

Guidelines for
Shariah Compliance in
Islamic Banking Institutions



March 25, 2008

State Bank of Pakistan
Islamic Banking Department
www.sbp.org.pk

The Team

Name	Designation	Contact
Pervez Said	Director	(9221)921 2495 pervez.said@sbp.org.pk
Mahmood Shafqat	Senior Joint Director	(9221)921 2509 mahmood.shafqat@sbp.org.pk
Zahid ur Rehman	Junior Joint Director	-
Ashfaq Ahmed	Assistant Director	(+9221)245 3736 ashfaq.iba@sbp.org.pk

Table of contents

The Team.....	ii
GUIDELINES FOR SHARIAH COMPLIANCE IN ISLAMIC BANKING INSTITUTIONS (IBIs)....	1
I. Shariah Compliance:	1
II. Internal Shariah Audit:.....	1
III. Investment in Shares:	2
IV. Policy for Profit Distribution with PLS depositors:	2
V Financial Reporting and General Disclosure:.....	3

GUIDELINES FOR SHARIAH COMPLIANCE IN ISLAMIC BANKING INSTITUTIONS (IBIs)¹

I. Shariah Compliance:

In order to strengthen the Shariah compliance mechanism within IBIs and to ensure that all relevant Islamic banking regulations are complied with in letter and spirit, IBIs are required to introduce Shariah compliance mechanism as a part of their control structure. Close coordination of Compliance officials with Shariah Advisor of the IBI may further help in streamlining the process with necessary inputs by the Shariah Advisor. The Shariah Compliance framework may include the following:

- A system of compliance having special emphasis on Shariah aspects with relevant provisions of existing laws, rules, regulations, policies and procedures related to Islamic Banking need to be embedded in the IBI's processes in such a manner that monitoring and reviewing of issues related to Shariah compliance forms part of internal control structure.
- Monitoring and reviewing for Shariah Compliance should cover all activities, products and locations of the IBI.
- The basic purpose of this responsibility is to ascertain whether the transactions, processes and products undertaken by the IBI are Shariah compliant and all related conditions are being met, as approved by Shariah Advisor.
- Access to all necessary documents/information should be provided to Shariah compliance officials in performance of their functions.
- Irregularities, if any, related to Shariah Compliance shall be properly recorded and rectified with the approval of Shariah Advisor.
- Proper training should be provided to the relevant staff in the area of Shariah Compliance.

II. Internal Shariah Audit:

Islamic Banking Institutions should introduce a system of internal Shariah audit, so as to ensure that the goals and objectives of Shariah compliance are achieved, having regard to the following guidelines:

- a) Internal Shariah Audit of IBI may form part of the regular internal audit or as a separate unit depending upon size of operations of the IBI. The primary objective of the Internal Shariah Audit is to ensure that the management of the IBI is discharging its responsibilities in compliance with Shariah rules and principles as prescribed by the State Bank of Pakistan and the Shariah Advisor of the IBI. The purpose of the Internal Shariah Audit is to ensure that the system of internal control for Shariah Compliance is conceptually sound and effective in implementation, so as to ensure that the goals and objectives for Shariah compliance are achieved.

¹ Islamic Banking Institution (IBI) means Islamic commercial bank, Islamic banking subsidiary or an Islamic banking branch of conventional bank licensed by State Bank of Pakistan.

- b) The Internal Shariah Audit shall be carried out in conformity with Shariah rules and principles, guidelines and instructions issued by the State Bank of Pakistan and Shariah advisor of the IBI. The internal Shariah auditors shall have direct and regular communications with all levels of management and Shariah Advisor. No scope limitation and restriction of access to information, documents, reports etc. shall be placed on Internal Shariah auditors.
- c) The report of Internal Shariah Audit shall contain observations and assessment of systems and controls in place for Shariah compliance. The Internal Shariah Audit report shall also include recommendations for potential improvements and corrective actions to be taken. Any disputes/difference of opinion between management and Internal Shariah auditors on matters relating to Shariah interpretation shall be referred to the Shariah Advisor of the IBI for decision.
- d) The report of the Internal Shariah Audit shall be placed before the SA for advising the appropriate corrective action and then before the Audit Committee of the IBI for consideration and appropriate remedial action as advised by the SA.

III. Investment in Shares:

- a) IBIs, in the course of their business, may invest their surplus funds in shares of such companies whose primary business is not prohibited under Shariah. For investment in shares of such companies, a screening process for the selection of shares shall be followed. In this process, companies with acceptable primary business activities should be identified, which should be further evaluated according to several ratio filters as advised by the Shariah Advisor of the IBI in order to eliminate companies with unacceptable levels of non-Shariah compliant debts/non-Shariah compliant income/liquid assets.
- b) If the IBI invests in shares which meet above mentioned criteria for investment, and in the event a portion of non-Shariah compliant income exists in the investee company's accounts, then income of IBIs from dividends shall need to be purified and IBI's share of non-Shariah compliant income shall be donated to charity on pro-rata basis for the period of its holding of the share.
- c) IBIs shall follow the regulatory limits prescribed by State Bank in Prudential Regulations in terms of their aggregate exposure in shares both in ready/cash and futures market, as amended from time to time.

IV. Policy for Profit Distribution with PLS depositors:

- a) IBIs shall have a policy statement in place, vetted by the Shariah Advisor and approved by the Board of Directors, regarding the policies and procedures to safeguard the interest of the Profit and Loss Sharing based deposit holders (PLS depositors). Following areas may be covered under this policy:
 - i) Identification and determination of pools of assets and related income and the basis of such determination together with method for allocation of profits/losses between the PLS depositors and the IBI (as a mudarib,

- Musharaka partner or as an investment manager), whether or not IBI participates in the investment with its own funds.
- ii) Policy for charging provisions against non-performing assets in compliance with Prudential Regulations and Profit Equalization Reserves out of income generated from PLS funds and to whom these provisions and reserves revert to, in case of write-back or recovery.
 - iii) Policy on the priority for investment of own funds and those of PLS depositors
 - iv) Basis for allocating expenses to equity holders and various classes of depositors for determination and appropriation of profit.
 - v) Profit Sharing Ratio and Weightages for distribution of profit among various categories of deposits and periodicity for changing the same.
- b) IBIs shall submit these policy statements to Islamic Banking Department of SBP within 60 days of issuance of these guidelines. Any modification in such policies shall be communicated to SBP within one month of the change.
 - c) On the basis of aforementioned policy, the distribution of profit and loss by IBIs shall be subject to verification/audit jointly by the Shariah Advisor and external auditor.
 - d) The applicable Profit Sharing Ratios and Weightages for each type of deposits should be displayed in the branches and on the websites of IBIs for information of the general public. However, weightages for special or treasury deposit pools for interbank transactions may be disclosed to the relevant customer only.

V Financial Reporting and General Disclosure:

- a) IBIs shall follow financial reporting standards for Islamic modes of financing issued by the Securities and Exchange Commission of Pakistan (SECP) under the Companies Ordinance, 1984. However for modes/areas not covered by these standards, IBIs are encouraged to use AAOIFI Accounting Standards.
- b) In the annual report, IBIs are encouraged to disclose:
 - 1. overall basis of working of profit distributed to depositors;
 - 2. break up of their financing by Islamic modes of finance; and
 - 3. remuneration of Shariah advisor.
- c) In addition, the annual report of conventional banks having Islamic Banking Branches shall include separate balance sheet and profit and loss statement of their Islamic banking operations. Additional disclosure in the form of cash flow statement of Islamic banking operations is also encouraged.

Nothing contained in these instructions and guidelines shall or be deemed to permit an IBI to engage in any business, transaction or trading which is contrary to the injunctions of Shariah.

