

# **Guidelines for Conversion of a Conventional Bank into an Islamic Bank**



**ISLAMIC BANKING DEPARTMENT**

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## **I. Introduction**

State Bank of Pakistan (SBP) has been actively engaged in development and promotion of Islamic banking in the country through various policy and regulatory initiatives. In 2004, SBP issued minimum Shariah regulatory standards covering instructions for establishment of full-fledged Islamic bank, Islamic banking subsidiary and setting up of standalone Islamic banking branches by existing conventional banks. Subsequently, it issued detailed criteria for conversion of existing conventional branches into Islamic banking branches in 2010.

In continuation of earlier efforts to augment the industry's progress, State Bank of Pakistan has developed detailed guidelines for conversion of existing conventional banks into full-fledged Islamic banks.

## **II. Eligibility Criteria**

The eligibility criteria for conversion of conventional bank into Islamic bank shall be as follows:

1. All banks having Islamic banking division/branches can apply for conversion into full fledged Islamic bank.
2. The bank which has not yet been granted approval by SBP for Islamic banking division shall first obtain the approval for opening Islamic banking division before applying for conversion into full-fledged Islamic bank.
3. The bank shall have minimum CAMELS rating 'Fair' in the last On-site inspection and/or minimum CAELS rating 'Fair' in the last Off-site report, with no major adverse findings against the bank.
4. The applicant bank shall be compliant with Minimum Capital Requirements (MCR), Capital Adequacy Ratio (CAR) and all other requirements as applicable on full-fledged Islamic banks, from time to time.

## **III. Necessary Measures**

1. The bank shall develop a comprehensive conversion strategy with clear milestones and defined timelines for conversion duly approved by bank's Board of Directors (BOD).
2. The bank shall start conversion process in line with Shariah rules and principles within six months from the grant of in-principle approval, failure to do so will lead to revocation of the in-principle approval.
3. The bank shall complete the conversion process within a maximum period of three years from the date of in-principle approval. In case of delay, the bank shall justify extension request with reasons and evidence, duly approved by its Shariah Board and Board of Directors.

4. The bank shall notify the plan of conversion to the public at least four weeks before the initiation of conversion process.
5. The bank shall set up all necessary procedures, create the required tools, and explore alternatives to Shariah non-permissible products & services, operations & arrangements.
6. The bank shall also train and develop the personnel required for proper implementation of the procedures of conversion.
7. The bank shall specify a cut-off date of conversion beyond which the bank will be prohibited from conducting any Shariah non-compliant banking activities, both on asset and liability sides, except in the framework of settlement of rights and obligations of banking activities undertaken in the conventional manner.
8. The bank shall not delay in clearing out non-permissible transactions unless such delay becomes a necessity and is approved by the Shariah Board. In case of delay, the bank shall submit proper justification of the same to SBP.

#### **IV. Process**

The Conversion process shall consist of three steps:

- A. In-principle approval from SBP for initiating full-fledged conversion of the conventional bank into an Islamic Bank;
- B. Conversion of conventional banking branches into Islamic banking branches; and
- C. Issuance of Islamic Bank license.

##### **A. In-principle Approval of Conversion Process**

1. The bank shall submit their application to the Director, Banking Policy & Regulations Department, SBP, seeking in-principle approval to initiate the conversion process, with a copy for information to the Director, Islamic Banking Department, SBP. The application shall comprise of comprehensive Conversion Plan duly approved by bank's BoD and Shariah Board, containing detailed processes & procedures along with well thought-out timelines and milestones regarding conversion of all products & services and segments etc. Bank's request should also contain following information:

##### **a. Essentials:**

- i Resolution of bank's Board of Directors for conversion of the bank into an Islamic bank.
- ii Proposed changes in by-laws (Memorandum and Articles of Association), alongwith an opinion of an external legal consultant.

- iii Information about the controlling / major shareholders / sister concerns / group companies / subsidiaries.
- iv Profiles of members of BoDs & Key Executives of the bank.
- v Existing and proposed organizational structure.
- vi Details of existing branches (conventional and Islamic) and Islamic banking windows network and employee strength.
- vii Latest audited financial statements.

**b. Business Plan:**

- i Mission and Vision for conversion of the conventional bank into an Islamic bank.
- ii Three to five years business plan of the bank alongwith assumptions and projected key financial figures & ratios.
- iii Feasibility study on market opportunity and economic potential.
- iv Operational / execution plan for mobilization and channeling of funds, and steps to be taken to carry out conversion.
- v Capital adequacy compliance plan.
- vi Brief plan for conversion of branches.

**c. Position and Treatment of Shariah impermissible items:**

- i Position and proposed treatment of all Shariah impermissible existing assets and liabilities with corresponding Shariah compliant solutions.
- ii Position and proposed treatment of all off balance sheet items with corresponding Shariah compliant solutions.
- iii Position of non-performing assets and proposed treatment of the same.
- iv Details of Shariah non-compliant income / earnings and mechanism adopted for its disposal.
- v Details and treatment of Shariah non-compliant collaterals / securities.
- vi Details of all the existing products and services being offered by the bank including deposits, loan/advances, trade finance, treasury, export refinance, liquidity management, online services, third party products like bancassurance etc., alongwith methodology adopted for their conversion into Shariah compliant forms including treatment of collaterals i.e. lien, hypothecation, pledge, mortgage, any form of encumbrance / charge.
- vii Details and proposed treatment of investment portfolio such as T-Bills, PIBs, TFCs, shares etc. alongwith existing position such as amount, nature, maturity, payments, accruals etc.
- viii Information on all conventional financing arrangements with State Bank.

- ix Details and proposed treatment of Nostro / Vostro Accounts.
- x Details and proposed treatment of conventional structured/un-programmed products and financial arrangements.

**d. Training and Capacity Building:**

- i Details of preliminary training provided to all or selected employees of key departments of the bank, prior to applying for conversion.
- ii The bank shall arrange certification / training programs in coordination with NIBAF-SBP and/or any renowned training institutions and submit a comprehensive Islamic banking training plan (specifying contents, trainers, schedule etc.) for the bank's staff designated at the Head Office including CAD, Risk, Audit, Compliance, Business, Operations, Regional / Area Offices and at the branch level including Branch Managers, Operation Managers and Relationship Managers.
- iii The training plan shall also include training arrangements for third party / contract staff.
- iv The bank shall specify arrangements / plan for training and capacity building of BOD, Key Executives, staff of Head Office and other bank officials to be entrusted with the execution of conversion process.

**e. Policies and Procedures:**

- i Proposed changes in all policies and procedures / manuals pertaining to all main functions such as Finance, Risk Management, Credit Management System, Information Technology, Internal Control, Internal Audit, Human Resource, Treasury etc. duly approved by Shariah Board and BOD.
- ii Infrastructure for Shariah Governance (which shall among others include Shariah Compliance and Shariah Audit of the overall bank) as per Shariah Governance Framework of SBP and other applicable existing instructions as amended from time to time.
- iii Contingency funding plan.
- iv Plans for IT integration / migration from conventional to Islamic banking.

**f. Systems and Controls:**

- i The bank shall submit information about the availability of systems and applications, with controls, for conducting full-scale Islamic banking operations including profit distribution & pool management etc.
- ii The bank shall ensure that proper systems and controls are in place to protect the interest of customers.

- iii 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 until the time of complete conversion. In this regard, bank shall also ensure that separate chart of accounts are being maintained for Islamic banking operations.

**g. Audit and Review:**

- i Plans for resolution of adverse findings of internal, external and statutory auditors specially regarding fraud, forgery, money laundering and terrorist financing (if any) before conversion.
- ii Plans to undertake comprehensive internal audit on the operations of the bank both at pre and post conversion stages.
- iii Shariah Compliance Department of the bank shall arrange for periodic internal Shariah review and prepare a report in coordination with Monitoring Committee. The report shall be submitted to BoD on a quarterly basis till the completion of conversion process.

**h. Marketing Arrangements and Public Notices:**

- i Marketing plan (if any) such as brand name, logo and tagline for launching full-fledged Islamic banking business and related details.
- ii Strategy for informing bank's customers and general public about conversion through direct contact, print and electronic media etc.
- iii Process for obtaining consent from existing customers for conversion to Islamic banking products and services (assets and liabilities) both locally and internationally (if applicable).
- iv Plan for settlement of all assets and liabilities of customers unwilling to continue relationship with the bank on new terms and conditions.

**i. Information on bank's subsidiary(ies):**

- i Details about bank's subsidiaries such as branch network, nature of business, management structure, major shareholding, staff strength etc.
- ii Future strategy / plan for conversion of bank's conventional subsidiaries (if any).

**j. Other:**

- i Plans for conversion of Shariah non compliant employee benefits / facilities into Shariah compliant modes.
- ii Information about activities / cases which do not have corresponding Shariah compliant solutions and where the income has to be given to charity.

- iii Summary of the court cases under litigation and the bank's plan for settlement of customers' and shareholders' rights and obligations. The bank shall also provide a legal opinion that the cases under litigation (if any) will have no effect on the conversion process.
2. State Bank will evaluate the proposal of the bank keeping in view merits of the case and upon its satisfaction, will grant an in-principle approval to the bank to initiate the conversion process.
  3. The bank shall be prohibited from expanding its conventional banking network from the date of grant of in-principle approval. All new branches will required to be opened as Islamic banking branches in terms of already approved and/or new Annual Branch Expansion Plan (ABEP) as per Branch Licensing Policy.
  4. The bank shall set up a helpdesk & a well-defined complaint handling mechanism with respect to customers' queries regarding conversion of the bank, with proper record keeping and reporting to appropriate predefined level.
  5. For smooth streamlining of business operations and conversion of conventional banking portfolio, the bank shall identify / hire experienced and trained key staff to handle the conversion process. Further, the bank shall form two core committees i.e. Implementation Committee (IC) and Monitoring Committee (MC) and submit their Terms of Reference (ToRs) to State Bank, duly approved by bank's Board of Directors. The committees shall present a report on the conversion progress and related details, on a quarterly basis, to the bank's Board of Directors.
  6. The bank shall submit a quarterly report on conversion progress and related matters duly signed by the CEO / President along with Shariah Board's certificate to BPRD, SBP and a copy for information to IBD, SBP till the completion of entire conversion process.

## **B. Conversion of Conventional Banking Branches into Islamic Banking Branches**

1. In terms of in-principle approval of bank-wide conversion, the bank may submit an Annual Branch Conversion Plan (ABCP), duly approved by bank's Shariah Board and BoD, containing year-wise branch conversion targets, training plan for branch staff, procedure of informing general public and obtaining customer consent (both on asset and liability sides), conversion methodology, latest audit ratings of the selected branches and plans for resolution of adverse findings (if any).
2. The bank may obtain a combined in-principle approval for bulk conversion of branches through an above specified ABCP or may approach State Bank for in-principle approval for individual branches.
3. The conventional banking branch licenses will be converted into Islamic banking branch licenses after fulfillment of all necessary branch conversion requirements.



4. No new licensing fee shall be applicable on conversion of conventional branches into Islamic banking branches.

### **C. Issuance of full-fledged Islamic Bank License**

1. Upon completion of all requirements in light of conversion plan, in-principle approval and obtaining Islamic banking branch licenses for converted conventional banking branches, the bank shall apply for issuance of full-fledged Islamic Bank license along with following information:
  - i Revised Memorandum & Articles of Association of Islamic Bank along with summary of changes made.
  - ii Shariah Review Report and Shariah Board's Certificate confirming that the whole conversion process has been undertaken in conformity with Shariah.
  - iii Comprehensive post-conversion report containing status on areas mentioned in the preceding sections, duly certified by bank's Shariah Board and BoD.
  - iv A certificate that policies and procedure/process manuals regarding Operations, Credit & Risk Management, Treasury, Internal Control including Shariah Compliance, Shariah Audit, Information Technology Systems and all products have been prepared / revised and approved by the Shariah Board and the Board of Directors of the bank.
  - v Confirmation that all HR policies including employee benefits and facilities have been converted from conventional modes into Shariah compliant modes.
  - vi Summary of changes made in the systems & controls and policies & procedures for conducting Islamic banking operations.
  - vii Detailed report about the initiatives taken for capacity building / training of human resource regarding Islamic Banking.
2. Based on satisfactory review, the bank shall be issued a new license of an Islamic Bank while the conventional banking license shall be surrendered by the bank.
3. After getting license from SBP as Islamic Bank, the bank shall only engage in Shariah compliant banking operations and the conversion from Islamic to conventional side will not be permissible.
4. The Islamic bank so formed, shall be subject to all prevalent banking and other laws, rules, regulations and directives issued by SBP from time to time.

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