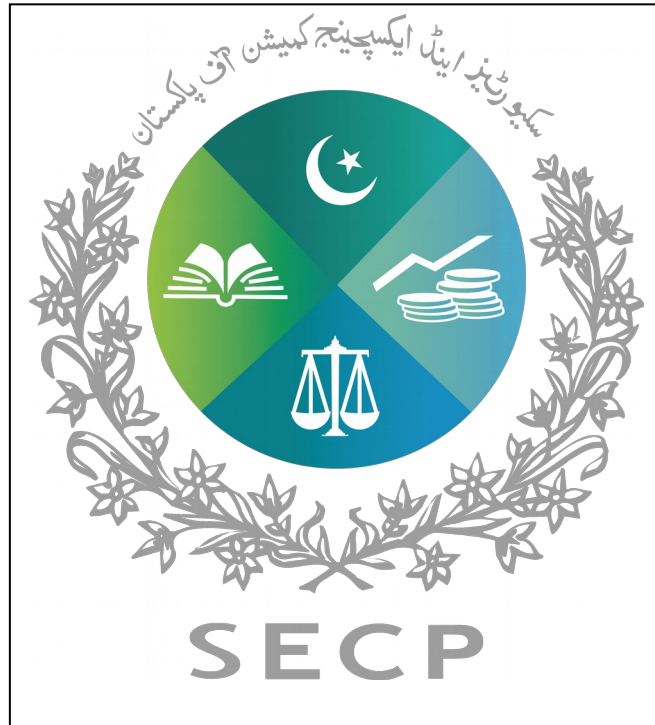


Concept Note – New Strategy for Adoption of AAOIFI Standards



Preamble:

This document focuses on the roadmap for bringing standardization in the practices of Islamic finance industry in the light of AAOIFI standards and global best practices. The document enumerates the new strategy for the adoption of AAOIFI Standards within regulated sectors of SECP.

1. Background:

Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), based in Bahrain, is the leading international standard setting body for development and issuance of standards for the global Islamic finance industry. AAOIFI is entrusted to ensure the soundness and stability of the Islamic financial services industry including banking, capital market and insurance/takaful in accordance with Shariah as well providing the guidance for regulatory and supervisory bodies. AAOIFI has footprints in around thirty-seven countries having 150 institutional members – including central banks, Islamic financial institutions (IFIs), and other participants of the international Islamic finance industry. The Securities and Exchange Commission of Pakistan (SECP) and the State Bank of Pakistan (SBP) are also the regulatory members of AAOIFI.

AAOIFI has, so far, promulgated a total of 119 standards¹ and technical pronouncements in the area of Shariah, accounting, auditing, governance, ethics for IFIs and Islamic finance transactions and structures, including Waqf and other ancillary institutions, with an aim to achieve progressive degree of harmonization in the international Islamic finance practices. AAOIFI's standards are fully or partially adopted by multiple regulators in more than 18 countries, besides several others follow these standards as guidelines or have developed their own standards and regulations in the light of AAOIFI standards.

1.1. Status of adoption of AAOIFI standards globally²

Level of AAOIFI standards adoption	No. of regulatory Jurisdictions			No. of countries		
	SHA	ACC	GOV	SHA	ACC	GOV
Full adoption	19	24	18	16	18	15
Partial adoption	4	5	6	3	5	6
Guidance/reference material	9	7	8	9	7	8
Local standards based on AAOIFI standards	2	4	4	2	4	3
Guidance & local standards based on AAOIFI standards	1	2	3	1	1	2
Supplementary reporting	0	1	1	0	1	1

(SHA – AAOIFI Shariah Standards, ACC – AAOIFI Accounting Standards, GOV – AAOIFI Governance / Auditing Standard)

1.2. Status of adoption of AAOIFI Shariah standards in Pakistan

AAOIFI Shariah Standards	SBP ³	SECP ⁴
Shariah Standard No. 2 (Debit Card, Charge Card and Credit Card)	✓	
Shariah Standard No. 3- Procrastinating Debtor	✓	✓
Shariah Standard No. 5 (Guarantees)	✓	
Shariah Standard No. 8-Murabahah to the Purchase Orderer	✓	✓

¹ <https://aaoifi.com/e-standards/?lang=en#>

² <http://aaoifi.com/foot-print-report-download/?lang=en>

³ <https://www.sbp.org.pk/ibd/2022/C1.htm> (SBP adopted AAOIFI Shariah Standards with certain clarifications and amendments)

⁴ <https://www.secp.gov.pk/islamic-finance/standardization-and-harmonization/>

Shariah Standard No. 9- Ijara and Ijarah Muntahia Bittamleek	✓	✓
Shariah Standard No. 10 (Salam and Parallel Salam)	✓	
Shariah Standard No. 11 (Istisna'a and Parallel Istisna'a)	✓	
Shariah Standard No. 12 (Sharika (Musharaka) and Modern Corporations)	✓	
Shariah Standard No. 13- Mudarabah	✓	✓
Shariah Standard No. 14 (Documentary Credit)	✓	
Shariah Standard No. 17 - Investment Sukuk	✓	✓
Shariah Standard No. 18- Possession (Qabd)	✓	✓
Shariah Standard No. 19 (Loan (Qard))	✓	
Shariah Standard No. 23 - Agency and the Act of an un-commissioned agent (Fodooli)	✓	✓
Shariah Standard No. 24 (Syndicated Financing)	✓	
Shariah Standard No. 25 (Combination of Contracts)	✓	
Shariah Standard No. 28 (Banking Services in Islamic Banks)	✓	
Shariah Standard No. 38 (Online Financial Dealings)	✓	
Shariah Standard No. 49 (Unilateral and Bilateral Promise)	✓	
Shariah Standard No. 50 (Irrigation Partnership (Musaqat)	✓	

1.3. AAOIFI Shariah standards in the process of adoption at SECP

Sr.#	AAOIFI Shariah Standards	Status
1	Shariah Standard No. 21 - Financial papers	To be notified
2	Shariah Standard No. 27 - Indices	To be notified
3	Shariah Standard No. 30 - Monetization (Tawarruq)	To be notified
4	Shariah Standard No. 44 - Obtaining and Deploying Liquidity	To be notified
5	Shariah Standard No. 45 - Protection of Capital and Investments	To be notified
6	Shariah Standard No. 46 - Al-Wakalah Bi Al-Istithmar (Investment Agency)	To be notified
7	Shariah Standard No. 53 - Arboun (Earnest Money)	To be notified
8	Shariah Standard No. 4 - Settlement of Debt by Set-Off	In-principle approval
9	Shariah Standard No. 5 - Guarantees	In-principle approval
10	Shariah Standard No. 19 - Loan (Qard)	In-principle approval

2. Need for adoption of standards in IFIs:

The reputation and credibility of IFIs rely on their ability to adhere to Shariah injunctions. Globalization and internationalization in Islamic finance have accentuated the need to create standardization and harmonization in the Shariah practices, their accounting treatments and governance in an integrated framework across the globe. Consistency in Shariah practices and their accounting treatments are instrumental in strengthening the trust of the general public and paves the way for positive public perception.

2.1 Existing strategy for adoption of AAOIFI standards

To achieve such standardization, SECP presently has deployed a flexible and market-oriented strategy for adoption/adaptation of AAOIFI standards. The policy is highly sensitized to industry feedback and emergent constraints of domestic market. Figure 1 explains the existing strategy for adoption as practiced by SECP.

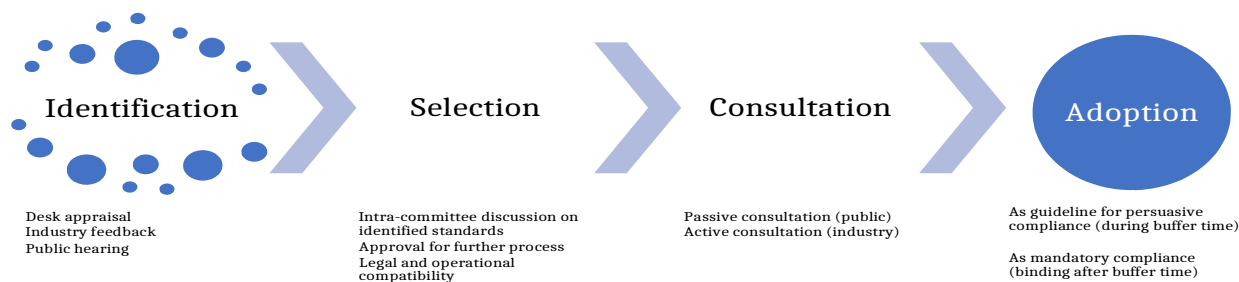


Figure 1: Existing Strategy for Adoption

2.2. Stages for adoption of AAOIFI Standards

Presently focus of standardization is limited to the adoption of the AAOIFI's Shariah standards and Islamic Financial Accounting Standards developed by ICAP and that too on need basis. The existing adoption process can be divided into the following stages;

Stage 1- Identification:

Identification of the standards to be adopted is evaluated by SECP on the basis of striking and foremost importance. The identification process starts with expert diligence at the desk. The standards are identified in line with the market trends/needs and suitability. Identification of the standards are validated through industry feedback and finalized after public hearings and /or consultation through roundtables.

Stage 2- Selection and Compatibility

At this stage an impact analysis of the standards is carried out. In this analysis, the standards are screened for their compatibility and suitability to the existing regulatory framework using in-house resources.

Stage 3 - Consultation

An ongoing passive public consultation is also arranged to attract valuable and insightful comments to tailor the standards as per the local needs. The experts in the relevant industry are also actively consulted through meetings, roundtables, and webinars, including but not limited to the Mutual Funds Association of Pakistan, NBF & Modaraba Association, Shariah Advisors, Consultants, IFIs, Insurance Association of Pakistan, Institute of Chartered Accountants of Pakistan, and others, in order to gain a more in-depth and keen perspective on the adoption of the identified standards.

Following the conclusion of the consultations, the recommendations, if any, are taken into consideration, and the proposed standards are then submitted to the SECP's Shariah Advisory Committee (SAC) for in-principle approval.

Stage 4 - Implementation:

Thereafter, a proposal for adoption and notification of the selected standard is submitted to the Commission for approval under proviso to sub-section (1) of section 225 of the Companies Act, 2017 read with regulation 38 of the Shariah Governance Regulations, 2023.

Upon notification of any standard, the compliance of the same shall be binding upon the providers of Islamic financial services within regulatory domain of SECP. However, the Commission reserves the right to exceptionally allow any IFIs, to its satisfaction based on compelling reasons recorded in prescribed manner, departure from any mandatory/binding compliance.

3. The case for paradigm shift in strategy for adoption

Over the period of experimentation and regulatory interventions around the globe, it has been observed that the existing strategy for adoption deployed to bring standardization in IFIs is less effective and marginally efficient. The existing strategy lacks comprehensiveness as it largely relies on adoption of shariah standards only. It further ignores the integration between Shariah, governance and accounting standards which is necessary for the credible functioning of IFIs. Lastly, existing strategy offers a very passive and less interactive process of adoption regarding industry feedback and doesn't effectively contribute to the preparedness of the industry for standardization to its true potential.

3.1. New strategy for adoption of AAOIFI standards

After rigorous consultations with AAOIFI, other stakeholders and in-house deliberations, a paradigm shift in strategy for adoption of AAOIFI standards has been developed. The main drivers for having a new strategy are:

Drivers	Description
Comprehensiveness	A holistic approach to adoption consisting of full range of relevant Shariah, accounting auditing, governance and ethics standards is deployed in line with global best practices.
Integration	The adoption is attempted to be achieved in an integrated framework to ensure smooth functioning of IFIs with enhanced confidence and credibility.
Interaction and Feedback	The new strategy is designed to develop a better and meaningful interaction with industry. It encourages feedback and makes the adoption highly flexible.
Preparedness	The approach is designed to be more efficient and effective in preparing

Considering maturity level of the IFI within regulatory domain of SECP and to address practical difficulties in implementation of standards, a staggered approach, as explained below, may be adopted.

Stage I – Guidance Approach:

All IFIs including but not limited to the issuers of Shariah compliant securities, Shariah compliant companies, regulated persons, licensed persons, registered companies, or entities offering Islamic financial services are encouraged to comply with all relevant standards (119 standards till date) issued by AAOIFI from time to time, with the goal of bringing standardization in practices and disclosures. The Commission, in line with its scope, may inform the stakeholders periodically upon receipt of intimation from AAOIFI about the new issuance of relevant standards and/or exposure drafts.

Considering the time-taking process for the formulation of Islamic Financial Accounting Standards by ICAP, the Shariah advisors of Shariah boards of the IFIs, Shariah compliant companies or issuers of Shariah compliant securities, as the case may be, shall consider devising an appropriate accounting approach to reflect the true spirit of financial transactions in light of AAOIFI's accounting standards and may also consider that how BOD be kept quarterly updated to the adoption. Any deviation from the relevant AAOIFI's accounting standards shall be carefully reviewed by the Shariah advisors or Shariah boards, as the case may be, and reasons for such deviations shall be recorded in the Shariah Review Report prepared by Shariah Advisor under Shariah Governance Regulations, 2023 and Guidelines for Offering Islamic Financial Services 2023.

Stage II – Comply or Explain Approach:

After general sensitization is achieved across the Islamic financial industry for the AAOIFI Standards, the Commission may, through regulatory intervention (circular, directive, regulatory amendments, etc.) introduce the comply or explain approach for standards. Consequently, the IFIs, Shariah compliant companies or institutions offering Islamic financial services (“the Institutions”) shall be required to either comply with such AAOIFI standards as non-binding guidelines or explain the rationale/reasons for the non-compliance. A disclosure in this regard shall be made by the industry to all relevant stakeholders. This phase shall remain intact unless, the sufficient compliance is achieved within a period of at minimum three years or any other extended period as may be advised by the Commission. No institution shall be penalized or adjudicated for the non-compliance during the phase, except for failure to make required disclosures.

This stage is the most important stage as the continuous industry feedback would help the Commission to understand importance of the standards, their suitability to the local industrial needs, and their compatibility with existing regulatory frameworks. The process would, in turn, further highlight the regulatory gaps and help the Commission to

better adapt the standards before mandatory compliance. The sufficient compliance would be achieved by working out inconsistencies and incompatibilities through a continuous interaction with industry and maintain an enabling environment.

Stage III - Comply Approach:

This phase shall be similar to the existing strategy wherein compliance with the notified standards shall be mandatory and in case of any deviation, specific approval of the Commission shall be required under section 225 of the Companies Act, 2017. The Commission may, to its satisfaction based on compelling and reasonable circumstances recorded in a prescribed manner, may grant any exemption to any of the Institutions from compliance of any of the mandatory standards.

All the Institutions shall be bound to comply with the notified AAOIFI standards with an aim to bring standardization in the practices and disclosures. A period of minimum three years shall be sanctioned after the adoption of the standards, enabling the Institutions to make an impact analysis of the standards.

3.2. Approach for already-adopted and notified Standards

The Shariah Standards issued by AAOIFI, and Islamic Financial Accounting Standards issued by ICAP that have already been notified by the Commission shall remain binding unless any required changes to that effect are approved by the Commission. In case, the Shariah Standards issued by AAOIFI overlap with such Islamic Financial Accounting Standards issued by ICAP that have been notified by the Commission, compliance with IFAS shall be mandatory and shall take precedence.

4. Way Forward:

- i. With the in-principle approval of the Commission, this consultation paper has been issued to seek feedback and comments from the general public. The comments can be emailed to Islamic.finance@secp.gov.pk.
- ii. Roundtables with market players and relevant stakeholders on the proposed strategy and deliberation for partial or full adoption of 10 Shariah Standards, as mentioned at paragraph 1.3;
- iii. As an outcome of public consultation, the new strategy will be considered for approval by the Commission and its notification under Section 225 of the Companies Act, 2017.
- iv. Post-issuance awareness, capacity building, and trainings on the AAOIFI Shariah Standards for SECP officers and regulated entities will be carried out.
