

CHAPTER 13

Adoption of AAOIFI Shari'a Standards: A case study of Pakistan

13.1 Introduction

Shari'a principles form the basis of Islamic finance and strict adherence to these values is what sets Islamic finance apart from conventional finance. The Islamic banking industry requires a framework that enables it to provide Shari'a compliant financial services, which is effective, robust and transparent. Realising this, the central bank of Pakistan has been proactive in providing the necessary legal structure for facilitating the practices of Islamic banking. The State Bank of Pakistan (SBP) has been part of all major international initiatives regarding the development of Islamic finance and has remained committed to the decisions of forums such as the AAOIFI and the IFSB. This chapter will provide a detailed view of the AAOIFI standards adapted by the SBP in its efforts to provide the Islamic banking industry in the country a regulatory structure that is based on international best practices.

13.2 Shari'a compliance framework

To ensure Shari'a compliance and the ongoing viability of the system, the SBP introduced a unique, comprehensive three tiered framework that includes: (i) Establishment of a Shari'a Board at SBP, (ii) Presence of a Shari'a Advisor at the bank level and (iii) Shari'a Compliance Inspection.

13.2.1 Shari'a board at SBP

A central and high powered Shari'a body was established at the SBP as the very first, and core, regulatory measure in October 2003, to ensure harmony in Shari'a rulings in the country. The main objective of this apex body is to guide the central bank about modality, stages and mechanisms of Shari'a Compliance in the banking

system. The Shari'a Board at the SBP has the following key responsibilities:

1. Review and approve, for Shari'a compliance, the products/instruments developed by the SBP to conduct its central banking and monetary management functions under the Islamic modes;
2. Advise the SBP on prudential regulations developed for the Islamic banking sector;
3. Advise the SBP on the Shari'a ruling in case of a conflict arising from the Shari'a audit of Islamic banking activities of the banks under the supervisory control of the SBP
4. Advise the SBP on the Shari'a ruling in case of a conflicting Shari'a opinion on the Islamic banking products; and
5. Perform such other functions as may be assigned from time to time, by the SBP for the smooth functioning of the Islamic financial system

To fulfil these responsibilities the composition of the board needed to be unique, covering Shari'a, legal, accounting and banking aspects. Keeping this in consideration, the board has five members – at least two Shari'a scholars, a chartered accountant, a lawyer and a professional banker. Given the importance of Shari'a compliance in Islamic banking, the position of the chairman resides with a Shari'a scholar. At the same time the board is competent to provide viable and comprehensive economic solutions.

13.2.2 Shari'a advisor

Under the regulatory framework of the SBP, all Islamic banking institutions are obligated to have a Shari'a Advisor, who is responsible for Shari'a compliance in all transactions of a bank. The Shari'a Advisor is also responsible for Shari'a related training of the staff. In case of any conflict between the Shari'a Advisor and SBP, the issue is referred to the central board and the decision of the board is considered binding.

As facilitator for the development of the Islamic banking industry in the country, the SBP has also established the Shari'a Advisory Forum (SAF) where Shari'a advisors from all banks are invited to discuss and debate issues relating to the industry. This forum acts as a link between the Shari'a board at SBP and the Shari'a Advisors of banks. The SAF is an important forum where research is conducted through the collection of feedback from the industry. Issues are thereafter debated before final recommendations are made which are subsequently presented to the Shari'a Board for approval.

13.2.3 Shari'a compliance inspection

Shari'a Compliance Inspection is instrumental in guaranteeing an effective supervisory and regulatory framework. Realising the significance and considering it as prime responsibility to ensure sustainability and public trust in the system, the central bank has always held Shari'a compliance as a priority since the renewal of interest in Islamic finance industry in the country.

For the effectiveness of this mechanism, a Shari'a inspection manual was issued to provide guidance to the inspecting staff. The Shari'a inspection is complemented by the Self Assessment Institutional Risk Assessment Framework (IRAF) of off-site surveillance and also by the enforcement framework that evaluates the overall performance of individual institutions.

13.3 Adaptation of AAOIFI Shari'a standards

Admitting the importance of standardisation for the sustainability of growth of the industry, the SBP has remained committed to provide an internationally acceptable regulatory structure. To this end the central bank is fully focused on adaptation of the AAOIFI Shari'a Standards. However, there is an awareness that these standards need to be tailored according to the legal and regulatory framework of the country and a rigorous approach for careful examination of Standards was opted to achieve this objective.

13.3.1 The process for implementation of AAOIFI Shari'a Standards

The Islamic banking department of the SBP invites comments on a Shari'a standard from Shari'a Advisors of all Islamic banks operational in the country. These comments are consolidated and analysed by the department, which are then discussed in the SAF or a sub forum in order to prepare recommendations for the Shari'a board for approval. After approval of the Shari'a board, the standard is vetted through the Legal and Pol-

icy department before the final implementation of the standard in the country. Adherence to these standards is binding on Islamic Banking Institutions (IBI) and any non-compliance is liable for penalty.

The SBP Shari'a board has been reviewing adoption of AAOIFI Shari'a standards since March 2008. As of December 2011, Pakistan has implemented 4 out of 41 Shari'a standards. The following section will discuss the key points of the implemented standards covering issues that have arisen during the discussions on them. However, it is worth mentioning that the Shari'a board has decided that amendments would be in the form of explanatory notes/footnotes and no change would be made in the main draft of standards.

13.4 Amended Shari'a standards

13.4.1 Shari'a Standard No. 03 (Defaults in payment by a debtor)

a) Sale of pledged asset for liquidation of debt

The creditor is entitled to apply for the sale of any asset pledged as collateral for the debt, for the liquidation of the debt. He is equally entitled to stipulate that the debtor must give a mandate to the creditor to sell the pledged asset without recourse to the courts.

The discussion on the standard raised concerns regarding the translation of the clause. It was decided to add the following: "on giving the debtor reasonable notice of sale" after the word "debt" on the 2nd line of above subclause.

13.4.2 Shari'a Standard No. 08 (Murabaha To The Purchase Orderer)

a) Exclusion of prior contractual relationship

It is essential to exclude any prior contractual relationship between the customer who is the purchase orderer and the original supplier of the item ordered, if any, regarding the supply of the item. It is a requirement of murabaha to the purchase orderer that the transaction between the two parties must genuinely, not fictitiously, exclude any prior contractual relationship.

This clause dictates that it is not permissible to transfer a contract that has been executed between the customer and the supplier of the ordered item to the institution. After deliberations at various forums, the central bank's Shari'a board opined that the principle of iqala suriah and not iqala haqiqiya applies here. It was therefore decided to add the explanatory footnote that the term "contract" refers to "prior sale contract".

b) Purchase of musharaka participation by means of murabaha

It is not permitted for the institution and the customer to agree to form a musharaka in a project or a specified deal together with a promise from one of them

to buy the other's musharaka participation by means of murabaha on either spot or deferred payment terms. However, it is permissible for one partner to promise to purchase the other's musharaka participation at market selling price or at a price to be agreed upon at the time of sale provided a new contract is drawn up. This sale may be on spot or on deferred payment terms.

The stakeholders in Pakistan agreed to include the explanatory note with the clause; *"This Clause is not applicable to Shirkat ul Milk"*.

c) Non-inclusion of bilateral promise in murabaha transaction

It is not permissible that the document of promise to buy (signed by the customer) should include a bilateral promise which is binding on both parties (the institution and the customer)

The SBP Shari'a board, with consent of Shari'a advisers of IBIs, suggested that the Master Murabaha Facility Agreement (MMFA) or Master Murabaha Agreements contain bilateral covenants regarding the purchase of the asset. These are standard provisions of the murabaha contracts and are necessary to lay down the covenants of both parties for the contract. Therefore the explanatory footnote is added with the clause; *"Currently, in the context of murabaha in Pakistan, a bilateral promise/agreement is permissible"*

d) Treatment of arbun

It is permissible for the institution to take arbun after concluding the murabaha sale with the customer. This may not be done during the contractual stage at which the customer has given his promise to purchase. It is preferable that the institution return to the customer the amount that remains after deducting the actual damage incurred from the arbun as a result of the breach, namely the difference between the cost of the item to the institution and its selling price to a third party.

The use of word "preferable" in this clause was debated at a Shari'a advisers' forum following which the central bank's Shari'a board decided to replace the word with "mandatory" in order to ensure that only actual damages incurred by the bank are recovered from the arbun. This was because since three of the four major schools of fiqh do not allow forfeiting of arbun. Therefore it was proposed to replace "preferable" with "mandatory" as it gives flexibility to banks to recover even the cost of funds, which is not allowed in Shari'a. Hence the following explanatory note was added:

"The institution shall return to the customer the amount of arbun (earnest money) after deducting the actual damages incurred"

e) Customer as agent of bank

The original principle is that the institution itself purchases the item directly from the supplier. However, it is permissible for the institution to carry out the purchase by authorizing an agent, other than the purchase orderer, to make the purchase and the customer (the

purchase orderer) should not be appointed to act as an agent except in a situation of dire need. Furthermore, the agent must not sell the item to himself. Rather, the institution must first acquire title of the item and then sell it to the agent.

It was indicated while making deliberations on this clause that it is important to provide clarification regarding the phrase of "dire need". Therefore it was suggested that if some special cases come up where cash has been provided directly to the client based on the concept of dire need then an explanation should be given by the IBI which is approved by their Shari'a Advisor. Therefore, the explanatory note was added:

"The agent shall not consume or purchase goods purchased on behalf of the institution until such goods are sold by the institution to the customer".

f) Conditions for customer to be agent

When the customer is authorised to purchase an item as the institution's agent, it is obligatory to adopt procedures which would ensure that certain conditions are observed. These conditions include the requirement that (a) the institution itself must pay the supplier, and not pay the price of the item into the account of the customer as agent and (b) the institution should obtain from the supplier the documents that confirm that a sale has taken place

It was indicated during discussions on the standard that the process Islamic banking institutions of the country are following, to make payments to supplier, achieve the objective of this clause. Therefore it was decided to add the following footnote to explain the link between current practice and the clause: *"The payment mechanism presently adopted by Islamic banking institutions, whereby the supplier is paid by the bank through the transaction account opened in the name of customer, and the customer acts as an agent, achieves the rationale behind this clause (3.1.4). However, in exceptional cases where the customer has to be given cash for onward payment to supplier, the matter can be decided by the Shari'a Adviser and his specific approval would be required for this purpose"*.

13.4.3 Shari'a Standard No. 09 (Ijara & Ijara Muntahia Bittamleek)

a) Sale & leaseback

With respect to the issue of sale and leaseback, it was viewed that although sale and lease back is permissible with certain conditions, it is not preferable. It was decided to add the foot note with clause 3.2 *"Prior approval from Shari'a Advisor of the IBI must be sought whenever an IBI is going to use it as a mode of Islamic finance"* and the explanatory note with clause 3.4; *"In special cases prior approval from Shari'a advisor must be sought"*

b) Termination of contract

Under this clause the two parties may terminate the ijara contract before it begins to run. It was decided to make amendment with addition of words *"with mutual consent"* after the word contract

c) Transferring of title of asset

This clause mentions that in ijara muntahia bittamleek the method of transferring the title of the asset must be through a separate document as per one of the following methods: a) Promise to Sell, b) Promise to give as gift or c) Promise to gift contingent on paying the remaining installments.

The clause was implemented with the addition of explanatory foot note *"In addition to the above, it is also permissible to ask the customer to give an "Undertaking to Purchase ijara Asset" from the bank in case of early purchase or default"*

13.4.4 Shari'a Standard No. 13 (Mudaraba)

This standard was implemented without any amendments; however few concerns were raised with particular reference to prevailing Islamic banking practices and legal infrastructure in the country. However, all those concerns were debated and agreed upon. It was eventually decided that the standard in its original form would be implemented in the country as it did not require any amendment or clarification.

13.5 Conclusion

The regulatory framework in Pakistan is at par with international standards. The adaptation of AAOIFI Shari'a Standards is a proof to the premise. The adoption of only four Shari'a Standards out of 41 issued standards shows a relatively slow process and the long and rigorous adoption procedure due to the sensitivity of the mechanism. However, these adapted standards along with other guidelines including essentials of basic modes of financing and their model agreements issued by the central bank are minimum requirement to be followed by Islamic banking institutions while developing products. Banking institutions are also allowed to adopt any other AAOIFI Shari'a Standards at their own discretion. While the growth of Islamic banking industry is likely to continue at reasonably fast pace, the standardisation and harmony of Shari'a rulings would bring maturity in the system.

Adoption Of Shari'a Standards

| Sr. No | Standard No | Standard Mode | Clause | Amendment/ Clarification |
|--------|-------------|------------------------------------|--------|---|
| 1 | 3 | Default In Payment By A Debtor | 2/1/e | The words "on giving the debtor reasonable notice of sale" shall be added after the word "debt" in 2nd line of above subclause. |
| 2 | 8 | Murabaha To The Purchase Orderer | 2/2/2 | The phrase, "prior contractual relationship" shall refer to "prior sale contract". |
| | | | 2/2/5 | This clause is not applicable to Shirkat-ul-Milk. |
| | | | 2/3/1 | Currently, in the context of Murabaha in Pakistan, a bilateral promise / agreement is permissible. |
| | | | 2/5/6 | The institution shall return to the customer the amount of Arbutn (earnest money) after deducting the actual damages |
| | | | 3/1/3 | The agent shall not consume or sell, goods purchased on behalf of the institution until such goods are sold by the institution to the customer. |
| 3 | 9 | Ijara & Ijara Muntahia Bittamleekt | 3/2 | Prior approval from Shari'a Advisor of the IBI shall be sought whenever an IBI is going to use it as a mode of Islamic finance. |
| | | | 3/4 | In special cases prior approval from Shari'a Advisor shall be sought |
| | | | 7/2/5 | The two parties may terminate the Ijara contract with mutual consent before it begins to run. |
| | | | 8/1 | It is also permissible to ask the customer to give an undertaking to purchase Ijara asset from the bank in case of early purchase or default |
| 4 | 13 | Mudaraba | Nil | Nil |