

Guidelines for
Islamic Microfinance Business by
Financial Institutions



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TABLE OF CONTENTS

Prologue:	1
Provision for offering Islamic Microfinance by Financial Institutions:	1
Option 1. Establishing Full Fledged Islamic Microfinance Banks (IMFB):	1
Licensing Requirements	1
Application Forms	2
Compliance with Legal Framework & Prudential Regulations for IMFBs.....	2
Option 2. Islamic Microfinance Services by Full-Fledged Islamic Banks:	3
Mode 1- Islamic Microfinance Counters at Existing Branches	3
Mode II- Standalone Islamic Microfinance Branches & Mobile Banking.....	3
Mode III- Establishing Independent IMFBs as Subsidiaries of Banks	3
Mode IV- Developing Linkages with Islamic MFBs/MFIs	4
Option 3. Islamic Microfinance Services by Conventional Banks:	4
Mode 1- Microfinance Counters at Existing Branches	5
Mode II- Standalone Islamic Microfinance Branches & Mobile banking	5
Mode III- Establishing Independent Islamic MFBs as Subsidiaries of conventional Banks.....	5
Mode IV- Developing Linkages with Islamic MFBs/MFIs	6
Option 4. Islamic Microfinance Services by Conventional Microfinance Banks:	6
Eligibility Criteria	6
Islamic Microfinance Division	7
Islamic Microfinance Fund	8
Systems and Control	8
Utilizing Conventional Branch Network	8
Internal Audit	9
Accounting Records and Disclosure	9
Statutory Liquidity and Cash Reserve Requirements	9
Consumer Education:	9

**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

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 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.

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