

# Consultation Paper

## Proposed Islamic Financial Services Law

Date of Issue: October 30, 2024

Last date of submission of comments: November 30, 2024



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## **CONSULTATION PAPER - PROPOSED ISLAMIC FINANCIAL SERVICES LAW**

### **1. Background**

Legal and regulatory frameworks play a pivotal role in developing any regulated sector, and the Islamic finance industry is no exception. Comprehensive financial laws provide the required clarity for every stakeholder, enable the development of medium- to long-term strategies, support business growth and expansion, and help complete the financial ecosystem.

Primary laws are the main source for developing a robust legal, regulatory, and operational framework with the support of subsidiary legislation. Pakistan's non-bank financial sector has seen a legal and regulatory overhaul in the recent past. Unfortunately, the overhaul primarily covers the conventional market with limited provisions for developing Shariah-compliant institutions, products, and processes within the non-bank financial sector. The Modaraba Companies and Modaraba (Floatation and Control) Ordinance, 1980, is the only primary legislation dedicated to Islamic finance in the non-bank financial sector, which is already four decades old.

The number of Islamic financial institutions, size of Islamic financial assets, and footprint of Islamic financial services within the non-bank financial sector have witnessed tremendous growth in the last few years. The higher proportion of market capitalization of Shariah-compliant securities on the stock exchange and the major portion of total Islamic assets in the voluntary pension funds demonstrate the potential of Islamic finance in the non-bank financial sector. The growth of the Islamic mutual funds industry, Takaful operations, non-bank micro-Islamic finance companies, etc. also evidences a need for better regulations and the development of Islamic financial services within the non-bank financial sector.

Islamic Finance Advisory and Assurance Services (IFAAS), a consultant to the Asian Development Bank (ADB) in the 'Islamic Finance for Inclusive Growth Project' (Project) under its Technical Assistance No. 9453-REG to the government of Pakistan, has prepared an initial draft of this consultation paper and the proposed law. Therefore, this consultation paper is primarily based on the said initial draft and has used information from the same while acknowledging the contribution of the IFAAS.

### **1. Existing legal and regulatory framework for Islamic financial services**

The Securities and Exchange Commission of Pakistan (SECP) is an apex regulator for varied licensed activities and oversees the capital market, non-bank financial institutions (NBFIs), and the insurance sector. The core functions of SECP include developing a legal and regulatory framework for the regulated sectors, supervising and enforcing the notified laws, and adjudicating non-compliances. The Islamic financial services industry under the regulatory purview of SECP includes (a) Islamic finance institutions like Modarabas, Takaful operators, Islamic NBFIs, (b) Islamic instruments like Sukuk, Islamic commercial papers, Shariah-compliant securities, Islamic mutual funds, Islamic exchange-traded funds (ETFs), Shariah-compliant real

estate investment trusts (REITs), and (c) Islamic finance intermediaries like Shariah advisors. These are collectively referred to as the “Islamic financial services industry” in this document.

To discharge regulatory obligations, the following are the legal and regulatory frameworks for the Islamic financial services industry:

- Institutions of Modaraba are being regulated through the Modaraba Companies and Modaraba (Floatation and Control) Ordinance, 1980, Modaraba Rules, 1981, and Modaraba Regulations 2021.
- The Takaful industry is being regulated under the Insurance Ordinance 2000 and the Takaful Rules, 2015.
- Non-banking finance companies and mutual fund industries are regulated under Part VIII of the Companies Ordinance, 1984, stipulating provisions for the Establishment and Regulation of Non-Banking Finance Companies, the Non-Banking Finance Companies (Establishment and Regulation) Rules, 2003, and the Non-Banking Finance Companies and Notified Entities Regulations, 2008, with an ordinary reference to Islamic products and services.
- The capital market and related institutions, intermediaries, products, and markets are primarily regulated under the Securities Act, 2015, and the Futures Market Act, 2016, with a number of subsidiary legislations made thereunder. This legal and regulatory framework does provide certain provisions, but as a whole, it does not adequately cover the regulation of the Islamic financial services industry.
- Shariah-compliant companies, Shariah-compliant securities, and Shariah-compliant advisors are being regulated under Section 451 of the Companies Act, 2017; and the Shariah Governance Regulations, 2023.
- Some other subsidiary legislation, like the Voluntary Pension System Rules, 2005, and the Real Estate Investment Trust Regulations, 2022, also enable the regulation of Islamic pension funds and Islamic REITs.

However, a closer examination of the legal and regulatory framework for Islamic financial services industry reveals that the current governing laws and regulations on Islamic finance in the non-banking sector are scattered and often inconsistent. Furthermore, the applicability of the Shariah Governance Regulations is limited and does not include sectors such as leasing companies, Real Estate Investment Trusts (REITs), Modarabas, Takaful, and housing finance companies. Thus, a dedicated and consolidated law will fill this gap by acting as a concise and comprehensive enabling primary/umbrella law on Islamic finance, unifying all existing laws pertaining to the Islamic finance industry in Pakistan.

## **2. Proposal**

With this background rationale, it is imperative to initiate working on developing a dedicated and full-fledged primary law for the Islamic financial industry in Pakistan. The proposed law, which

may be called the Islamic Financial Services Act, may consolidate all the relevant provisions into one piece of legislation while serving as a reference point for the development of case laws in the judicial system. The proposed law will free the development of Islamic financial products from the need to wrap Islamic concepts into a conventional framework, e.g., developing commodity Murabahah as a “future contract,” reflecting Murabahah as a financing tool instead of trading where holding inventory is possible, etc. The primary law will also serve as the basis for developing a parallel structure of capital market institutions capable of replacing the conventional market and achieving Islamization of the financial system and economy.

Furthermore, the Federal Shariat Court of Pakistan (FSC) Judgment dated April 28, 2022, has specifically held that the challenged laws or provisions of the laws have been declared to have no effect after June 1, 2022, while the entire economy has to be transformed by December 2027. The main thrust of the judgement is on banking. The regulated financial markets and institutions falling within the regulatory ambit of SECP have not been specifically touched upon, apparently because of the non-challenge to laws administered by SECP. The FSC declared that all the prevailing forms of interest, either in banking transactions or in private transactions, fall within the definition of Riba. The FSC directed that the federal government and provincial governments must amend relevant laws and issued directives that the country's banking system should be free of interest by December 2027. It is therefore appropriate to enact a specialized law for the Islamic financial services industry in order to comply with the decision and direction of the FSC.

### **3. Rationale for the Proposal**

The Islamic financial services industry in Pakistan is expected to continue its growth trajectory over the medium term, driven by a strong government push and steadily rising public demand for Islamic products. However, the industry faces key challenges that could slow its growth, such as the still-developing Islamic finance regulatory framework.

In April 2022, the FSC ruled that ‘*Riba*’ or interest is prohibited in Islam, including relating to banking transactions. The FSC directed the government to adopt Shariah-compliant modes while seeking financing from domestic or foreign sources in the future. The FSC set an implementation timeline of five years to convert the economy of Pakistan into an “equitable, asset-based, risk-sharing, and interest-free economy” by the end of 2027. This judgment reaffirmed the legitimacy of the current Islamic financial services industry in the country.

At the macro level, article 2 of the Constitution of the Islamic Republic of Pakistan 1973 lays down that Islam shall be the state religion of the country. Furthermore, article 227 of the Constitution requires that all existing laws be brought into conformity with the injunctions of Islam as prescribed in the Holy Quran and Sunnah, and no law shall be enacted that is repugnant to such injunctions. Likewise, article 38(f) obliges the government to eliminate Riba as early as possible. Moreover, Section 3 of the Enforcement of Shariah Act 1991 specifically declares Islam as the supreme law of Pakistan, while Section 8 of the Act stipulates that the state shall take measures to ensure that the economic system of Pakistan is construed on the basis of Islamic economic objectives, principles, and priorities.

On the micro level, the laws governing the Islamic finance industry in Pakistan can be classified into two separate categories, namely, the financial institutions under the ambit of the State Bank

of Pakistan (SBP) and the ones under the SECP; the former regulates all banking institutions and markets, while the latter regulates all non-banking financial institutions and markets.

In view of the lack or even absence of a proper legal and regulatory framework for Islamic finance in the country, a number of judgments on various issues pertaining to the Islamic finance industry were delivered by the courts, which ignored the unique nature of this segment and treated it similar to conventional finance regimes. Such judgments indicate unclarity in conducting Islamic finance businesses, and they are likely to be an obstacle to the development of the industry. For instance, the learned Sindh High Court struck down the charity clause in a contract offered by a licensed financial institution, rendering it void on the grounds that charity is not covered under the Financial Institution (Recovery of Finances) Ordinance, 2001. Considering such unfolding events, it is evident that there is a stark need for a concise and comprehensive enabling primary umbrella law on Islamic finance, unifying all existing laws pertaining to the Islamic financial services industry in Pakistan. Promulgation of a dedicated and separate Islamic banking law is also under consideration of the SBP.

In addition, numerous Shariah reputational and regulatory risks, such as the conduct of unregulated Shariah business activity, arbitrary interpretation of Shariah, and discretionary labelling of businesses as Shariah-compliant, have been prevalent in Pakistan. The situation sometimes resulted in the occurrence of events, like the famous Modaraba scandal, in which thousands of innocent people lost their hard-earned money, having dire consequences for the masses, the regulator, and the respective government agencies. Given such circumstances, there is a need to introduce additional measures to uphold the sanctity of Shariah in business and financial dealings and operational practices to ensure the long-term sustainability of the Islamic financial system. Absence of a dedicated law for the Islamic financial services industry and scattered enabling provisions in conventional laws also create legal risk in terms of lack of standardization of legal interpretations in the Islamic financial services industry at the institution or product level, lack of legal coverage to enable innovation and growth in the Islamic financial services industry, and in cases of litigation, i.e., conflict between existing public and private laws.

#### **4. Aims and Objectives**

The overarching objectives of the proposed law are to:

- Provide a concise and comprehensive umbrella/primary law on Islamic finance, unifying all existing laws pertaining to Islamic finance in the non-bank financial sector.
- Assist the Commission in revamping its existing framework related to Islamic finance and confer upon it powers to make secondary legislation in matters of Shariah governance and compliance for all regulated sectors.
- Provide for the establishment of a national-level Shariah supervisory board, serving as the highest-level authority in all matters pertaining to Shariah interpretation and compliance in the Islamic financial services industry.
- Overcome legal uncertainty and legal risk by providing a reference primary law to the courts for deciding matters pertaining to the Islamic finance industry.
- Enable standardization in Shariah related matters across all regulated sector in Islamic financial services industry.

## 5. Methodology

The following methodology is to be adopted in the process of drafting the proposed law:

- **Documentary reviews:** All existing laws and regulations pertaining to Islamic finance are to be collated and closely examined in order to grasp the legal and regulatory environment of Islamic financial services under the regulatory ambit of SECP, covering acts, ordinances, rules and regulations, etc.
- **Benchmarking and international best practices:** In order to present a robust and comprehensive framework for the effective regulation and supervision of Shariah compliant business activities, standards issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB) are to be analysed. Given that the standards and technical pronouncements of the two organizations are currently followed by many Islamic financial institutions and jurisdictions across the world and have introduced a progressive degree of harmonization of international Islamic finance practices, their standards will be a key point of reference in the formation of the law.

Furthermore, the legal framework of several leading Islamic finance markets, like Malaysia, Indonesia, the United Arab Emirates, and the Kingdom of Saudi Arabia, must be reviewed while being fully conscious of the national context of each jurisdiction. In particular, the primary laws of Malaysia related to both Islamic and conventional finance are to be analysed to see how these laws are different from each other and what value addition the former has made. These laws included the Islamic Financial Services Act, 2013 and its conventional counterpart, the Financial Services Act, 2013, as well as the Capital Markets Services Act, 2007, which is applicable to both Islamic and conventional capital markets.

- **Stakeholders engagement:** A number of roundtable meetings with the main stakeholders from the public and private sectors, among others, will be conducted in order to capture their perceptions of Islamic finance within the country. Some of the main stakeholders include capital market infrastructure institutions, the NBFIs and Modaraba Association, the Mutual Funds Association of Pakistan, the Pakistan Stock Brokers Association, the Insurance Association of Pakistan, the Institute of Chartered Accountants of Pakistan and the Institute of Cost and Management Accountants of Pakistan, the State Bank of Pakistan, the Pakistan Banks Association, Shariah scholars, law experts, academicians, and others.

## 6. Proposed Approach

The primary focus of this initiative is to introduce a concise and comprehensive primary law for governing the Islamic financial services industry. While the law may lay down the legal foundation of and illustrate the guiding principles, it is pertinent to highlight that the provisions in the proposed law do not aim to substitute for or relieve licensed persons from any other general provisions or requirements of the existing laws and regulations. Furthermore, the proposed law

shall override any conflicting matters pertaining to the Shariah governance of the licensed persons/entities. Likewise, the proposed law will enable the Commission to have high levels of authority and confers powers to make secondary legislation through regulations as and when required.

Therefore, the approach for drafting this law is intended to set the overall direction and principles for achieving the desired legal outcome. Drafting the law requires a balance between legal rigor, Shariah compliance, and market realities. Therefore, the law is to be drafted within these three verticals. The draft law process is expected to prioritize alignment with Shariah, foster collaboration among stakeholders (legal experts, Shariah scholars, industry practitioners, and public representatives), balance growth, financial stability, and investor's protection, promote transparency and accountability, enable innovation, create harmonization with existing national and international legal requirements, etc. and enable effective discharge of fiduciary responsibility by the institutions offering Islamic financial services.

The proposed law shall provide a high level / broader framework with enabling provisions to cover all aspect of Islamic financial services, products, markets, and intermediaries. Detailed provisions may be covered through subsidiary legislation, which may be framed keeping in view the specialized needs of respective sectors.

Further, the proposed law shall introduce and establish the 'principle of proportionality' that aims to strike a balance between risk, cost, and efficiency in conducting business. The principle implies that the legal and regulatory requirements shall reflect the nature, volume, and size of the licensed person's institution. Hence, a large financial institution shall have a more rigorous framework and more requirements to ensure the Shariah compliance of the complex business as compared to a small institution with one standard product.

The following provides further details on the approach considered in the process of drafting the law, explains the structure, and stipulates a broader outline of the envisaged provisions.

### **Part I: Preliminary**

This part presents the introductory part of the law, highlighting the title, extent, commencement, definitions of terms, and the act to override.

#### **Title**

- ✓ The Act may be titled the Islamic Financial Services Act.

#### **Extent**

- ✓ The extent of the Act will be the institutions, markets, products, regulated person and services included in the SECP's mandate, as modified on time to time.
- ✓ The Federal Government shall be empowered to extend the mandate under this Act by specifying any institution in whatever form, markets, products, or services, subject to compliance with this Act. For example, the federal government may bring in the mandate for Islamic National Saving schemes within the scope of this law.

- ✓ The provisions of this Act shall apply in addition to the provisions of the SECP Act and administered legislation, unless the said provisions are inconsistent. In cases of inconsistent provisions, the provisions of the Act shall prevail.

#### **Definitions**

- ✓ These shall be aligned with the definitions provided in the SECP Act and the administered legislation. Only the terms not defined therein and the terms specifically required to be defined shall be defined.
- ✓ In the case of a term not defined in any existing law or regulation, alternative sources such as the AAOIFI and IFSB standards can be referred to in order to harmonize and ensure the consistency of the used terms.

#### **Override**

- ✓ Subject to limitation provided in the “extent” provision, this Act shall have overriding powers, specifically the SECP Act and administered legislation, and in matters of Islamic finance, any other legislation.
- ✓ The subsidiary legislation made under this Act shall also have similar overriding powers. This may be achieved by declaring that subsidiary legislation made under this Act shall be considered part of the Act for this purpose.

### **Part II: Offering Islamic Financial Services**

This part shall contain the general provisions, including restrictions on providing such services without recognition as per requirements of the law.

#### **Prohibition**

- ✓ There shall be a prohibition on offering or claiming to be offering Islamic financial services without recognition under the Act. This shall include:
  - Offering or claiming to be offering any Shariah-compliant financial product or service by any person (including unregistered entities).
  - Claiming to be an Islamic financial institution, entity or establishment in any form
  - Claiming any of its security to be Shariah-compliant by an issuer.
  - Claiming publicly that a security or securities issued by others are Shariah-compliant without such claims by the issuer.
  - Offering or rendering Shariah advisory services in respect of any of the products, services, markets, or institutions subject to compliance with this Act
- ✓ Any violation of this provision shall be a criminal offence the mandate of a law enforcement agency.
- ✓ General conditions for offering Islamic financial services, Shariah-compliant markets, products, and securities can be provided.
- ✓ Enabling provision to establish the ‘principle of proportionality’.



### **Part III: Recognition of Islamic Financial Services and Related Matters**

This part shall contain the provisions for the recognition of providers of Islamic financial services (covering both dedicated full-fledged Islamic financial institutions and intuitions offering Islamic financial services through window operations), issuing or claiming securities to be Shariah compliant, etc.

#### **Recognition as an Islamic financial institution (full-fledged Islamic financial institution)**

- ✓ The Act may provide enabling provisions for the recognition of an Islamic financial institution while enabling the specification of detailed requirements for such recognition through regulations.
- ✓ These institutions shall include all licensed and regulated persons, including but not limited to Takaful operators, NBFCs, AMCs, managers of pension funds, private funds, REITs, Modarabas, brokers, trustees, securities advisors, portfolio managers, etc.

#### **Recognition as institutions offering Islamic financial services either through window operations (other than full-fledged Islamic financial institutions)**

- ✓ The Act may provide enabling provisions for the recognition of such institutions while enabling the specification of detailed requirements for such recognition through regulations.
- ✓ The Act may also provide for enabling provisions for conversion of such institutions into full fledged Islamic financial institutions.

#### **Recognition of Shariah-compliant markets, products, and securities**

- ✓ The Act may provide enabling provisions for the recognition of Shariah-compliant markets, products, and securities while enabling the specification of detailed requirements for such recognition through regulations.

#### **Recognition as Shariah advisors, consultants, arrangers, auditors, and any related service providers**

- ✓ The Act may provide enabling provisions for the recognition of Shariah advisors, consultants, arrangers, auditors, and any related service providers while enabling the specification of detailed requirements for such recognition through regulations.
- ✓ Fit and proper criteria for sponsors, directors, senior management officers of the institution offering Islamic financial services.

#### **Recognition of institutions and initiatives for the conduct of training and capacity-building activities in the Islamic financial services industry**

- ✓ The Act may provide enabling provisions for the recognition of institutions and initiatives for the conduct of training and capacity-building activities in the Islamic financial services industry and any related service providers, while enabling the specification of detailed requirements for such recognition through regulations.
- ✓ The Commission may establish an institution for training and capacity-building activities and provide avenues for Shariah scholars to be trained. Such further development programs with regard to the human development aspect of Shariah governance

framework are also precedents in other leading Islamic finance jurisdictions, such as Malaysia and Bahrain, among others. Collaboration with such institutions may also be explored for the benefit of the industry.

#### **Part IV: Shariah Governance**

The provisions in this part enable the establishment of the four pillars of Shariah governance, namely: a national Shariah board (at a national level), the Shariah supervisory boards (at an institutional level), the Shariah compliance function, and the Shariah audit (internal and external).

##### **National Shariah Board**

- ✓ It may be an independent national body constituted by the Commission, serving as the highest-level authority in all matters pertaining to Shariah governance in the Islamic finance services industry.
- ✓ The broad-level scope, functions, composition, powers, and responsibilities of this body shall be provided with enough flexibility to extend its scope, functions, powers, and responsibilities.
- ✓ It shall be mainly responsible for the interpretation of and providing guidance in matters related to Shariah at the industry or national level as well as of the standards issued by international standards setting organizations.
- ✓ It shall have a role in the Islamic finance developmental activities, including proposing and approving initiatives, strategies, and action plans for the development of the industry and playing a thought leadership role in this connection, besides performing any ancillary responsibilities assigned to it by the Commission.
- ✓ It shall be the highest-level authority in matters pertaining to the determination of Shariah matter in the Islamic financial services industry, however, it shall not be ranked equal with the existing judicial system of the country.
- ✓ It may refer any matter for consideration by the Federal Shariat Court.
- ✓ It may have an operational mechanism somewhat similar to that of the Council of Islamic Ideology.

##### **Institutional level Shariah Governance**

- ✓ This shall include requirements to have a Shariah supervisory board or Shariah advisor and obligations towards Shariah compliance through the Shariah compliance function and internal and external Shariah audits.
- ✓ The detailed Shariah governance framework is to be specified through regulations.

#### **Part V: Disclosures, Reporting, and Disciplinary Proceedings**

The provisions in this part shall empower the Commission to require any person to make disclosures, submit reports, and initiate disciplinary proceedings in cases of non-compliance.

- ✓ The Commission's disciplinary powers including, but are not limited to, the following:

- Power to call information or produce records
- Powers to pass prohibitory orders
- ✓ Power to monitor compliance through offsite review and onsite inspections
- ✓ Power to conduct investigations
- ✓ Power to initiate enforcement actions that may result in the imposition of restrictions, suspension of recognition, derecognition, imposition of fines, and initiating criminal proceedings
- ✓ Provisions for offenses and penalties
- ✓ Provisions to enable alternative dispute resolution

#### **Part VI: Modaraba**

If it is decided to merge the Modaraba Ordinance into this law, this part may contain specific provisions on Modaraba pertaining to matters such as licensing requirements, the policy on charging fees, and the due diligence of the interests of the Modaraba certificate holders.

#### **Part VII: General Provisions**

This part shall provide general stipulations, including the following:

- ✓ Powers to make rules by the federal government
- ✓ Powers to make regulations by the Commission
- ✓ Powers of the Commission to amend the schedule of fees and charges
- ✓ Powers to issue circulars, guidelines, notifications, etc.
- ✓ on all other miscellaneous matters related to the Islamic finance industry, such as the alternative dispute resolution system. This is to establish the hierarchy in matters related to disputes over the interpretation of Shariah and avoid deviating from the already established legal system of the country.
- ✓ Transitional provisions, removal of difficulty, and repeal and savings clauses (may include Modaraba Ordinance, Section 451 of the Companies Act).

### **7. Ways forward**

The proposed law represents an ideal and the highest conceivable framework for the establishment of a law governing the Islamic financial industry specific to Pakistan. In order to take the matter forward, this consultation paper is published with the approval of the Commission to seek stakeholders' feedback and comments.

A roundtable consultation session can be held with the stakeholders who choose to provide comments and feedback on this consultation paper.

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