

Guidelines for Offering Islamic Financial Services, 2023



SECURITIES AND EXCHANGE COMMISSION OF PAKISTAN

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Note: For any question, query or comment, please contact Islamic Finance Department at Islamic.finance@secp.gov.pk

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1. Preamble

- 1.1. The Securities and Exchange Commission of Pakistan (the "Commission") is pleased to issue the **Guidelines for Offering Islamic Financial Services 2023**, under Section 40B and in pursuance of clause (x) of sub-section 4 of Section 20 of the Securities and Exchange Commission of Pakistan Act, 1997.
- 1.2. These guidelines shall be applicable to persons engaged in offering Islamic financial services in the financial services markets, except for any financial service exclusively regulated by the State Bank of Pakistan.
- 1.3. These guidelines are not meant to amend or modify the existing legal and regulatory frameworks issued or administered by the Commission.
- 1.4. These guidelines are voluntary in nature, and regulated persons, Shariah-compliant companies, issuers of Shariah-compliant securities, and others concerned are encouraged to apply them.

2. Interpretations

- 2.1. In these guidelines, unless there is anything repugnant in the subject or context,
 - (a) "Act" means the Securities and Exchange Commission of Pakistan Act, 1997 (XLII of 1997);
 - (b) "Commission" means the Securities and Exchange Commission of Pakistan, established under section 3 of the Act;
 - (c) "Islamic financial institution" means a company, entity, or institution offering Islamic financial services as its main business activity, including but not limited to the following:
 - (i) an NBFi, as defined in clause (n) of sub-section (1) of section 2 of the Act;
 - (ii) a regulated person, as defined in clause (pb) of sub-section (1) of section 2 of the Act;
 - (iii) a financial institution as defined in clause (31) of sub-section (1) of section 2 of the Companies Act, 2017; and

- (iv) any other type of company, entity, or institution, as may be notified by the Commission from time to time,
but shall not include a banking company as defined in clause (c) of section 5 of the Banking Companies Ordinance, 1962 (LVII of 1962) or any other company, entity, or institution regulated by the State Bank of Pakistan;
- (d) "Islamic financial services" include Shariah-compliant financial products and other financial services offered by an Islamic financial institution under the Act or any administered legislation in accordance with Shariah principles and rules;
- (e) "Shariah principles and rules" means requirements, standards, rulings, or permissions pertaining to Islamic financial services, derived from the following:
- (i) legal and regulatory framework administered by the Commission;
 - (ii) Shariah standards issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), as notified by the Commission;
 - (iii) Islamic Financial Accounting Standards, developed by the Institute of Chartered Accountants of Pakistan, as notified by the Commission;
 - (iv) guidance and recommendations of the Shariah advisory committee, as notified by the Commission; and
 - (v) approvals, rulings, or pronouncements of the Shariah supervisory board or the Shariah advisor of the Islamic financial institution, in line with (i) to (iv) above;
- (f) "Shariah compliant company" means a company as defined in clause (64) of sub-section (1) of section 2 of the Companies Act, 2017 (XIX of 2017) and declared a Shariah compliant company under sub-section (1) of Section 451 of the Companies Act, 2017;
- (g) "Shariah compliant security" means a security declared under sub-section (2) of Section 451 of the Companies Act, 2017 (XIX of 2017) as a Shariah compliant security;
- (h) "Shariah advisory committee" means the Shariah advisory committee constituted by the Commission under section 11A of the Act to advise the Commission on Shariah-related matters; and

(i) "Shariah supervisory board" means a board constituted, appointed, or engaged by the Islamic financial institution to advise it on matters concerning Shariah principles and rules and Islamic products.

2.2. Words and expressions used but not defined in these guidelines shall have the same meanings as are assigned to them in the Act or applicable administered legislation.

3. Conditions for offering Islamic financial services

3.1. An Islamic financial institution may offer Islamic financial services in the financial services market, subject to any approvals that may be required under the applicable laws.

3.2. Every person offering Islamic financial services needs to:

- (a) ensure that its board of directors and management are fully aware of their fiduciary responsibility regarding Shariah compliance and governance towards its stakeholders and endeavour to discharge the same in true letter and spirit;
- (b) prudently recognize any additional considerations or exceptional circumstances that may require it to apply proportionality and/or other considerations towards the implementation of the Shariah principles and rules.

3.3. It is necessary for every Islamic financial institution that is a company to obtain a certificate of Shariah-compliant company in terms of sub-section (1) of Section 451 of the Companies Act, 2017.

3.4. It is necessary for every security to be issued by an Islamic financial institution to obtain a certificate of Shariah compliance as required under Section 451 of the Companies Act, 2017.

4. Shariah-compliant structure and operations

4.1. With respect to the Shariah-compliant structure and operations of a person offering Islamic financial services, it is recommended to ensure that;

- (a) its constitutive documents clearly provide for offering Islamic financial services;
- (b) its policy framework, including policies and manuals as approved by its board of directors for operational matters, adheres to Shariah principles and rules, particularly the following;
- (c) relationships should preferably be established under Shariah-compliant arrangements;
- (d) endeavour to avoid using conventional insurance and instead obtain reasonable takaful coverage, where required;
- (e) any material for the promotion of a product or service shall state the names of members of the Shariah supervisory board who reviewed the product or service and the contents of the marketing material.
- (f) its product development process is based on Shariah principles and rules;
- (g) it has a framework and arrangements in place to ensure Shariah compliance with respect to its operations, affairs, and activities on an ongoing basis; and
- (h) it has a framework in place for adequate disclosure of the status of compliance with Shariah principles and rules.

5. Shariah-compliant products

- 5.1. For offering Shariah-compliant products in the financial services market, applicable Shariah principles and rules are required to be adhered to at product development as well as product offering stages.
- 5.2. A Shariah-compliant financial product may be offered with the approval of the respective Shariah supervisory board. However, in the case of a Shariah-compliant product that has been approved by the Commission and/or is being offered through a centralized platform by a regulated person with the approval of the Commission, no further review or approval from the respective Shariah supervisory board may be required.
- 5.3. All proposed Shariah-compliant financial products may be reviewed by the Shariah supervisory board in light of Shariah principles and rules. Any observations of the

Shariah supervisory board or deviation from the requirements of the Shariah principles and rules, if any, must be justified and explained with rationale.

- 5.4. For any deviation from the requirements of any Shariah standards that have been adopted and notified by the Commission, prior written approval of the Commission shall be obtained as required under Section 225 of the Act.
- 5.5. The Shariah pronouncements of the Shariah supervisory board, including observations, restrictions, and deviations as mentioned above, are to be made part of the Shariah opinion and adequately disclosed to the customers of such Shariah-compliant financial products.

6. Shariah-compliant investments

- 6.1. An investment policy may be approved by its Shariah supervisory board for guiding Islamic financial institutions in Shariah-compliant investments that may include investments in Shariah-compliant companies, Shariah-compliant securities, or any other entity whose core business is based on Shariah principles and rules.
- 6.2. For securities investments, the Shariah screening criteria outlined in the Shariah Governance Regulations, 2018, can be followed.

7. Disposal of Shariah-noncompliant investments

- 7.1. Shariah-noncompliant investments above the applicable threshold and any such Shariah-compliant investments that may subsequently become Shariah-noncompliant investments, may be divested in a manner and within such a time period as may be determined by the Shariah supervisory board.
- 7.2. A policy for the purification of its income and the disbursement of Shariah-noncompliant income as charity may be made and implemented by an Islamic financial institution with the approval of its Shariah supervisory board.

8. Shariah-compliant mobilization of financial resources

- 8.1. Financial resources can be mobilized through Shariah-compliant securities.
- 8.2. Except for Modarabas, an Islamic financial institution before mobilizing financial resources through Shariah compliant securities shall obtain the necessary approval as required under Section 451 of the Companies Act, 2017.
- 8.3. Financial resources can also be mobilized from the Islamic banks or Islamic windows of conventional banks through Shariah-compliant modes, as permitted by the State Bank of Pakistan.

9. Conversion of a financial institution into an Islamic financial institution

- 9.1. In the event that a conventional financial institution intends to convert itself into an Islamic financial institution, either all at once or in phases, it may do so through the following process:
 - (a) initiate the conversion process with the approval of the board of directors;
 - (b) form a dedicated team, function, or department to prepare the conversion plan and spearhead conversion activities;
 - (c) prepare a conversion plan in light of the Shariah principles and rules and the Shariah screening criteria provided in the Shariah Governance Regulations, 2018;
 - (d) appoint or engage a Shariah supervisory board to review and vet the conversion plan and oversee its implementation;
 - (e) obtain approval of the conversion plan from the board of directors, if required, and may voluntarily intimate the Commission for information;
 - (f) appropriately disclose the approved conversion plan to the relevant stakeholders.
- 9.2. The conversion plan referred to above can, *inter alia*, include the following:
 - (a) changes required to be made, if any, to the mission and vision statements and constitutive documents;
 - (b) regulatory approvals required to be obtained, if any;
 - (c) determination of a cut-off date of conversion beyond which the financial institution shall not enter into any new Shariah-noncompliant business on

either the asset or liability side. However, it can continue settlement of Shariah non-compliant business undertaken previously, as per plan;

- (d) a three- to five-year business plan with assumptions and projected financial figures;
- (e) feasibility study on business viability as an Islamic financial institution;
- (f) operational and execution plans;
- (g) strategy to deal with Shariah impermissible items, including but not limited to, existing assets, liabilities, off-balance sheet items, non-performing assets, Shariah non-compliant income or earnings, collaterals and securities, etc.;
- (h) a detailed plan for the conversion or replacement of existing Shariah-noncompliant products with alternative Shariah-compliant products;
- (i) a detailed plan regarding existing portfolio investments and the proposed Shariah-compliant alternative;
- (j) comprehensive plan regarding the training and capacity building of existing employees and the induction of a new workforce to undertake Shariah-compliant business;
- (k) changes required to be made in manuals and procedures relating to financing, risk management, credit management, information technology, internal control, human resources, etc.;
- (l) strategy for compliance with the requirements of the Shariah Governance Regulations, 2018;
- (m) mechanism for separate account-keeping of Shariah-compliant and interest-bearing businesses until complete conversion into an Islamic financial institution;
- (n) Shariah governance policy, including the appointment or designation of a Shariah compliance officer, the mechanism for undertaking Shariah internal as well as external audits, the reporting and disclosure framework, etc.
- (o) policy for resolution of adverse findings in internal, external, and statutory audits;
- (p) marketing plan and strategy, particularly concerning the brand name, logo, and tagline for the Islamic financial institution, if applicable;

- (q) strategy for dealing with existing customers about the conversion, including obtaining consents, revising agreements, revising terms and conditions of the relationship, if any, and devising mechanisms to deal with unwilling customers;
- (r) strategy for dealing with existing vendors, suppliers, service providers, etc. about the conversion, including obtaining consents, revising agreements, revising terms and conditions of relationships, if any, and devising mechanisms to deal with unwilling persons;
- (s) plan for the conversion of non-Shariah-compliant employee benefit schemes; and
- (t) summary of cases under litigation along with any possible impact of conversion on such cases.

9.3. During the execution of the conversion plan, the Shariah supervisory board may be mandated to oversee its progress and report any issue concerning Shariah compliance to the board of directors for necessary corrective action.

9.4. After meeting the Shariah screening criteria provided in the Shariah Governance Regulations 2018, the financial institution may seek and obtain a Shariah compliance certificate as provided in the said regulations.

10. Islamic windows of conventional financial institutions

10.1. A conventional financial institution may establish an Islamic window for providing Islamic financial services through the following options:

- (a) it may establish an independent legal entity wholly owned by the financial institution or establish an identifiable unit within the financial institution;
- (b) it shall comply with the relevant registration or licencing regime, as may be introduced for Islamic windows, with the obligation to follow the minimum regulatory requirements of capital allocation and maintenance, governance, and operations.
- (c) a specialized Shariah governance framework can be prepared and implemented to ensure meticulous compliance with Shariah principles and rules;

- (d) an "institution within institution" model can be followed, allowing maximum independence of the Islamic window to pursue its activities without unnecessary and undue interference or influence from the management of the parent financial institution;
- (e) all business units and functions, including products, sales, service, and marketing, can be directly managed by the Islamic window, while control and support functions may be shared with the parent financial institution provided that there are defined cost allocation and service level agreements;
- (f) Islamic windows may ideally operate through dedicated Islamic-only branches and dedicated staff for these branches, serving only Islamic window customers. No customer-facing staff of any function may be allowed to serve both conventional and Islamic window customers;
- (g) Islamic window may be allowed to spin off into a separate legal entity if and when it reaches a certain threshold of assets and regulatory capital;
- (h) Islamic windows are encouraged to maintain separate books of accounts and prepare a supplementary set of financial statements accordingly;
- (i) external auditors, as part of their review, may certify that separate controls and systems have been maintained to ensure that there is no commingling of funds from the Islamic window with those of the parent financial institution;
- (j) the Shariah supervisory board may be empowered to express an opinion in its report as to whether the Islamic window's funds were commingled with those of the parent financial institution during the reporting period;
- (k) the ultimate responsibility of the Islamic window is with the board of directors of the parent financial institution; and
- (l) the Islamic window can receive funds from its parent financial institution under a Shariah-compliant contract. However, it may not place funds with its parent financial institution or with any other conventional financial institution, either directly or through a third party.

11. Shariah governance framework

11.1. Every Islamic financial institution may have in place a comprehensive Shariah governance framework, which encompasses a set of institutional and/or system-wide arrangements for the effective and independent oversight of Shariah compliance of its products, services, processes, and business operations.

11.2. The key objectives of the Shariah governance framework are to:

- (a) provide a structure and a system for governing all the business activities of the Islamic financial institution in order to ensure Shariah compliance at all times and at all levels;
- (b) enable the Islamic financial institution to be acknowledged as Shariah-compliant by the stakeholders, including the general public; and
- (c) protect the Islamic financial institution from financial and reputational loss on account of Shariah non-compliance.

11.3. The Shariah governance framework can at least cover the following:

- (a) appointment, engagement, constitution, or establishment of a Shariah supervisory board, a Shariah compliance function, an internal Shariah audit function, and an independent external Shariah audit. For this purpose, governance standards issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) can be referred to as "good practices."
- (b) roles and responsibilities of its board of directors and senior management towards upholding the Shariah compliance of its activities and operations;
- (c) in the case of an Islamic window or an Islamic subsidiary of a conventional financial institution, a specialized Shariah governance framework for the operations of such an Islamic window or Islamic subsidiary, as the case may be;
- (d) mechanism to prudently recognise any additional considerations or exceptional circumstances that may require it to apply proportionality and/or other considerations for ensuring compliance with Shariah principles and rules;
- (e) suitable disclosure and transparency in Shariah governance to its shareholders, customers, other relevant stakeholders, and market participants; and

- (f) code of ethics and code of conduct, focusing on Shariah principles and rules, for the financial institution and its employees.

11.4. Every Islamic financial institution is encouraged to ensure that:

- (a) its business is carried out in conformity with Shariah principles and rules under the guidance of its Shariah supervisory board;
- (b) significant changes in any of the existing product structures, financing agreements, terms, and conditions require prior written approval from the Shariah supervisory board;
- (c) all material changes in the existing product structures, agreements, terms, and conditions are duly disclosed to the concerned stakeholders;
- (d) a monitoring and review system for Shariah compliance has been introduced that encompasses all activities and products of the Islamic financial institution;
- (e) its human resources are sufficiently trained to perform duties concerning Shariah compliance; and
- (f) irregularities, if any, recorded and reported by internal Shariah auditors are rectified under the guidance of the Shariah supervisory board.

12. Shariah supervisory board

12.1. Every Islamic financial institution is encouraged to constitute, appoint, or engage a Shariah supervisory board, at the earliest possible time, comprising at least two persons qualified to be registered as Shariah advisors under the Shariah Advisors Regulations, 2017, to advise the board of directors and management of the Islamic financial institution on all Shariah-related matters and perform such other functions entrusted under these guidelines. However, one of the members of the Shariah supervisory board shall be registered as a Shariah advisor with the Commission.

- 12.2. Until a Shariah supervisory board is constituted, appointed, or engaged by an Islamic financial institution, the institution may appoint or engage a Shariah advisor, who can also perform the functions of the Shariah supervisory board until such time.
- 12.3. The Shariah supervisory board or the Shariah advisor, as the case may be, are recommended to be empowered to enjoy such powers as provided in the Shariah Advisors Regulations, 2017 and perform such functions as may be provided in these guidelines and the Shariah Advisors Regulations, 2017.
- 12.4. In case of any dispute or difference of opinion arising between the Islamic financial institution and the internal Shariah auditor on matters relating to Shariah interpretation, the same can be referred to the Shariah supervisory board for a decision.
- 12.5. In case of any difference of opinion between the Shariah supervisory board and the Islamic financial institution, the matter can be referred by the Commission for consideration by the Shariah advisory committee, the Shariah board for Takaful, or the Religious board for Modarabas, as the case may be.

13. Shariah compliance function

- 13.1. Every Islamic financial institution is encouraged to establish a Shariah compliance unit headed by a Shariah compliance officer suitably qualified, trained, and experienced in the field of Islamic finance.
- 13.2. The Shariah compliance unit can work under the overall guidance and supervision of the Shariah supervisory board, with parallel reporting to the head of the compliance department or internal audit department, as the case may be.
- 13.3. The Shariah compliance officer can coordinate between the Shariah advisor, the Shariah advisory board, and management and may be entrusted with responsibility for:
 - (a) review all the product proposals and related agreements, contracts, manuals, and process flow before presenting these to the Shariah supervisory board for approval;

- (b) ensure that the operations of Islamic financial institutions are in conformity with Shariah principles and rules; and
- (c) periodically submit a Shariah compliance report to the management on the overall Shariah compliance environment.

14. Internal Shariah audit

- 14.1. Every Islamic financial institution is encouraged to strengthen its internal audit department, either by appointing an internal Shariah audit resource having relevant qualifications or expertise in the field of Islamic finance or by training at least one of its employees in the internal audit department for the purpose of internal Shariah audit from a reputable training institute.
- 14.2. The scope and methodology of the internal Shariah audit may be reviewed and approved by the board of directors or audit committee of the Islamic financial institution.
- 14.3. The internal Shariah audit resource may follow the same reporting norms as are applicable to the internal auditor.
- 14.4. The duties of the internal Shariah audit may include, but are not limited to, the verification of:
 - (a) transactions entered into are consistent with the Shariah principles and rules;
 - (b) financing agreements entered into are Shariah-compliant and are in the formats approved by the Commission, if all the related conditions are met;
 - (c) offering documents, investments, and contracts have been reviewed by the Shariah supervisory board;
 - (d) product structure, process flow, and operations are duly vetted by the Shariah supervisory board;
 - (e) process for purification of income has been carried out, and Shariah-non-compliant income has been transferred into a charity account and distributed to approved charitable institutions;

- (f) findings are shared with the management and Shariah supervisory board in respect of all the above items, including irregularities, inadequacies in risk management, governance, and internal controls, which are necessary to avoid non-Shariah compliant business transactions; and
 - (g) investments in securities and other instruments and fund-raising are in accordance with the requirements of these guidelines.
- 14.5. The internal Shariah auditor may submit an internal Shariah audit report annually to the board of directors or audit committee.
- 14.6. The internal Shariah auditor may maintain liaison with the Shariah supervisory board and may seek his guidance in ensuring Shariah compliance.
- 14.7. An Islamic financial institution may outsource its internal Shariah audit function.

15. External Shariah audit

- 15.1. An Islamic financial institution may opt for an external Shariah audit for each financial year, which may be undertaken by the existing external auditors or an independent external Shariah auditor.
- 15.2. For the purpose of this clause, the provisions of sections 223 and 247 of the Companies Act, 2017, can be followed with regard to an external Shariah audit and an external Shariah auditor, respectively, and the audit firm that has expertise in Islamic finance may be preferred.
- 15.3. The scope of an external Shariah audit may include an independent and objective assessment of compliance of operations with Shariah principles and rules and any further conditions imposed by the Commission from time to time.
- 15.4. The external Shariah auditor may assess the compliance of the Islamic financial institution's financial arrangements, contracts, and transactions with the Shariah principles and rules.
- 15.5. The external Shariah auditor may be mandated to prepare a report in a format as may be prescribed by the Institute of Chartered Accountants of Pakistan or any other

suitable format for the board of directors of the Islamic financial institution, giving their opinion on:

- (a) the status of Shariah compliance;
- (b) the risks associated with Shariah non-compliance;
- (c) the capacity and quality of the internal controls to measure, manage, and mitigate the Shariah non-compliance risks;
- (d) the adequacy and effectiveness of the Shariah governance framework;
- (e) the level of awareness and sensitivity of the management and the board of directors in addressing the Shariah risks; and
- (f) any other issues deemed significant by the external auditors with respect to Shariah compliance.

16. Accounting, auditing, and governance standards

16.1. Financial statements of Islamic financial institutions are to be prepared in accordance with all the applicable Shariah and other standards, as notified by the Commission for adoption under Section 225 of the Companies Act, 2017, or any other regulatory framework, from time to time.

17. Reporting by the Islamic financial institution

17.1. An Islamic financial institution, in addition to any other reporting requirements under the respective regulatory framework, may be required by the Commission to submit additional information and documentation from time to time.

18. Power of the Commission to intervene

18.1. Subject to the powers of the Commission under the Act, it may impose restrictions on the Islamic financial institution through a directive under Section 40B of the Act, if:

- (a) the Islamic financial institution does not operate in conformity with Shariah principles and rules; or

- (b) any condition imposed by the Commission is not adhered to; or
- (c) there exist sufficient reasons to believe that Shariah compliance is not being observed;
- (d) there are sufficient reasons to believe that the acts and conduct of an Islamic financial institution, from the standpoint of ethics and adherence to values and objectives, create a reputation risk for the Islamic finance industry; and
- (e) the penalty, if any, imposed by the Commission has not been paid within the stipulated time period.

18.2. For the purposes of clause 1, the Commission may prohibit an Islamic financial institution from doing any one or more of the following, namely:

- (a) entering into transactions;
 - (i) of a specified description or other than a specified description; or
 - (ii) in specified circumstances or other than in specified circumstances; or
 - (iii) to a specified extent or other than to a specified extent.
- (b) soliciting business from persons of a specified description or from persons other than those of a specified description; or
- (c) carrying on business in a specified manner or other than in a specified manner.

18.3. For the information of stakeholders, the Commission may publish a press release about its imposition of restrictions on the Islamic financial institution in at least two newspapers of wide circulation in Pakistan and/or place the same on its official website.