall be required to submit such further information as required by State Bank while processing the case.

Upon satisfaction, SBP shall grant an approval in principle to the bank for offering Islamic microfinance products and services upon such terms and conditions as it deems fit. However, license for individual branch opening shall be issued on receipt of formal application on prescribed format under MFI branch licensing policy and on receipt of evidence about adequate security arrangements at the proposed place of business and meeting the town planning regulations. The branch(es) shall be subject to the relevant microfinance laws, rules and directives issued by SBP from time to time.

The permission may be revoked in case it subsequently transpires that the MFB had made material misrepresentation of facts or concealment of material information and the responsible official(s) shall personally be liable for action under the relevant laws.

Before commencement of business, the MFB shall ensure that all the documents, agreements and guidelines pertaining to each type of products and services have been prepared and duly vetted by Shariah Advisor.

***Islamic Microfinance Division:***

The bank shall be required to set up an Islamic Microfinance Division (IMD) at the Head Office in Pakistan.

The bank shall submit the organizational structure of the IMD alongwith details of key persons of the division (qualification and years and type of experience) to State Bank of

Pakistan alongwith the Application Form.

The responsibilities of the IMD shall be as follows:-

- (a) To manage and be responsible for the operations of Islamic microfinance, including policy and procedural matters;
- (b) To liaise with other departments in the bank and Shariah Adviser to ensure smooth operations of Islamic microfinance department;
- (c) To ensure that all funds pooled into the Islamic Microfinance Fund are channeled into Shariah compliant financing and investment activities;
- (d) To arrange training of staff on Islamic microfinance;
- (e) To arrange for compilation and submission of such returns, as may be required to be submitted to State Bank from time to time;
- (f) To ensure that all directives and guidelines, particularly those applicable to Islamic microfinance, issued by State Bank are strictly complied with;
- (g) To maintain the Statutory Cash Reserve and Liquidity Requirement with State Bank as prescribed by State Bank from time to time;
- (h) Other roles and responsibilities as determined by the bank or State Bank from time to time.

The IMD shall be headed by a senior and experienced officer directly reporting to the Chief Executive and manned by qualified staff.

***Islamic Microfinance Fund***

- i) The IMD shall be required to maintain a minimum fund of Rs 10 million or 15% of the risk weighted assets of Islamic microfinance, whichever is higher.
- ii) The Islamic Microfinance Fund shall be funded by way of an allocation by the head office of the MFB.
- iii) The Islamic Microfinance Fund shall be placed under the control of IMD to fund the operations of the Islamic microfinance branch(es).

***Systems and Control***

The MFB shall ensure that proper systems and controls are in place in order to ensure segregation of funds and protect the interest of depositors, including but not limited to the followings:-

- a) The IMD shall prepare a full set of documents pertaining to the deposit, investment and financing products pertaining to Islamic microfinance operations.
- b) The full set of the documents duly vetted by their Shariah Adviser shall be maintained by the IMD. Similarly, all documents in respect of new schemes offered by Islamic microfinance branches shall also be prepared and maintained by IMD before launching of the scheme.

***Utilizing Conventional Branch Network:***

Initially MFB shall be allowed to open only dedicated branches for Islamic microfinance products and services. Subsequently, in order to efficiently utilize its branch network, the

MFB may authorize some of its branches to offer Islamic microfinance products and services. However, in such cases proper systems and control should be in place to ensure that the fund transfer takes place on the same day to/from the dedicated Islamic microfinance branches or IMD. For this purpose, it is recommended that facility of online transfer of funds should be available at the branches and IMD. The authorized conventional branches shall not, in any manner whatsoever, receive/pay interest on such services. The authorized branches may charge a reasonable fee/commission on sale of such deposit/financing schemes under a policy to be approved by the management.

### ***Internal Audit***

The MFB shall be required to undertake comprehensive internal audit including internal Shariah Review on the operations of the authorized Islamic microfinance branches as well as IMD at least once in a year.

### ***Accounting Records***

The MFB shall keep separate books of account in respect of Islamic microfinance operations and ensure proper maintenance of records for all transactions for segregation of funds. The MFB shall also disclose information about Islamic microfinance business as prescribed by State Bank from time to time.

### ***Statutory Liquidity and Cash Reserve Requirements***

In order to maintain the Statutory Cash Reserve and Liquidity requirement in respect of IMB operations, the IMD shall open a separate current account with State Bank. In this account, IMD shall maintain the Cash and Liquidity Reserve with State Bank in the manner prescribed by SBP from time to time.

### **Consumer Education:**

For all the microfinance arrangements described in the foregoing pages, following additional guidelines can help the institutions offering Islamic microfinance to facilitate their customers.

- Preparation of FAQs and brochures in local/national languages to address the commonly asked questions regarding the products and services offered as well as general introduction of the same. These brochures should be prominently placed in the branch and on the websites of the institutions.
- Website of the institutions should allocate a separate page for Islamic microfinance products offered by the bank. All relevant information and FAQs etc. should be available on that page and should be regularly updated. Moreover, postal and email address, phone and fax numbers, through which customers and interested public can raise their queries, should be provided in the webpage of the institution.

★ ★ ★ ★ ★

# **Risk Management Guidelines**

**for**

# **Islamic Banking Institutions**



**State Bank of Pakistan**  
Islamic Banking Department

**[www.sbp.org.pk](http://www.sbp.org.pk)**

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## RISK MANAGEMENT GUIDELINES FOR ISLAMIC BANKING INSTITUTIONS

### **Preamble:**

i) With the intention of rolling out standards issued by Islamic Financial Services Board (IFSB) in Pakistan, Risk Management guidelines for Islamic Banking Institutions (IBIs) have been compiled by tailoring the *IFSB guiding principles on Risk Management* to our market. However, these guidelines should be considered in addition to the various Risk Management Guidelines issued by SBP from time to time and IBIs will be required to comply with both set of guidelines. These Guidelines for IBIs will further complement and enhance the current Risk Management regime of SBP by identifying and suggesting technique to manage various types of risks unique to IBIs.

ii) These Risk Management Guidelines provide a set of best practices for establishing and implementing effective risk management in IBIs. These Guidelines set out fifteen principles of risk management that give practical effect to managing the risks underlying the business objectives that IBIs may adopt. The principles contained in these Guidelines are designed to complement the current risk management principles issued by the 'Basel Committee on Banking Supervision' (BCBS) and other international standard-setting bodies.

iii) These Risk Management Guidelines for IBIs provide specific guidance for each category of risk, drawn from discussion on industry practices, outlining a set of principles applicable to the following six categories of risk:

- Credit risk
- Equity investment risk
- Market risk
- Liquidity risk
- Rate of return risk
- Operational risk

iv) All IBIs are expected to make meaningful risk assessments based on the principles described in these Guidelines. However, it is crucial for IBIs to recognize and evaluate the overlapping nature and transformation of risks that exist between and among the categories of the above-mentioned risks. In addition, IBIs may face consequential business risks relating to developments in the external marketplace. Adverse changes in IBIs' markets, counterparties, or products as well as changes in the economic and political environments in which IBI operate and the effects of different Shariah rulings are examples of business risk. These changes may affect IBI's business plans, supporting systems and financial position. In this regard, IBIs are expected to view the management of these risks from a holistic perspective.

v) IBIs are also exposed to reputational risk arising from failures in governance, business strategy and process. Negative publicity about the IBIs' business practices, particularly relating to Shariah non-compliance in their products and services, could have an impact upon their market position, profitability and liquidity.

## **1. General Requirement:**

**Principle 1.0:** IBIs shall have in place a comprehensive risk management and reporting process, including appropriate board and senior management oversight, to identify, measure, monitor, report and control relevant categories of risks. The process shall take into account appropriate steps to comply with Shariah rules and principles and to ensure the adequacy of relevant risk reporting to the supervisory authority.

### **Board of directors (BOD) and senior management oversight:**

1. As with any financial institution, the risk management activities of IBIs require active oversight by the BOD and senior management. The BOD shall approve the risk management objectives, strategies, policies and procedures that are consistent with the IBIs' financial condition, risk profile and risk tolerance. Such approvals shall be communicated to all levels in the IBI involved in the implementation of risk management guidelines.
2. The BOD shall ensure the existence of an effective risk management structure for conducting IBI's activities, including adequate systems for measuring, monitoring, reporting and controlling risk exposures.
3. IBIs shall have in place a Shariah Advisor, in accordance with sound principles of corporate governance and SBP's Fit and Proper Criteria for Shariah Advisors, to oversee that IBIs' products and activities comply with Shariah rules and principles as advised by SBP and Shariah Advisor.
4. The BOD shall approve limits on aggregate financing and investment exposures to avoid concentration of risk and ensure that IBIs hold adequate capital against these exposures. The BOD shall review the effectiveness of the risk management activities periodically and make appropriate changes as and when necessary.
5. Senior management shall execute the strategic direction set by the BOD on an ongoing basis and set clear lines of authority and responsibility for managing, monitoring and reporting risks. The senior management shall ensure that the financing and investment activities are within the approved limits.
6. Senior management shall ensure that the risk management function should be separated from risk taking function and is reporting directly to the BOD or senior management. Depending on the scope, size and complexity of IBI's business activities, the risk management function is carried out by personnel from an independent risk management unit. These personnel shall define the policies, establishes procedures, monitor compliance with the established limits and report to top management on risk matters accordingly.

### **Risk Management Process:**

7. IBIs shall have a sound process for executing all elements of risk management, including risk identification, measurement, mitigation, monitoring, reporting and control. This process requires the implementation of appropriate policies, limits, procedures and effective management

information systems (MIS) for internal risk reporting and decision making that are commensurate with the scope, complexity and nature of IBIs' activities.

8. IBIs shall ensure that an adequate system of controls with appropriate checks and balances is in place. The controls shall (a) comply with the Shariah rules and principles; (b) comply with applicable regulatory and internal policies and procedures; and (c) take into account the integrity of risk management processes.

9. IBIs shall make appropriate and timely disclosure of information to depositors having deposits on Profit and Loss Sharing basis, minimum requirements of which are specified by SBP in its Guidelines for Shariah Compliance in IBIs", so that they are able to assess the potential risks and rewards of their deposits and to protect their own interests in their decision making process.

10. In addition to the above, following general requirements shall also be taken into account by the IBI.

- a) *Application of Emergency and Contingency Plan:* The senior management shall draw up an emergency and contingency plan, approved by the board of directors in order to be able to deal with risks and problems which may arise from unforeseen events.
- b) *Integration of Risk Management:* While assessing and managing risk, the management should have an overall view of risks the institutions is exposed to. This requires having a structure in place to look at risk interrelationships across the organization. Such a setup could be in the form of a separate department or bank's Risk Management Committee could perform such function. The structure should be such that ensures effective monitoring and control over risks being taken.
- c) *Risk Measurement:* For each category of risk, IBIs are encouraged to establish systems/models that quantify their risk profile. The results of these models should be assessed by independent risk review function.
- d) *Utilization:* The IBIs should develop a mechanism which should, to the possible extent, monitor that funds provided by them were utilized for the purpose these were advanced.
- e) *Role of Finance Administration Department:* It should be separated from finance origination department. It should be among the responsibilities of Finance Administration Department to monitor that the documents are obtained according to the requirement as specified in the product. For example, the dates play a very important role in Murabaha transactions and any transaction can be rendered invalid if the sequencing of obtaining documents is changed.
- f) *Management Information System:* The IBIs should specify control reports to be prepared by independent department that should be periodically submitted to board or senior management committee.
- g) *Human Resource:* IBI shall ensure that staff has been adequately trained regarding Shariah principles and procedures. There should be ongoing emphasis on staff training and development planning with clear objective for individual staff members. For this purpose, periodic workshops should be arranged by the IBI in coordination with Shariah Advisor.

## 2. Credit Risk:

11. These guidelines address the credit risk associated with specific features of Islamic financing contracts. The risk assessment and measurement processes undertaken by IBIs shall also be applicable to profit sharing assets (Mudarabah and Musharakah) which are classified under equity investments. Rigorous risk evaluation (including due diligence) and controls of these investments are necessary in view of their exposure to capital impairment.

12. The credit risk principles in this section are also applicable to credit risks associated with securitization and investment activities because, in the IBIs, an investment certificate or sukuk generally represents a direct pro-rata beneficial ownership of the holder in the assets of the underlying project.

### Definition and Profiles of Credit Risk:

13. Credit risk is generally defined as the potential that a counterparty fails to meet its obligations in accordance with agreed terms. This definition is applicable to IBIs managing the financing exposures of receivables and leases (for example, Murabahah, Diminishing Musharakah and Ijarah) and working capital financing transactions/projects (for example, Salam, Istisna or Mudarabah). IBIs need to manage credit risks inherent in their financings and investment portfolios relating to default, downgrading and concentration. Credit risk includes the risk arising in the settlement and clearing transactions.

14. The following premises relate to the sound processes of credit risk management in IBIs:

- The role of IBIs can embrace those of financiers, suppliers, Mudarib and Musharakah partners. IBIs concern themselves with the risk of a counterparty's failure to meet their obligations in terms of receiving deferred payment and making or taking delivery of an asset. A failure could relate to a delay or default in payment, or in delivery of the subject matter of Salam or Parallel Istisna, entailing a potential loss of income and even capital for the IBIs.
- Due to the unique characteristics of each financing instrument, such as the non-binding nature of some contracts, the commencement stage involving credit risk varies. Therefore, credit risk shall be assessed separately for each financing instrument to facilitate appropriate internal controls and risk management systems.
- IBIs will consider other types of risks that give rise to credit risk. For example, during the contract life, the risk inherent in a Murabahah contract is transformed from market risk to credit risk. In another example, the invested capital in a Mudarabah or Musharakah contract will be transformed to debt in case of proven negligence or misconduct of the Mudarib or the Musharakah's managing partner.
- IBIs are prohibited from using the amount of any penalty for their own benefit; they must donate any such amount to charity. This increases the cost of default.

**Principle 2.1: IBIs shall have in place a strategy for financing, using various instruments in compliance with *Shariah*, whereby they recognize the potential credit exposures that may arise at different stages of the various financing agreements.**

15. The BOD of IBIs shall define and set the institution's overall levels of risk appetite, risk diversification and asset allocation strategies applicable to each Islamic financing instrument, economic activity, geographical spread, season, currency and tenor. IBIs shall be mindful of and take into account the permissible types of financing instruments available in different locations wherever IBIs undertake cross-border transactions.

16. IBIs will take into account seasonal aspects resulting from a shifting or termination of use of certain financing instruments, thus affecting the overall concentration exposures of the IBIs's financing portfolio. For example, the IBIs may offer Salam contracts during a certain season where a product can most likely be delivered and sold at maturity.

17. IBIs' financing strategies shall include a list of all types of applicable and approved transactions and financings. The approved list must include formal exclusions from any engagement by the IBIs in industries dealing in Haram or unlawful goods and services. The approved list will be kept up to date and communicated to the relevant personnel within the IBIs, and an internal compliance function will be organized and empowered to ensure that such rules are applied.

18. IBIs shall be aware of the commencement of exposure to credit risk inherent in different financing instruments and in various jurisdictions when developing the strategy. The non-binding promise and legal enforcement aspects may give rise to operational risks and other risk management problems relating to Shariah compliance.

19. When setting the level of risk appetite relating to counterparties, IBIs shall ensure that (a) the expected rate of return on a transaction is commensurate with the risks incurred; and (b) excessive credit risk (at both individual and portfolio levels) and risk concentration (for example financing instruments, economic activity, geographical spread) are being managed effectively.

**Principle 2.2: IBIs shall carry out a due diligence review in respect of counterparties prior to deciding on the choice of an appropriate Islamic financing instrument.**

20. IBIs shall establish policies and procedures defining eligible counterparties (retail/consumer, corporate or sovereign), the nature of approved Shariah Compliant financings and types of appropriate financing instruments. IBIs shall obtain sufficient information to permit a comprehensive assessment of the risk profile of the counterparty prior to the financing being granted.

21. IBIs shall have a policy for carrying out a due diligence process<sup>1</sup> in evaluating counterparties, in particular, for transactions involving:

- New ventures with multiple financing modes: IBIs shall carry out due diligence processes on customers or sovereigns using multiple financing modes to meet specific financial objectives designed to address Shariah, legal or tax issues of customers.

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<sup>1</sup> The process may include Value at Risk, stress testing and sensitivity analysis, amongst others.

- Creditworthiness that may be influenced by external factors: Where significant investment risks are present in participatory instruments, especially in the case of Mudarabah financings, additional counterparty reviews and evaluations will focus on the business purpose, operational capability, enforcement and economic substance of the proposed project including the assessment of realistic forecasts of estimated future cash flows. Risk mitigating structures should be put in place by IBIs as far as possible.

22. IBIs, in their policy for approval, shall engage appropriate experts, including a Shariah advisor to review and ensure that new financing proposals that have not been proposed before or amendments to existing contracts are Shariah-compliant at all times. IBIs may also engage an appropriate technical expert (for example an engineer) to evaluate the feasibility of a proposed new project and to assess and approve progress billings to be made under the contract.

23. In a financing involving several related agreements, IBIs need to be aware of the binding obligations arising in connection with credit risks associated with the underlying assets for each agreement. To be Shariah compliant, subject to the interpretation of its Shariah scholars, IBIs shall ensure that all components of the financial structure are contractually independent, although these may be executed in a parallel manner despite their interrelated nature.

**Principle 2.3: IBIs shall have in place appropriate methodologies for measuring and reporting the credit risk exposures arising under each Islamic financing instrument.**

24. IBIs shall develop and implement appropriate risk measurement and reporting methodologies relevant to each Islamic financing instrument in respect of managing their counterparty risks, which may arise at different contract stages (including counterparty performance risk in Salam and Istisna contracts). Depending on the Islamic financing instrument, the IBIs may employ an appropriate methodology that takes into account the price volatilities of the underlying assets. The selected methodology shall be appropriate given the nature, size and complexity of the IBIs's credit related activities. IBIs shall ensure that adequate systems and resources are available to implement this methodology.

**Principle 2.4: IBIs shall have in place Shariah-compliant credit risk mitigating techniques appropriate for each Islamic financing instrument.**

25. IBIs shall clearly define their credit risk-mitigating techniques including, but not limited to, having in place:

- a methodology for setting mark-up rates according to the risk rating of the counterparties, where expected risks should have been taken into account in the pricing decisions;
- permissible and enforceable collateral<sup>2</sup> and guarantees;
- clear documentation as to whether or not purchase orders are cancelable; and
- Clear procedures for taking account of governing laws for contracts relating to financing transactions.

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<sup>2</sup> IBIs are expected to include in its process, an ongoing monitoring of quality and valuation of any collateral.

26. IBIs shall establish limits on the degree of reliance and the enforceability of collateral and guarantees. They shall protect themselves against legal impediments that may restrict the accessibility of collateral when they need to enforce their rights in respect of a debt. IBIs shall formally agree with the counterparty at the time of signing the contract on the usage, redemption and utilization of collateral if the counterparty defaults in payment.

27. IBIs shall have policies to define adequately the action to be taken by the IBIs when a customer cancels a non-binding purchase order. The policies will describe how the IBIs (a) monitor and control their exposures to suppliers, and especially during delivery between suppliers to the IBIs where a customer is acting as an agent; and (b) identify whether the risks associated with the assets will be borne by the supplier or the customer (which acts as agent and accepts the assets from the supplier). For example, the IBIs may enter into a purchase contract with a supplier on a "sale or return" basis, with an option to return the purchased item within a specified period.

28. IBIs shall have appropriate credit management systems and administrative procedures in place to undertake early remedial action in the case of financial distress of a counterparty or, in particular, for managing problem credits, potential and defaulting counterparties. This system will be reviewed on a regular basis. Remedial actions will include both administrative and financial measures.

29. Administrative measures may, inter-alia, include:

- negotiating and following-up pro-actively with the counterparty through maintaining frequent contact with the counterparty;
- setting an allowable timeframe for payment or to offer debt-rescheduling or restructuring arrangements (without an increase in the amount of the debt);
- using a debt-collection agency;
- resorting to legal action, including the attachment of any credit balance belongs to defaulters according to the agreement between them;

And financial measures may include, among others:

- imposing penalties, the proceeds of which should be disposed of in charitable causes in compliance with Shariah as decided by the IBIs Shariah Advisor; and
- Establishing the enforceability of collateral or third party guarantees.

30. IBIs shall set appropriate measures for early settlements, which are permissible under their Shariah rules and principles for each Islamic financing instrument.

31. IBIs shall assess and establish appropriate policies and procedures pertaining to the risks associated with their own exposures in parallel transactions. For instance, in the case of an Istisna transaction, the IBIs enter into an Istisna contract as sellers to provide manufactured goods or a building to a customer. The IBIs will then enter into another (parallel) Istisna contract as buyers with a supplier (manufacturer or builder), using the specifications drawn up for the original contract. If the supplier fails to deliver the manufactured goods or the building according to the agreed specifications, IBIs would equally be in default of their obligation. If necessary, an outside expert may be engaged to evaluate, approve and monitor the technical aspects. IBIs may also

stipulate that the party to the first contract must inspect the manufactured goods or building from time to time during the production or construction process to satisfy themselves that the specifications are being met.

32. IBIs shall establish appropriate policies and procedures that require them to honour their commitment to the parallel contract counterparty. However, there must be no legal linkages between the two contracts.

33. IBIs shall have in place a system to ascertain and fulfill their obligations in respect of leased assets, which are permanently impaired through no default of the lessee. In case of such impairment, IBIs are required to provide the lessee with a replacement asset with similar specifications, if such specifications were agreed upon, or if the contract was renewed, or to refund the additional amounts (capital payments) included in the Ijarah Muntahia Bittamleek lease rentals as compared with those in an operating Ijarah. IBIs shall establish appropriate risk management policies to mitigate losses arising from such damage during the term of the lease.

34. IBIs shall ensure, whenever possible, that there is sufficient Shariah-compliant insurance (takaful) coverage of the value of the assets, subject to availability. If necessary, IBIs shall engage an insurance advisor at an early stage to review the insurance coverage of the leased assets.

35. If a loss arises from negligence by the lessee, IBIs are permitted to claim compensation from the lessee. The IBIs (as lessors) bear the risks associated with the leased assets and cannot use lessees' guarantees to recover the amount of the losses on the leased assets (unless these are due to misconduct, negligence or breach of contract on the part of the lessees).

36. IBIs shall have in place an appropriate policy for determining and allocating provisions for (a) doubtful debts including counterparty exposures; and (b) estimated impairment in value of leased assets.

### **3. Equity Investment Risk:**

37. This section sets out the principles pertaining to the management of risks inherent in the holding of equity instruments for investment purposes. In particular, for IBIs, the relevant instruments are typically those based on the Mudarabah and Musharakah contracts. This section focuses on such instruments. The risks entailed by holding equity instruments for trading or liquidity purposes are dealt with under market risk in Section 4 below. While investments made via Mudarabah and Musharakah instruments may contribute substantially to IBIs' earnings, they entail significant market, liquidity, credit<sup>3</sup> and other risks, potentially giving rise to volatility in earnings and capital.

38. The capital invested through Mudarabah and Musharakah may be used to purchase shares in a publicly traded company or privately held equity or invested in a specific project, portfolio or

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<sup>3</sup> One example of credit risk exposure arises from the *Mudarib's* obligation to pay the agreed share of profit to the IBIs as *Rabb al-mal* when such payment falls due. Failure to meet this obligation constitutes a case of misconduct and negligence in the part of the *Mudarib*.



through a pooled investment vehicle. In the case of a specific project, IBIs may invest at different investment stages.

39. One distinct difference between Mudarabah and Musharakah financings is in terms of IBIs' involvement in the investments during the contract period. In Mudarabah, the IBIs invest their money as silent partners and, the management is the exclusive responsibility of the other party, namely the Mudarib. In contrast, in Musharakah financing the IBIs (and its partner or partners) invest their funds together, and the IBIs may be silent partners, or may participate in management. Regardless of the authority under which the profit sharing instruments are used, both Musharakah and Mudarabah are profit-sharing financings, under which the capital invested by the provider of finance does not constitute a fixed return, but is explicitly exposed to impairment in the event of losses (capital impairment risk).

40. The type of equity investment risk dealt with in this section may be broadly defined as the risk arising from entering into a partnership for the purpose of undertaking or participating in a particular financing or general business activity as described in the contract, and in which the provider of finance shares in the business risk.

41. The characteristics of such equity investments include considerations as to the quality of the partner, underlying business activities and ongoing operational matters. By nature, this type of equity investment is exposed to a confluence of risks associated with Mudarib or Musharakah partner, business activity and operations.

42. In evaluating the risk of an investment using the profit sharing instruments of Mudarabah or Musharakah, the risk profiles of potential partners (Mudarib or Musharakah partner) are crucial considerations for the undertaking of due diligence. Such due diligence is essential to the fulfillment of IBIs' fiduciary responsibilities as an investor of deposits on a profit-sharing and loss-bearing basis (Mudarabah) or a profit and loss sharing basis (Musharakah). These risk profiles include the past record of the management team and quality of the business plan of, and human resources involved in, the proposed Mudarabah or Musharakah activity.

43. Factors relating to the legal and regulatory environment affect equity investment performance, and need to be considered in the risk evaluation. These factors include policies pertaining to tariffs, quotas, taxation or subsidies and any sudden policy changes affecting the quality and viability of an investment.

44. Moreover, risks of change in technology and risk of substitution by new innovations being introduced in the marketplace can also affect the investment performance in a particular business.

45. IBIs are exposed to the risks attaching to a lack of reliable information on which to base their investment appraisals, such as an inadequate financial control system. The mitigation of these risks may require the investor to take an active role in monitoring the investment, or the use of specific risk mitigating structures.

46. Although timely allocation of profit can be agreed upfront, IBIs should be prepared for delays and variations in cash flow patterns and possible difficulties in executing a successful exit strategy.

47. The risks arising from the use of profit sharing instruments for financing purposes do not include credit risk in the conventional sense, but share a crucial characteristic of credit risk because of the risk of capital impairment.

**Principle 3.1: IBIs shall have in place appropriate strategies, risk management and reporting processes in respect of the risk characteristics of equity investments, including Mudarabah and Musharakah investments.**

48. IBIs shall define and set the objectives of, and criteria for, investments using profit sharing instruments, including the types of investment, tolerance for risk, expected returns and desired holding periods. For example, a Musharakah structure may contain an option for redemption whereby the IBIs as financiers have a contractual right to require their partner periodically to purchase, under a separate contract, a proportion of the IBIs's share in the investment at net asset value or, if the contract so specifies on some agreed basis (Diminishing Musharakah).

49. IBIs shall have, and keep under review, policies, procedures and an appropriate management structure for evaluating and managing the risks involved in the acquisition of, holding and exiting from profit sharing investments. IBIs shall ensure proper infrastructure and capacity are in place to monitor continuously the performance and operations of the entity in which IBIs invest as partners. These should include evaluation of Shariah compliance, adequate financial reporting by, and periodical meetings with, partners and proper recordkeeping of these meetings.

50. IBIs shall identify and monitor the transformation of risks at various stages of investment lifecycles, for example, where the investee's business involves innovative or new products and services in the marketplace. IBIs that employ different financing instruments (where one of which include Musharakah) at different contract stages shall have appropriate procedures and controls in place, as different stages may give rise to different risks.

51. IBIs shall analyze and determine possible factors affecting the expected volume and timing of cash flows for both returns and capital gains arising from equity investments.

52. IBIs shall use Shariah compliant risk-mitigating techniques, which reduce the impact of possible capital impairment of an investment. This may include the use of Shariah permissible security<sup>4</sup> from the partner.

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<sup>4</sup> Any collateral/security obtained by IBIs for Musharaka and Mudaraba shall not be applied or utilized to cover losses of the IBI except where Shariah permits application or usage of such collateral/security.

**Principle 3.2: IBIs shall ensure that their valuation methodologies are appropriate and consistent, and shall assess the potential impacts of their methods on profit calculations and allocations. The methods shall be mutually agreed between the IBIs and the Mudarib and/or Musharakah partners.**

53. IBIs shall agree with the Mudarib and/or Musharakah partners before entering into any agreement, on the appropriate valuation methods and periods for which the profit is to be calculated and allocated taking into account market practices and liquidity features.

54. Valuation and accounting play an important role in measuring the quality of an equity investment, especially in a privately held entity, for which independent price quotations are neither available nor sufficient in volume to provide a basis for meaningful liquidity or market valuation. An appropriate and agreed method to be applied to determine the profit of the investment can be in the form of a certain percentage of either gross or net profit earned by the Mudarabah or Musharakah business, or any other mutually agreed terms. In the case of a change of the partnership's shares in a Musharakah (for example in a Diminishing Musharakah), the shares changing hands shall be valued at fair value or on some other mutually agreed basis.

55. IBIs shall assess and take measures to deal with the risks associated with potential manipulation of reported results leading to overstatements or understatements of partnership earnings. Reported earnings can be either gross or net. If for some reason the practices of smoothing profits over accounting periods and the establishment of escrow accounts to hold certain profit portions during the life of an equity investment are recognized and agreed by all the investing parties, the IBIs will incorporate their potential impact in the IBIs's overall earnings.

56. IBIs may agree with the Mudarib and/or Musharakah partners to engage independent parties where necessary to carry out audits and valuations of the investments. Provided these are properly executed and completed, these measures will help to ensure transparency and objectivity in valuation and in the distribution of profits and the determination of amounts to be redeemed.

**Principle 3.3: IBIs shall define and establish the exit strategies in respect of their equity investment activities, including extension and redemption conditions for Mudarabah and Musharakah investments, subject to the approval of the institution's Shariah Advisor.**

57. IBIs shall establish the criteria for exit strategies, including the redemption of equity investments and the divestiture of under-performing investments. The criteria may include alternative exit routes and the timing of exit. In case of losses where improved business prospects exist, IBIs may indicate an investment extension period. IBIs' expectations should be based on their assessment that there are plausible grounds for believing that there will be a business turnaround during the period resulting in the view that the investment will, in time, recover and yield profits.

58. IBIs shall recognize that, as a going concern, an investee may not always have the liquidity necessary to enable making profit distributions. Hence, IBIs shall agree with the investment partner the methods for the treatment of retained profits by the investee.

#### 4. Market Risk

**Principle 4.1:** IBIs shall have in place an appropriate framework for market risk management (including reporting) in respect of all assets held, including those that do not have a ready market and/or are exposed to high price volatility.

##### **Definition and Profiles of Market Risk**

59. Market risk is defined as the risk of losses in on- and off-balance sheet positions arising from movements in market prices i.e. fluctuations in values in tradable, marketable or leaseable assets (including sukuk) and in off-balance sheet individual portfolios. The risks relate to the current and future volatility of market values of specific assets (for example, the commodity price of a Salam asset, the market value of a sukuk, the market value of Murabahah assets purchased to be delivered over a specific period) and of foreign exchange rates.

60. In operating Ijarah, a lessor is exposed to market risk on the residual value of the leased asset at the term of the lease or if the lessee terminates the lease earlier (by defaulting), during the contract. In Ijarah Muntahia Bittamleek, a lessor is exposed to market risk on the carrying value of the leased asset (as collateral) in the event that the lessee defaults on the lease obligations.

61. In Salam, IBIs are exposed to commodity price fluctuations on a long position after entering into a contract and while holding the subject matter until it is disposed of. In the case of parallel Salam, there is also the risk that a failure of delivery of the subject matter would leave the IBIs exposed to commodity price risk as a result of the need to purchase a similar asset in the spot market in order to honour the parallel Salam contract.

62. When IBIs are involved in buying assets that are not actively traded with the intention of selling them, it is important to analyze and assess the factors attributable to changes in liquidity of the markets in which the assets are traded and which give rise to greater market risk. Assets traded in illiquid markets may not be realizable at prices quoted in other more active markets.

63. IBIs are also exposed to foreign exchange fluctuations arising from general FX spot rate changes in both cross-border transactions and the resultant foreign currency receivables and payables. These exposures may be hedged using Shariah compliant methods.

64. In addition to the above, there should be middle office to perform market risk management function and to independently monitor, measure and analyze risks inherent in treasury operations of Islamic Banks. Besides the unit should also prepare control reports indicating deviations for the information of senior management.

#### 5. Liquidity Risk:

65. Liquidity risk is the potential loss to IBIs arising from their inability either to meet their obligations or to fund increases in assets as they fall due without incurring unacceptable costs or losses.

**Profiles of Fund Providers:**

66. There are two major types of fund providers: (a) current account holders; and (b) PLS deposit holders. These account holders require a degree of liquidity to be maintained by the IBIs to meet their requirements for withdrawals.

67. As current account holders do not participate in the profits of the IBIs' business activities, a sound repayment capacity is required to meet fully cash withdrawal requests as and when they arise. IBIs may rely heavily on funds provided by current account holders. Repayment by the IBIs of the principal amounts deposited by current account holders is guaranteed without any rights to share in profits, as the current account holders do not share in the risks of the IBIs.

68. PLS deposit holders are those depositors who participate in the uncertainties of IBIs' business; therefore, they share in profits and bear losses arising from investments made on their behalf, to the extent of their share. Apart from general withdrawal needs, the withdrawals made by PLS deposit holders may be the result of (a) lower than expected or acceptable rates of return; (b) concerns about the financial condition of the IBIs; and (c) non-compliance by the IBIs with Shariah rules and principles in various contracts and activities.

69. Where the principle of Mudarabah is employed to source the funds, from an asset-liability management perspective, IBIs may be viewed as being hedged to the extent that the PLS deposit holders bear the risks of the assets in which their funds are invested. This statement is true only if the Mudarib (IBI) has acted in accordance with its fiduciary duties under the Mudarabah contracts and without misconduct or negligence.

70. PLS deposit holders do not share in the risks on assets financed by current accounts, which are borne by shareholders alone.

71. As fiduciary agents, the IBIs are concerned with matching their investment policies with risk appetites of PLS deposit holders and shareholders. If these investment policies are not consistent with the expectations and risk appetites of PLS deposit holders, the latter may withdraw their funds leading to a liquidity crisis for the IBIs. This applies particularly to PLS deposit holders.

**Principle 5.1: IBIs shall have in place a liquidity management framework (including reporting) taking into account separately and on an overall basis their liquidity exposures in respect of each category of current accounts and PLS deposits.**

72. IBIs need to identify any future shortfalls in liquidity by constructing maturity ladders based on appropriate time bands. The IBIs may have their own criteria for classifying cashflows, including behavioural methods, and may consider differentiating the types of cashflows as indicated below:

- Known cash flows – the maturities and the amounts are known in advance. This category includes receivables from Murabahah, Ijarah, Ijarah Muntahia Bittamleek receivables and Diminishing Musharakah.

- Conditional but predictable cashflows (Salam and Istisna) – conditionality is defined in terms of the type of contract or performance of work based on the agreed terms and conditions over an agreed period.
- Conditional and unpredictable cash flows – in some cases, an investment in a Musharakah is for an open-ended period and an exit strategy may be assessed periodically. The redemption of invested capital and possible levels of return on investment is conditional upon the performance of the activities.

73. When calculating net funding requirements (NFR), a substantial influence on the liquidity situation of IBIs relates to the management of their PLS deposit holders' expectations. While the basis of an NFR calculation is to assume that the funds are repaid at the contractual maturity date, it may not be realistic to assume that all PLS deposit holders will maintain their funds at the IBIs until maturity. Therefore, an internal assessment of their expectations and incentives will be part of an NFR calculation.

74. Due to IBIs' dual role in meeting their obligations to current account holders and managing the expectations of their PLS deposit holders, the IBIs should make periodical cash-flow analyses under various market scenarios and conditions. The scenarios may vary, depending on local market conditions, and may be based on (a) a "normal" operating environment (for example a steady state condition); and (b) scenarios of adverse circumstances (for example non-linear events and chaotic conditions). For example:

- The analysis shall include assumptions about the repayment of invested capital to the PLS deposit holders.
- The scenarios shall be based on relevant assumptions based on factors affecting the IBIs' on- and off-balance sheet exposures. Liquidity levels and early withdrawal profiles computed under these scenarios will be back-tested periodically to validate the underlying assumptions of the measurement process.
- In analyses based on behavioural assumptions and scenarios, IBIs will assess and apply the liquidity measures that reflect the specificities of each portfolio.

75. IBIs shall establish the maximum amounts of cumulative liquidity mismatches which they consider acceptable (within the regulatory requirements) and manageable for different time bands, as a percentage of total assets available. The effects of liquidity shortages may vary according to the fund providers' liquidity preferences; hence, separate limits on liquidity mismatches should be set up accordingly. These limits shall be regularly reviewed, taking into account the IBIs' liquidity situation, economic climate and market conditions.

**Principle 5.2: IBIs shall assume liquidity risk commensurate with their ability to have sufficient recourse to Shariah-compliant funds to mitigate such risk.**

76. IBIs shall assess the necessity and extent of their access to available funding sources. In managing their liquidity, IBIs have the following possible funding sources – natural cash flows arising from their usual banking activities, the realisation of tradable invested assets, asset securitisation, and their capacity to access shareholders' and/or head office funds.

77. IBIs' liquidity management policies shall include some form of contractually agreed orderly liquidation procedures ensuring maximum possible yield, to avoid having to liquidate assets at unfavourable prices, resulting in the erosion of the PLS deposit holders' capital and damage to the IBIs' reputation and viability.

78. IBIs must have a liquidity contingency plan addressing various stages of a liquidity crisis. IBIs should define the classification of these stages but may consider differentiating the stages as follows:

- Identification of a liquidity gap or a situation which acts as a triggering event where withdrawals do not follow predictable patterns when, for example, the IBIs may suffer an institutional rating downgrade;
- A need to liquidate assets or investments in an orderly manner to meet such a liquidity gap or situation; and
- Emergency measures to be taken in the event that the previous steps fail to meet the liquidity gap adequately.

79. Where appropriate, IBIs shall include in their contingency plans the following factors and define appropriate action points at each stage:

- Holdings of tradable high quality liquid assets, which may be readily disposed of in sizeable amounts in deep markets taking into account the likelihood that it will not be possible to realise full book value;
- Profile of other assets and the degree of liquidity of these assets;
- Assessment of Shariah-compliant and available funding products in the market including possible cooperation agreements with either other IBIs or conventional institutions on an interest-free basis for accessing temporary funding, or sale and leaseback arrangements for longer term funding;
- Possible liquidity arrangements with the central bank (on an interest-free basis);
- Establishment of a crisis management team or personnel responsible for taking actions at different stages of the liquidity crisis; and
- Notification procedures for communication with IBIs' head office and/or supervisory authorities.

80. However, to the extent that IBIs intend to rely on the types of cooperation agreements mentioned above, they need to ensure that willing counterparties will exist for such arrangements.

## **6 Rate of Return Risk:**

81. This section sets out principles in respect of rate of return risks. The rate of return risk is generally associated with overall balance sheet exposures where mismatches arise between assets and balances from fund providers.

82. Since IBIs' responsibility is to manage their PLS deposit holders' expectations and their liabilities to current account holders, the rate of return risk is a strategic risk issue forming part of IBIs' balance sheet risk management.

### **Definition and Profiles of Rate of Return Risk**

83. IBIs are exposed to rate of return risk in the context of their overall balance sheet exposures. An increase in benchmark rates may result in PLS deposit holders' having expectations of a higher rate of return. Rate of return risk differs from interest rate risk in that IBIs are concerned with the result of their investment activities at the end of the investment-holding period. Such results cannot be pre-determined exactly.

84. A consequence of rate of return risk may be displaced commercial risk. IBIs may be under market pressure to pay a return that exceeds the rate that has been earned on assets financed by PLS deposit holders when the return on assets is under-performing as compared with competitors' rates. IBIs may decide to waive their rights to part or their entire Mudarib share of profits in order to satisfy and retain their fund providers and dissuade them from withdrawing their funds. Displaced commercial risk derives from competitive pressures on IBIs to attract and retain investors (fund providers). The decision of IBIs to waive their rights to part or all of their Mudarib share in profits in favour of PLS deposit holders is a commercial decision, the basis for which needs to be subject to clear and well defined policies and procedures approved by the IBIs's BOD.

### **Operational Considerations:**

**Principle 6.1: IBIs shall establish a comprehensive risk management and reporting process to assess the potential impacts of market factors affecting rates of return on assets in comparison with the expected rates of return for PLS deposit holders.**

85. IBIs shall take necessary steps to ensure that the management processes relating to the identification, measurement, monitoring, reporting and control of the rate of return risk (including appropriate structure) are in place. Since the rate of return risks are emanating from various balance sheet positions, IBIs shall have in place competent staff to undertake the analysis of risk exposures arising from their consolidated balance sheet activities.

86. IBIs shall be aware of the factors that give rise to rate of return risk. The primary form of rate of return risk to which the IBIs are exposed comprises increasing long-term fixed rates in the market. In general, profit rates earned on assets reflect the benchmark of the previous period and do not correspond immediately to changes in increased benchmark rates.

87. IBIs shall assess the effect of the level of their dependency on current account holders' funds. Although no returns are expected by current account holders, the sudden withdrawal of these funds would have an adverse impact on the overall potential rate of return for IBIs.

### **Rate of Return Risk Management**

88. IBIs shall have in place appropriate systems for identifying and measuring the factors which give rise to rate of return risk.



89. When calculating a rate of return, IBIs shall employ a gapping method for allocating positions into time bands with remaining maturities or repricing dates, whichever is earlier.

90. Fixed and floating rate assets of IBIs will be classified according to their receivable dates because the returns on these receivables represent the fund providers' direct and beneficial ownership of the assets. Actual cash flows may indicate a gap for a given time band, affecting the rate of return for that period. Depending on the complexity and the nature of their business operations, IBIs may employ techniques ranging from simple gap to advance simulation or dynamic approaches to assess future cash flow variability and net income. The estimates derived from selected approaches may provide acceptable approximations of periodic future earnings' variability; hence, the outcomes will yield different levels of expected returns to PLS deposit holders.

91. The measurement of rate of return risk highlights the importance of cash flow forecasting for instruments and contracts where IBIs are required to simulate and assess their behavioural maturity, underlying assumptions and parameters, which must be reviewed periodically for reliability. The materiality of potential threats to future earnings and the usefulness of the resulting information shall be considered in determining the type and extent of forecasted behaviour for IBIs.

92. In assessing whether a potential threat is likely to have a material, likely and imminent impact on a balance sheet position, IBIs will ensure that they understand the different characteristics of their balance sheet positions in the different currencies and jurisdictions within which they operate.

93. In assessing exposure to rate of return risks, IBIs shall take into account the non-contractual behavioural maturity of the transactions in the context of the environment in which they operate and changing market conditions.

94. IBIs are encouraged to employ balance sheet techniques to minimize their exposures using the following strategies, among others:

- Determining and varying future profit ratios according to expectations of market conditions;
- Developing new Shariah-compliant instruments; and
- Issuing securitization tranches of Shariah permissible assets.

#### Displaced Commercial Risk Management

**Principle 6.2:** IBIs shall have in place an appropriate framework for managing displaced commercial risk, where applicable.

95. IBIs shall have in place a policy and framework for managing the expectations of their shareholders and PLS deposit holders. Where market rates of returns of competitors' PLS deposit holders are higher than those of IBIs' PLS deposit holders, the IBIs will evaluate the nature and extent of the expectations of their PLS deposit holders and assess the amount of the gap between competitors' rates and their own PLS deposit holders' expected rates.

## 7. Operational Risk:

96. IBIs are exposed to risks arising from failures in their internal controls involving processes, people and systems. The controls should provide reasonable assurance of the soundness of operations and reliability of reporting.

97. IBIs are also exposed to reputational risk arising from failures in governance, business strategy and process. Negative publicity about the IBI's business practices, particularly relating to Shariah non-compliance in their products and services, could have an impact upon their market position, profitability and liquidity.

98. IBIs shall consider the full range of material operational risks affecting their operations, including the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. IBIs shall also incorporate possible causes of loss resulting from Shariah non-compliance and the failure in their fiduciary responsibilities.

99. IBIs are exposed to risks relating to Shariah non-compliance and risks associated with the IBIs' fiduciary responsibilities towards different fund providers. These risks expose IBIs to fund providers' withdrawals, loss of income or voiding of contracts leading to a diminished reputation or the limitation of business opportunities.

100. A reliable IT system is a must for profit sharing mechanism, failure of which may lead to Shariah non-compliance risk. The bank should identify key risk indicators and should place key control activities like Code of Conduct, Delegation of authority, segregation of duties, succession planning, mandatory leave, staff compensation, recruitment and training, dealing with customers, complaint handling, record keeping, MIS, physical controls etc.

**Principle 7.1: IBIs shall have in place adequate systems and controls, including Shariah Advisor, to ensure compliance with Shariah rules and principles.**

### **Shariah Non-Compliance Risk:**

101. Shariah non-compliance risk is the risk that arises from IBIs' failure to comply with the Shariah rules and principles prescribed by State Bank of Pakistan and Shariah Advisor of the IBIs. Shariah compliance is critical to IBIs' operations and such compliance requirements must permeate throughout the organisation and their products and activities. As a majority of the fund providers use Shariah-compliant banking services as a matter of principle, their perception regarding IBIs' compliance with Shariah rules and principles is of great importance to sustainability of IBIs. In this regard, Shariah compliance is considered as falling within a higher priority category in relation to other identified risks.

102. IBIs shall ensure that they comply at all times with the Shariah rules and principles as advised by the Shariah Advisor as well as SBP, with respect to their products and activities. This means that Shariah compliance considerations are taken into account whenever the IBIs accept deposits and investment funds, provide finance and carry out investment services for their customers.

103. IBIs shall ensure that their contract documentation complies with Shariah rules and principles – with regard to formation, termination and elements possibly affecting contract performance such as fraud, misrepresentation, duress or any other rights and obligations.

104. IBIs shall undertake a Shariah compliance review at least annually, performed either by a separate Shariah audit department or as part of the existing internal audit function by persons having the required knowledge and expertise for the purpose. The objective is to ensure that (a) the nature of the IBIs's financing and equity investment and (b) their operations are executed in adherence to the applicable Shariah rules and principles as per the fatwa, policies and procedures approved by the IBIs's Shariah Advisor.

105. IBIs shall keep track of income not recognized arising out of Shariah non-compliance and assess the probability of similar cases arising in the future. Based on historical reviews and potential areas of Shariah non-compliance, the IBIs may assess potential profits that cannot be recognized as eligible IBIs' profits.

**Principle 7.2:** IBIs shall have in place appropriate mechanisms to safeguard the interests of all fund providers. Where PLS deposit holders' funds are commingled with the IBIs' own funds, the IBIs shall ensure that the bases for asset, revenue, expense and profit allocations are established, applied and reported in a manner consistent with the IBIs' fiduciary responsibilities.

**Fiduciary risk:**

106. Fiduciary risk is the risk that arises from IBIs' failure to perform in accordance with explicit and implicit standards applicable to their fiduciary responsibilities. As a result of losses in investments, IBIs may become insolvent and therefore unable to (a) meet the demands of current account holders for repayment of their funds; and (b) safeguard the interests of their PLS deposit holders. IBIs may fail to act with due care when managing investments resulting in the risk of possible forgone profits to PLS deposit holders.

107. IBIs shall establish and implement a clear and formal policy for undertaking their different and potentially conflicting roles in respect of managing different types of investment accounts. The policy relating to safeguarding the interests of their PLS deposit holders may include the following:

- Identification of investing activities that contribute to investment returns and taking reasonable steps to carry on those activities in accordance with the IBIs's fiduciary and agency duties and to treat all their fund providers appropriately and in accordance with the terms and conditions of their investment agreements;
- Allocation of assets and profits between the IBIs and their PLS deposit holders will be managed and applied appropriately to PLS deposit holders having funds invested over different investment periods; and
- Limiting the risk transmission between current and investment accounts.

108. IBIs shall adequately disclose information on a timely basis to their PLS deposit holders and the markets in order to provide a reliable basis for assessing their risk profiles and investment performance, as prescribed by SBP from time to time.

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