

GUIDELINES & CRITERIA FOR

I. OPENING OF STAND ALONE ISLAMIC BANKING BRANCHES (IBBs) BY A CONVENTIONAL BANK

II. COMMENCEMENT OF SHARIAH COMPLIANT BUSINESS AND OPERATIONS BY A DEVELOPMENT FINANCE INSTITUTION (DFI)

1. Submission of Application

Conventional Banks (CBs) and Development Finance Institutions (DFIs) desirous of commencing Shariah compliant business and operations, are required to apply to the Banking Policy & Regulations Department (BPRD), State Bank of Pakistan (SBP) for issuance of license and grant of permission respectively under these guidelines.

2. In-Principle Approval

a. Eligibility Criteria for In-Principle Approval

The eligibility of a CB/DFI to commence Shariah compliant business and operations shall be considered by keeping in view, among others, the following:

- i. Adequacy of capital structure (meeting the prevailing Minimum Capital Requirement & Capital Adequacy Ratio), record of earning capabilities/profitability, managerial capabilities, & liquidity position.
- ii. Track record of the CB's/ DFI's overall compliance with applicable laws, rules, regulations etc., quality of risk management, credit discipline, quality of customer services.
- iii. CBs/DFIs having latest on-site composite ratings by SBP of at least "Fair" shall be eligible for commencing Shariah compliant business and operations.
- iv. There should not be major adverse inspection findings against the CB/ DFI.

b. Proposal

The applying CB / DFI is required to submit a proposal (approved by the Board of Directors) including the overall strategy for Shariah compliant businesses and operations, a feasibility study along with a long and short term business plan to the Banking Policy & Regulations Department of the State Bank of Pakistan, with a copy to Islamic Banking Department outlining the following details:-

- i. Approved annual Islamic branch/ window expansion & conversion plan including number of branches (at least five in case of banks) to be opened/ converted along with name of the cities. The CB/DFI needs to identify specific locations for branches and shall have to fulfill the related formalities for branch opening in line with SBP's Branch Licensing Policy as applicable on CBs/DFIs. For conversion of branches of commercial bank, SBP's Circular No. 2 of 2010 or as amended from time to time shall be applicable whereas for conversion of business & operations/branches of DFIs, **Appendix -A** of these guidelines shall be referred to.
- ii. Proposed Shariah compliant products and services to be offered by the CB/DFI including fund mobilization, financing, investment, etc.

- iii. The projected figures for Shariah compliant business & operations covering details such as branch network, balance sheet size along with its key components (deposits, financings, equity etc.) profitability, ROA, ROE, number of employees etc.
- iv. Method of completely segregating funds of Shariah compliant business from the conventional business both at the Head Office and branch level.
- v. The CB /DFI shall identify experienced and trained key staff to handle the Shariah compliant business & operations.
- vi. Infrastructure and logistic requirements, including manpower and training programs.
- vii. Accounting aspects, such as accounting policies to be followed, profit and loss sharing mechanism, etc. keeping in view SBP circulars/ regulations and related SBP instructions issued from time to time.
- viii. The banks/DFIs will be required to submit latest approved copy of their Memorandum and Articles of Association and any addendum required in it regarding commencement of Shariah compliant business and operations.
- ix. The particulars / information about Shariah Board members/ Shariah Adviser¹ which are/ is to be appointed in accordance with “Fit & Proper Criteria” as prescribed in SBP’s instructions on Shariah Governance Framework. **Appendix-B** of these guidelines may be referred to for details regarding applicability of Shariah Governance Framework on conventional banks and DFIs intending to commence Shariah compliant business and operations under these guidelines.

SBP may also seek any additional information/documents as deemed necessary.

c. Issuance of In-Principle Approval

State Bank will evaluate the proposal of the CB/DFI keeping in view merits of the case and upon its satisfaction, will grant an in-principle approval to the CB/DFI for starting Shariah compliant business and operations upon such terms and conditions as it deems fit. The in-principle approval shall lapse if the CB/DFI fails to commence Shariah compliant business and operations within a period of six months from the date of grant of such approval.

3. Setting up of Islamic Banking/Islamic Finance Division (IBD in case of a Conventional Bank/IFD in case of DFI)

- i. After getting in principle approval the CB/DFI will be required to set up an Islamic Banking /Islamic Finance Division, (IBD/IFD) preferably at the Head Office in Pakistan to manage, control, monitor and supervise all matters relating to its Shariah compliant business and operations. The Head of IBD/IFD will report directly to the CEO (in case of foreign banks, the Country Manager) of the CB/DFI.
- ii. The IBD/IFD shall be manned by qualified staff and headed by a senior, qualified and experienced officer meeting fit and proper criteria of SBP for key executives. Related qualification/training and experience in Islamic finance shall be mandatory in this regard.
- iii. The CB/DFI will also submit the organizational structure of the IBD/IFD along with detailed CVs (qualifications, years and type of experience) of key persons of the IBD/IFD and other related functions like product development, risk management, Shariah audit & Shariah compliance etc. to Banking Policy and Regulations Department of the State Bank of Pakistan.

¹ In case of a CB, a Shariah Board shall be appointed whereas DFI shall appoint a Shariah Board or Shariah Advisor.

- iv. The functions of the IBD/IFD shall be as follows:-
 - a. To manage the Shariah compliant business and operations, including policy and procedural matters
 - b. To liaise with other departments in the CB/DFI and Shariah Board / Shariah Adviser to ensure smooth operations.
 - c. To ensure that all funds (e.g. all types of deposits, Islamic Banking/ Islamic Finance Fund (IBF/IFF etc.) are channeled into Shariah compliant financing and investment activities;
 - d. To arrange training of staff regarding Shariah compliant business and operations, including at branches
 - 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 maintain separate Statutory Cash Reserve (CRR) and Statutory Liquidity Requirement (SLR) as prescribed by SBP from time to time.
 - g. To ensure that all regulatory directives and guidelines issued by State Bank are strictly complied with.
- v. The Head of Islamic banking/ Islamic finance division shall also ensure the following:
 - a. Shariah Compliant Business and operations are covered in overall strategic planning process of the CB/DFI
 - b. Prepare, monitor and execute annual business plan specific to Shariah compliant business and operations (covering deposits, financing, expansion etc. targets and annual budget) along with performance evaluation.
 - c. Submission of a report annually to the Board of Directors on performance status of component of strategic plan of the CB/ DFI related to Shariah Compliant Business and also on their annual business plan targets.
 - d. The Bank / DFI shall put in place a Shariah Board and BoD approved Service Level Agreement (SLA) for allowing staff working for IBD/IFD to administratively report to the officials/ executives of the conventional side of the bank/ DFI.
 - e. Other roles and responsibilities as determined by the CB/DFI or SBP from time to time.

4. Requirements for Commencement of Business

- i. Before commencement of Shariah compliant business and operations, the CB/ DFI will ensure that all the necessary policies, including credit & investment policy, risk management policy, compliance policy, human resource policy, accounting & audit policy, charity policy, operation/product manuals, agreements and other related documents pertaining to each type of products and services along with risk management guidelines, plans for internal control and IT systems are approved by Shariah Board /Shariah Adviser. In this regard the CB/DFI shall also refer to Para 3 of BSD Circular No. 03 of 2007 or any other related instructions.
- ii. All relevant documents/agreements, manuals etc. should be duly vetted and certified by their Shariah Board /Shariah Adviser and a certificate in this regard shall be submitted to the State Bank.
- iii. Conventional banks opening Islamic banking branches shall formulate a pool management and profit and loss distribution policy in light of SBP instructions issued from time to time. In this regard the bank shall have in place an adequate IT based system which inter alia 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.
- iv. Charity policy shall also be in line with instructions issued by SBP on the subject from time to time.
- v. Regarding continuous capacity building of all organs of corporate and Shariah governance, a comprehensive Shariah board/ Shariah adviser vetted and BoD approved training policy along with annual training plan shall also be submitted as per applicable Islamic banking and other SBP departments instructions, issued from time to time.
- vi. The conventional side of the CB/DFI may provide support functions/services like human resource management, administration, accounting, IT and other secretarial and general services for the IBD/ IFD under BoD approved service level agreements (SLAs) which shall inter alia include detailed transfer pricing mechanism. The SLA shall also cover the clear roles and responsibilities of the authorized officials/committees and functions to be shared.

All the above should also be made available to the SBP Inspection Team during inspection of the bank/DFI.

5. Issuance of Branch License/ Permission Letter

- i. Individual branch license in case of bank / permission letter in case of DFI for Shariah compliant business and operations shall be issued on receipt of formal request in this regard from the CB/ DFI along with the evidence that they have fulfilled the related terms and conditions. This will be issued when evidence is provided that adequate security arrangements have been provided at the proposed place of business and the town planning regulations or other applicable rules/regulations of the concerned authority(ies) are not violated.
- ii. In subsequent years, if the CB /DFI desires to open more new branches, it shall submit to State Bank of Pakistan for approval, an Annual Branch Expansion Plan (ABEP) in accordance with Branch Licensing Policy issued by SBP.
- iii. The in-principle approval / license /permission letter may be revoked in case it subsequently transpires that the CB/DFI 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.

6. Islamic Banking/Islamic Finance Fund (IBF for CBs / IFF for DFIs)

- i. A CB shall be required to have and maintain at all times a minimum Islamic Banking Fund of Rs. 500 million whereas the DFI shall be required to have and maintain at all times a minimum Islamic Finance Fund of Rs. 150 million and they shall also maintain Capital Adequacy Ratio (CAR) as prescribed by SBP from time to time.
- ii. The IBF/IFF shall be funded by way of an allocation by the head office of the CB/DFI, or in case of foreign bank, its country office.
- iii. The IBF/IFF shall be placed under the control of IBD/IFD to fund the Shariah compliant business and operations of CB/DFI.

7. Physical set-up

Every branch of a CB/DFI authorized to conduct Shariah compliant business and operations shall carry a name which should be prominently displayed outside the place of business with the name of branch on Signboard/Signage as per requirement of SBP instructions, issued from time to time.

8. Systems and Control

- i. The CB/DFI shall ensure that proper systems and controls are in place in order to ensure segregation of funds between Shariah compliant and conventional business and operations and to protect the interest of all stakeholders.
- ii. The CB/DFI shall be required to prepare procedure manuals for Shariah compliant business and operations duly vetted by their Shariah Board /Shariah Adviser.
- iii. The CB/DFI shall prepare a full set of documents, duly vetted by their Shariah Board /Shariah Adviser, pertaining to all the liability and asset side products of Shariah compliant business and operations.
- iv. The full set of the documents shall be maintained by the IBD/IFD. Similarly, all documents in respect of new schemes offered by IBD/IFD shall also be approved by Shariah Board/ Shariah adviser before launching of the scheme under SBP prescribed instructions.
- v. All documents (including ledgers, registers, TDRs, Certificates of Investments, letterheads, cheques, pay-in-slips, receipts, passbooks, brochures, complaint forms/applications, etc.) used in the CB/DFI for Shariah compliant business and operations shall be appropriately marked, so as to easily distinguish them from the documents pertaining to conventional side.
- vi. In order to efficiently utilize the existing conventional branch network, the CB/DFI may as per relevant SBP regulations issued from time to time operate at its conventional branches separate Islamic banking windows / Islamic finance windows (IBWs/IFWs). However, proper systems and control should be in place to ensure complete segregation and that the fund transfer takes place on the same day. 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 products and services under their BoD and Shariah Board /Shariah Adviser approved policy.

9. Accounting Records and Disclosure

- i. The CBs/DFIs shall have separate chart of accounts and keep separate books of accounts in respect of Shariah compliant business and operations for segregation of funds and ensure proper maintenance of records for all transactions.
- ii. CBs/DFIs shall prepare and submit separate financial statements for its Shariah compliant business and operations along with its periodical financial statements on the format prescribed by State Bank from time to time.
- iii. The CBs/DFIs in line with relevant SBP regulations shall maintain proper accounts and records regarding all transactions relating to Charity Fund and make necessary disclosures in periodic financials (including annual audited financials) as per SBP prescribed format under its instructions, issued from time to time.
- iv. The CBs / DFIs shall prepare a separate daily trial balance of their Shariah compliant business and operations.

10. Statutory Liquidity and Cash Reserve Requirements

- i. In order to maintain the Statutory Cash Reserve (CRR) and Liquidity Requirement (SLR) the IBD/IFD shall open separate accounts with State Bank.

- ii. The CRR and SLR in respect of Shariah compliant business and operations shall be maintained as prescribed by SBP from time to time.

11. Reporting to State Bank

- i. In the various mandatory regulatory returns/reports submitted to the State Bank, the banks/DFIs shall submit separately the position of Shariah compliant business and operations as per prescribed formats.
- ii. The CBs/DFIs shall also be required to submit such other statements regarding their Shariah compliant business and operations as prescribed from time to time.

12. Applicable Regulations

- i. The CB/DFI shall be subject to the prevalent regulations and other laws, rules and directives issued by SBP from time to time.
- ii. With regard to Shariah compliant business and operations of DFIs; unless specified otherwise, they would also follow all the relevant instructions/ guidelines/circulars already issued for Islamic Banking Institutions.

Criteria for Conversion of Existing Shariah Non Compliant Business & Operations / Branches of DFIs

A DFI may convert part of its conventional business and operations into Shariah compliant mode. Only those DFIs which have Islamic Finance Divisions duly allowed by SBP shall be eligible to apply for conversion of their conventional portfolio/branches into Islamic. In such a case it shall submit the request to Banking Policy & Regulations Department (with copy to Islamic Banking Department) for in-principle approval along with a detailed time bound plan for its portfolio/branches to start and complete the conversion process duly approved by Shariah Board / Shariah adviser.

The conversion plan shall inter alia cover the following:

- Identification of proposed assets/ liabilities portfolio
- Rationale for conversion along with business potential and feasibility report covering impact analysis on profitability/overall performance of DFIs
- Delineation of procedure for getting consent from existing customers/investors
- Methodology for conversion of assets and liabilities into Islamic modes in Shariah compliant manner
- The DFI must set all necessary procedures, explore alternatives to Shariah non-compliant products both on asset and liability side, and build capacity for implementation of conversion
- Plans / strategy for resolution of adverse findings of internal, external and statutory auditors, if any, before conversion
- The IBD Circular No. 02 of June 25, 2010 or as amended from time to time on Criteria for Conversion of Conventional Banking Branches into Islamic Banking Branches, wherever relevant, shall also be applicable
- Any other requirement specified by Shariah Adviser / Board

Based on the quality of conversion plan and other SBP instructions, an in-principle approval may be granted to allow the DFI to initiate conversion process and complete it within time lines prescribed. At the completion of conversion “Final Report along with a Completion Certificate of Conversion” duly vetted and approved by Shariah Board / Shariah Adviser shall be submitted to SBP within 15 days of the completion process.

Shariah Governance Framework**I. Conventional Bank**

In case of a CB, after grant of in-principle approval and before commencement of business it shall appoint a Shariah Board as prescribed in SBP Shariah Governance Framework. The Shariah Governance Framework prescribed by SBP from time to time is also applicable on conventional banks operating Islamic banking branches.

II. Development Financial Institution

In case of a DFI, after grant of in-principle approval and before commencement of business, the DFI shall after SBP's approval appoint the Shariah Adviser on a full time basis as per Fit and Proper Criteria prescribed by SBP. However, it may alternatively appoint a Shariah Board. In both the cases the Shariah Governance Framework prescribed by SBP for Islamic banking institutions as amended from time to time will also be applicable on DFIs under these guidelines. However, in case of appointment of a single Shariah adviser instead of a Shariah Board, the following may be noted:

- All relevant instructions applicable to Shariah Board and its members covered in the Shariah Governance framework for the purpose of DFIs would be deemed to be applicable on the Shariah adviser.
- Furthermore, the role and responsibilities enumerated in the framework for Resident Shariah Board Member (RSBM) shall also be applicable on the Shariah Adviser of the DFI.
- The Shariah adviser of a DFI shall not serve in any capacity whatsoever in any other DFI in Pakistan. However, he may with prior approval of the BoD of the DFI serve as a member of Shariah Board of a maximum two other IFIs.
- A vacancy arising due to resignation, removal or termination or death of the Shariah Adviser shall be filled by the BoD within one month from the date on which such vacancy was caused.

In case of appointment of a Shariah Board, the RSBM of a DFI shall not serve in any capacity whatsoever in any other DFI in Pakistan. However, he may with prior approval of the Shariah Board of DFI serve as a member of Shariah Board of a maximum two other IFIs.

Furthermore, following may also be noted by the DFI:

- i. Keeping in view the scale of Shariah compliant business and operations carried out by the DFI it may establish a dedicated and adequately staffed Shariah compliance unit (SCU) within the existing compliance department. Alternatively, the existing compliance department of the DFI may look after this function through such staff that have adequate training / exposure in Islamic finance. In either case the Shariah compliance function shall report to the Shariah Board/ Shariah Adviser.
- ii. Untill such time as prescribed by SBP the requirement of external Shariah audit shall not be applicable on DFIs.
- iii. A DFI may approach the Islamic banking department, SBP for any further exemptions required from the Shariah Governance Framework based on any valid reason such as its network/ size/scale of operations etc.

Process Flow (Annexure-III)

1. Submission of Application

The conventional banks/ DFIs shall submit an application with Banking Policy and Regulations Department of SBP.

2. Issuance In Principle Approval

SBP shall assess the applicant in light of eligibility criteria and review the proposal submitted and upon its satisfaction shall issue the in principle approval for start of Shariah compliant business and operations.

3. Issuance of Branch License/ Permission Letter

Upon fulfilment of related terms and conditions, SBP will issue the branch license / permission letter to the bank/ DFI respectively.

4. Commencement of Business

The bank/ DFI shall be allowed commencement of Shariah compliant business and operations after SBP is satisfied that pre commencement terms and conditions have been adequately met.