

Draft Guidelines
for Provision of Islamic Microfinance
Services and Products by
Financial Institutions



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Common Elements between Islamic finance and microfinance:

There are many similarities in the nature of Islamic banking and microfinance as both forms of finance represent unconventional solutions to financial needs starting from egalitarian approaches being open to all customers without setting any apparent restriction to different categories of clientele. Similarly both the systems advocate financial inclusion, entrepreneurship and risk-sharing through partnership finance. Moreover, both have their focus on developmental and social goals to be accomplished in the society.

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:

1. Establishing Full Fledged Islamic Microfinance Banks (IMFB)
2. Islamic microfinance services by Full-fledged Islamic banks
3. Islamic microfinance services by Conventional banks
4. Islamic microfinance services by Conventional microfinance banks

It must be mentioned that the forthcoming criteria will be in addition to the requirements already issued under respective category of financial institutions. These regulations and guidelines, by any means, are not replacing the regulations and guidelines already issued by SBP from time to time.

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

The sponsors who wish to establish Full fledged Islamic microfinance banks would be required to obtain a licence from State Bank of Pakistan under the Microfinance Institutions Ordinance, 2001.

For granting a licence for IMFB, the criteria and conditions for grant of license for establishing microfinance banks/institutions available at <http://www.sbp.org.pk/about/micro/criteria.htm> notified under the MFIs Ordinance 2001, would be followed. In addition to the conditions mentioned therein, the following criteria would be followed for persons/entities applying for full fledged Islamic Micro-finance bank:

- i) All financial transactions of Islamic MFB will be in accordance with the injunctions of SHARIAH.
- ii) Every Islamic MFB will be required to appoint a Shariah Advisor who should meet the "Fit and Proper Criteria" for Shariah Advisors, issued vide IBD Circular 3 of 2004. Appointment of Shariah Advisor will require 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 structure proposed to be used for raising resources and extending financial assistance to the clients.

- iv) The applicant will also indicate expertise and other facilities available with them for ensuring compliance of their banking business with Shariah.
- v) All the deposits accepted by the MFB should 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 will also submit the following documents along with the request:-

- Shariah compliance mechanism
- Manpower and Training programs
- Detailed CV of proposed Shariah Advisor alongwith his particulars on Form-SAP
- Policies, Manuals and Procedures 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 Islamic MFBs have been placed on SBP website and can be accessed by clicking the link 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 IMFBS

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.

2. Islamic microfinance services by Full-fledged Islamic banks:

Islamic Banking Institutions (IBIs) 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 for fulfilling the social responsibility and poverty alleviation.

Full fledged Islamic banks are allowed to use 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 fledge 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 should be submitted to Islamic Banking Department and SMFD alongwith its vetting from the Shariah Advisor.

Mode II- Standalone Microfinance Branches & Mobile Banking

Similar to the license for new branch for banking business, SBP will issue license for Islamic microfinance branch opening on receipt of formal application on prescribed format. The license will 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 IsMF operations of Islamic banks either through IsMF Counters at existing branches or Standalone IsMF branches, will be subject to Prudential Regulations for Micro Finance Business issued under Banking Companies Ordinance 1962 for commercial banks undertaking microfinance.

Mode III- Establishing Independent IMFBS as Subsidiaries of Banks

The Islamic banks 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 Islamic bank will 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 Islamic bank.

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 will be required to get the products and their mechanisms vetted from their Shariah Advisor. Islamic banks will be allowed to enter into financing arrangements with only such MFIs whose own model is in conformity with Shariah. It should be taken into account that most of the NGO-MFIs don't 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 Islamic 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 Department of SBP under the above heading of SMED Circular 10 of 2006, Islamic banks will 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 will also be submitted

confirming that MFI is providing microfinance products and services in Shariah compliant manner.

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 Shariah compliance mechanism etc., only such conventional banks can offer Islamic microfinance products which have been issued license(s) for Islamic banking branches. These banks 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 should 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 product is 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 should be in place to ensure that the fund transfer takes place on the same day to/from the nearest Islamic Banking Branch. 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 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 above-mentioned SMED Circular should be submitted to Islamic Banking Department and SMFD alongwith its vetting from the Shariah Advisor.

Mode II- Standalone Islamic Microfinance Branches & Mobile banking to be monitored by Islamic Banking Division:

If a conventional bank with IBBs opts for opening standalone Islamic microfinance branches, same should be monitored by Islamic Banking Division of the bank. All the products and services should be dully vetted by Shariah Advisor of the bank. License for individual branch opening shall be issued by Banking Policy and Regulations Department of SBP 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.

Mode III- Establishing Independent Islamic MFBS as Subsidiaries of conventional Banks

The conventional banks having IBBs 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

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Islamic bank will 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 Islamic bank. Other requirement of establishing Islamic MFB will be same as discussed under 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 will be required to get the products and their mechanisms vetted from their Shariah Advisor. These banks will be allowed to enter into financing arrangements with only such MFIs whose own model is in conformity with Shariah. It should be taken into account that most of the NGO-MFIs don't 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 Department of SBP under the above heading of SMED Circular 10 of 2006, banks will 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 will also be submitted to IBD and SMFD confirming that MFI is providing microfinance products and services in Shariah compliant manner.

4. Islamic microfinance services by Conventional microfinance banks:

Conventional MFB will also be allowed to offer Islamic microfinance products and services subject to the following conditions.

Licensing Process:

Any MFB desirous of offering Islamic microfinance products and services will be required to apply to the State Bank for issuance of a license under the following guidelines:

Eligibility Criteria

The eligibility of a MFB to offer Islamic microfinance (IsMF) 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 will submit a proposal to the State Bank of Pakistan, outlining the following details:-

- i) Complete 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 funds of Islamic MF 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 banks will be required to submit such further information as required by State Bank while processing the case.

Upon satisfaction, will 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 license 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 will 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 will be required to set up an Islamic Microfinance Division (IMD) at the Head Office in Pakistan.

The bank will 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

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- (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 MF, 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 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 8% of the risk weighted assets of Islamic microfinance, whichever is higher.
- (ii) The IMFF shall be funded by way of an allocation by the head office of the MFB.
- (iii) The IMFF shall be placed under the control of IMD to fund the operations of the IMB(s).

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 will be allowed to open only dedicated branches for Islamic microfinance products and services. 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 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 and Disclosure

The MFB shall keep separate book of accounts in respect of Islamic microfinance operations and ensure proper maintenance of records for all transactions for segregation of funds.

Statutory Liquidity and Cash Reserve Requirements

In order to maintain the Statutory Cash Reserve and Liquidity requirement in respect of IMB operations, the IMD will open a separate current account with State Bank. In this account, IMD will 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 microfinance institution to facilitate their customers.

- Preparation of FAQ 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, contact address, phone and fax numbers as well as email should be provided where people can ask their queries.