

## *Process for Standardization of Shariah Practices*

Shariah compliance is the most important aspect of Islamic banking/finance. The credibility of Islamic Banking Institutions (IBIs) not only depends on the financial health of the institution but also on its adherence to the Shariah. Under the current strategy for promotion and development of Islamic Banking as a parallel, viable and compatible banking system, State Bank of Pakistan has taken a number of steps to ensure Shariah compliance by IBIs and for standardization of Shariah practices.

To bring in harmony and standardization of Shariah practices, the State Bank has put together a comprehensive compliance/harmonization framework. This is based on a detailed analysis of international and local industry practices. The framework consists of multiple elements utilizing formal as well as informal forums.

However, it is to mention here that a flexible approach has been adopted while devising the said Shariah compliance/ harmonization framework. This has been done to avoid revisiting the experience of 1980's where a rigid model was applied that resulted in a stalled process of product innovation and development. The aim this time is not to standardize each and every practice just for the sake of standardization only. Rather emphasis has been on a market based approach wherein the industry can on an on going basis provide Shariah compliant banking services through a parallel and compatible system.

This paper highlights the framework already put in place and new initiatives undertaken by SBP which either directly contributes to, or indirectly augments the process of Standardization of Shariah practices in the Islamic banking industry of Pakistan both in the local as well as global context.

### **Shariah Compliance Structure put in place by SBP**

This structure has the following salient features:

1. Shariah Board at SBP
2. Shariah Advisor as per Fit & Proper Criteria
3. Essentials & Model Agreements of Islamic Modes of Financing
4. Shariah Compliance Inspection
5. Meetings of Shariah Advisors

#### **1. Shariah Board at SBP:**

- The Shariah Board of SBP advises on the procedures, laws and regulations pertaining to Islamic Banking in line with Shariah principles. All the instructions / guidelines pertaining to the Islamic banking Industry are issued with the approval of SBP Shariah Board.
- Conflict Resolution in Shariah Rulings is also managed through the Shariah Board of SBP as in case of any difference of opinion the decision of SBP Shariah Board is considered final. The Shariah Board members are well versed with local & international practices both in the field of banking as well as Shariah and are thus instrumental in ensuring that the advice given to SBP is in line with international practices.

## **2. Shariah Advisor as per Fit & Proper Criteria (prescribed by SBP) :**

- Each Islamic banking institution (i.e. Islamic Bank and conventional bank having Islamic Banking Branches) is required to appoint a Shariah Advisor as per Fit and Proper Criteria prescribed by SBP. The requirement for Shariah Advisors to meet the said criteria ensures that they have adequate and relevant education, knowledge and experience, which in turn plays a vital role in harmonization of Shariah Practices in different Islamic banking institutions.
- Shariah advisor of the bank is responsible to ensure that all the products and services, operations and documents of the bank are compliant / consistent with the Shariah Rules and Principles outlined for the respective modes of financing. Before launching any new products the banks are required to get formal approval from the Shariah Advisor regarding Shariah compliance of the product and its related documents.

## **3. Essentials & Model Agreements of Islamic Modes of Financing :**

- **Essentials of Islamic modes of Financing** entail the basic principles of Islamic modes of financing that have to be observed by Islamic banking institutions while designing their product structures, manuals policies etc. These essentials ensure compliance with minimum Shariah Standards by the Islamic banking institutions.
- **Model Agreements for Islamic Modes of Financing** have been introduced in order to facilitate the existing Islamic banks and the potential market players in developing Islamic banking products in a harmonized manner (without restricting the process of product innovation).

## **4. Shariah Compliance Inspection:**

- SBP conducts Shariah Compliance Inspection on the basis of recently developed Shariah Compliance Inspection Manual for Islamic Banking Institutions.
- Shariah Inspection helps in identifying variation in procedures adopted by different banks. The decisions on Shariah Inspection findings are also a source that helps in achieving the goal of having standardized procedures for Shariah practices in the Islamic banking industry.

## **5. Meetings of Shariah Advisors:**

- When Shariah opinion is required regarding an Islamic banking issue of mutual/collective interest, the same is taken up in the meetings of Shariah advisors for discussion and possible resolution if so required.
- In case the issue requires detailed study/clarification, a sub committee is formed from the panel of Shariah Advisors to do some research and submit/present their findings to SBP. In case of need the matter under consideration may be taken to the SBP Shariah Board for its final resolution.
- Since some of the learned Shariah Advisors are based in other parts of the globe like Middle East, we also get feedback/views based on their global prospective/experience through their representatives.

## **New Initiatives for bringing in further Standardization in Shariah practices.**

### **1. Adoption / Adaptation of Shariah Standards developed by Accounting and Auditing Organization for the Islamic Financial Institutions (AAOIFI).**

- The introduction of international players in our Islamic banking industry has further necessitated the need to bring our industry at par with the global Shariah standards. Shariah Standards developed by Accounting and Auditing Organization for the Islamic Financial Institutions (AAOIFI) are an important and effective source available for bringing in the desired standardization in the Shariah practices.
- In order to bring our industry at par with the international standards and also achieve standardization of Shariah practices locally, a mechanism for adoption/adaptation of these Shariah standards has been developed by SBP. According to this mechanism the meetings of Shariah Advisors of all IBIs are being held with a view to thoroughly study the AAOIFI Shariah Standards one by one, for their possible adoption / adaptation in our market.

### **2. Draft Instructions & Guidelines for Shariah Compliance :**

- Draft Instructions for Shariah Compliance cover regulations in areas related to appointment, duties/ responsibilities and report of Shariah Advisor; conflict resolution in Shariah rulings; permissible modes of financing and investment; essentials of Islamic modes of financing; use of charity fund; introduction of new products & services and schedule of service charges.
- Draft Guidelines for Shariah Compliance cover areas like Internal Shariah compliance, Internal Shariah Audit; investment in shares; policy for profit distribution with PLS account holders and financial reporting & general disclosure requirements.
- Finalization of these instructions & guidelines will further contribute towards the process of standardizing practices in the respective areas.

### **3. IFSB Risk Management Guidelines**

- Islamic Financial Services Board (IFSB) promotes the development of a prudent and transparent Islamic financial services industry through introducing new or adapting existing international standards consistent with Islamic Shariah principles.
- IFSB has issued standards/guidelines regarding Capital Adequacy, Risk Management and Corporate Governance for institutions offering Islamic financial services (other than Takaful). SBP is planning to adopt these standards keeping in view the local environment and in consultation with various internal and external stakeholders of Islamic banking.
- Currently SBP is working on the guidelines for Risk management of Islamic banking institutions by tailoring them to the needs of local market. The aim of these guidelines is to further complement and enhance the current Risk Management regime of SBP by identifying and suggesting techniques to manage various types of risks unique to Islamic banking institutions. This exercise will further contribute towards the desired process of standardization in the industry.