ISLAMIC BANKING IN PAKISTAN

In the early decades of 20th century, the Islamic Banking was only limited to models and modus operandi. The full-fledged system of Islamic banking was introduced in 1960s by an Egyptian bank "**Myt Ghamr Savings Bank**". The earliest Islamic banks faced serious problems and challenges in achieving their goals. Since then, the Islamic banks have achieved remarkable financial and market success. Accordingly, at present, there are around 70 countries in which the Islamic financial institutions are operating in full-fledged or in part. Recently six countries including Bahrain, Saudi Arabia, Malaysia, Indonesia, Brunei and Sudan have signed a memorandum of understanding for establishment of the first ***International Islamic Financial Market (IIFM)*** in co-operation of Islamic Development Bank. A ***Liquidity Management Centre (LMC)*** is also working in Bahrain which addresses the critical need for liquidity management by Islamic banks in line with the Shariah principles. LMC addresses the critical need for liquidity management in line with the Shariah principles, the IIFM is designed to provide a co-operative framework among around 200 Islamic banks & financial institutions over the world.

The Islamic Financial Institution (IFI) can be further divided into two categories – i.e. Islamic commercial banks and Islamic investment institutions and international holding companies. IFIs includes the institutions like Daral Maal Al Islami (Geneva), Dallah Al-Baraka Group of Saudi Arabia, the Bahrain Islamic Investment Bank, Al-Rajhi Banking & Investment Corporation (Saudi Arabia), Al Meezan Bank (Pakistan), Faisal Islamic Bank (Egypt), Jordan Islamic Bank, Islami Bank Bangladesh; and Bank Islam Malaysia Berhad.

In Pakistan, the process of Islamic Financing and Banking started with the reforms in specialised financial institutions like NIT, ICP and HBFC in conformity with the Islamic principles. From 1st July 1985, all the commercial banking operations were made "interest free".

Recently, the State Bank of Pakistan has allowed the formation of full-fledged Islamic Banks in the Private Sector. The existing scheduled commercial banks are also authorised to open subsidiaries for Islamic Banking operations. Such subsidiaries shall be considered as the Islamic Banking Subsidiaries and shall have a separate body of governance. It is a statutory requirement for the bank to appoint a Shariah Adviser/Shariah Supervisory Committee consisting of Shariah scholars of repute to advise the Islamic Bank on matters pertaining to Shariah. Shariah Adviser/Committee will be responsible to vet all agreements, and products and services offered by the Islamic Bank. The detailed criteria for setting up Islamic Banking Subsidiaries has been issued by the State Bank with the following insertion in Sub-Section (1) of the section 23 of the Banking Companies Ordinance 1962, in terms of Banking Companies (Amendment) Ordinance, 2002:

> "the carrying of banking business strictly in conformity with the
> Injunctions of Islam as laid down in the Holy Quran and Sunnah"

The highlights of the criteria for setting up Islamic Banking Subsidiaries are as follows:

(i) The proposed subsidiary would be a Public Limited Company and would be listed on the Stock Exchange;
(ii) The subsidiary are required to conduct the banking strictly in accordance with the Shariah;
(iii) To commence business, the subsidiary shall have a minimum paid up capital of Rs. 1 billion and also shall at all times maintain minimum capital adequacy ratio of 8% based on risk weighted assets; and
(iv) At least 51% of the total paid up capital shall be subscribed by the banking company. A maximum of 49% of shares shall be offered to the public.

The eligibility criteria of a bank to open an Islamic Banking Branch (IBB) is the financial strength, adequacy of its capital structure, earning capabilities, future earning prospects, managerial capabilities, liquidity position, track record of the bank's adherence to prudential regulations, credit discipline, quality of customer services, etc. The applying bank is required to submit a proposal to the State Bank of Pakistan, stating the number of branches to open, products & services to offer, methods of segregating the funds of

IBB from the funds of applying commercial bank, etc. State Bank will evaluate the proposal of the bank keeping in view merits of the case and upon its satisfaction, will grant an approval to the bank for opening of branch.

The Guidelines for opening of Stand-alone branches for Islamic Banking by existing commercial banks are as follows:

Commencement of Business:
Before commencement of business, the bank will ensure that all of the documents and agreements pertaining to each type of products and services alongwith Risk Management Guidelines, Plants for Internal Control and Information Technology Systems are in place. All relevant documents/agreements and guidelines should be duly certified by their Shariah Adviser/Committee and a certificate in this regard will be submitted to the State Bank alongwith the Application Form.

Islamic Banking Division (IBD):
The bank will be required to set up an Islamic Banking Division (IBD) at the head office / country office in Pakistan. The bank will submit a full detail of the organisational structure of the IBD to the State Bank alongwith the Application Form. The responsibilities of IBD shall be as follows:

(a) To manage and be responsible for the operations of Islamic Banking Branch (IBB) including policy and procedural matters;
(b) To liaise with other departments in the bank and Shariah Adviser / Committee to ensure smooth operations of IBB;
(c) To ensure that all funds pooled into the Islamic Banking Fund (IBF) are channelled into Shariah compliant financing and investment activities;
(d) To arrange training of staff on Islamic banking;
(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 banking, 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; and
(h) Other roles and responsibilities as determined by the bank or State Bank from time to time

Islamic Banking Fund (IBF):
The bank shall be required to maintain a minimum fund of Rs. 50 million or 8% of the risk weighted assets of IBB, whichever is higher. The funds of Islamic Banking shall be funded by the head office or its country office and controlled by the IBD for the operations of IBB.

Shariah Compliance:
The sole purpose of the Islamic banks is to conduct banking business strictly in accordance with the Shariah principles as outlined in the Holy Quran and Sunnah. The bank is required to ensure the Shariah compliance on all the agreements, and products and services offered and handled by the IBD and/or IBB. The responsible authority for the Shariah compliance is the Shariah Adviser / Committee consisting of Shariah scholars having sufficient related knowledge, qualifications and experience. The Shariah Advisor or Shariah Supervisory Committee, appointed by the bank, shall advise the IBD on all of the business matters pertaining to Shariah.

Systems and Control:
The bank will ensure that proper systems and controls are in place in order to ensure the segregation of funds and protection of the interest of depositors, including but not limited to the followings:

(a) The bank shall be required to prepare procedure manuals for the IBD and IBB operations duly approved by their Shariah Adviser/Shariah Supervisory Committee as well as the Board of Directors or in case of branches of foreign banks operating in Pakistan, by their Head Office;

(b) The bank shall prepare a full set of documents pertaining to the deposit, investment and financing products pertaining to IBB operations;

(c) The full set of the documents duly vetted by their Shariah Adviser/Shariah Supervisory Committee shall be maintained by the IBD. Similarly, all documents in respect of new schemes offered by IBB shall also be prepared and maintained by IBD before launching of the scheme;

(d) All the documents (incl. Ledgers, registers, pay-in-slips, cheques, receipts, passbooks, etc.) used in the IBD and IBB shall be appropriately marked, so as to easily distinguish them from the documents pertaining to commercial banking;

(e) In order to efficiently utilise the existing branch network, the bank may authorise some of its branches to sell the Islamic banking deposit schemes. 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 IBB. The authorised branches shall be required to conduct the Islamic banking business strictly in accordance with the Shariah principles. Proper training in Islamic banking should also be provided to the staff of authorised branches dealing with such deposit schemes; and

(f) The bank shall be required to undertake comprehensive internal audit including internal Shariah Review on the operations of the IBB and IBF at least once in a year.

<u>Accounting Records and Disclosure:</u>

The bank is required to maintain the books of accounts in respect of Islamic Banking operations separately from the commercial banking in order to ensure the proper maintenance of records for all transactions and segregation of funds. The bank shall prepare and submit separate daily trial balance, and annual and quarterly financial statements for the IBB operations on the prescribed format to State Bank of Pakistan from time to time.

<u>Statutory Liquidity Requirements (SLR) and Cash Reserve Requirements (CRR):</u>

The Islamic Banks are required to maintain a Statutory Cash Reserves and Liquidity Requirements and open a current account with the State Bank of Pakistan. In this account, the IBD will maintain a cash reserve with the State Bank in the manner as prescribed for commercial banks (i.e. @ 5% of Time & Demand Liabilities – TDL). The IBD is also required to maintain an additional cash amount equivalent to 6% of their TDL in the same current account with SBP in lieu of Statutory Liquidity Requirement (SLR). Therefore, in all, the IBD is required to maintain 11% of the time and demand liabilities in the current account with SBP on weekly average basis and 10% of TDL on daily basis in lieu of CRR and SLR.

<u>Reporting to State Bank:</u>

The bank is required to report SBP on the weekly position of the IBB operations and other statements from time to time.

<u>References:</u>

1. Muhammad Ayub, **Islamic Banking and Finance – Theory and Practice**, State Bank of Pakistan
2. State Bank of Pakistan, **State Bank News**, Volume XLII No. 2