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Bank of Zambia

Islamic Finance Guidelines

I. Introduction

1. In terms of the Banking and Financial Services Act (1994) otherwise referred to as the BFSA, as amended,

(i) Existing banks licensed under the BFSA are deemed to be licensed to carry on Islamic finance business through a window; and

(ii) Banks may be granted an Islamic finance license by the Bank of Zambia to conduct Islamic finance business exclusively.

2. This guideline is accordingly issued to licensed banks intending to offer Islamic banking through window operations and institutions which may be granted an Islamic banking license to conduct Islamic banking business exclusively, hereinafter referred to as "Islamic financing institutions (IFIs)".

3. The requirements of this guideline serve to complement the current regulatory framework applicable to financial institutions. Accordingly, in addition to this guideline, IFIs are required to adhere to the other laws, regulations and guidance notes issued by the Bank of Zambia from time.

II. Interpretation

4. In this guideline,

"Investment account holders" means persons who have effected placements of funds with an IFI on the basis of either sharing of the profits to be realised by the latter, or profit-and-loss sharing where risks generated from the funding project are borne by both parties;

"Scholar" means a distinguished expert in the understanding and interpretation of Shari'ah, and is an individual who is qualified in the field of Islamic jurisprudence and Islamic commercial law;

"Shari'ah" refers to the corpus of Islamic law which embodies all aspects of the Islamic faith, including beliefs and practices;

"Stakeholders" means a person with vested interest in the well-being of the IFI: principally the shareholders but also employees, customers, suppliers, supervisors and the authorities.

This guideline also includes a glossary of Arabic terms that provide standard definitions of a selected number of Islamic financial products, the list of which is presented in Annex 1.

III. Regulatory Capital Requirements

5. A financial service provider holding an Islamic financing license shall comply with the minimum capital requirements prescribed by the Bank of Zambia. In the case where Islamic financial services are offered by financial service providers operating Islamic window, these will be covered by existing paid up or assigned capital of that financial service provider

6. Every IFI shall, in terms of Statutory Instrument number 184 of 1995, be subject to the prescribed capital adequacy ratio requirements.

7. An IFI shall be required to take into account the substance of Shari'ah principles in the treatment of financial instruments for deriving its regulatory capital requirements. The risk-weighted assets shall be categorized and computed in line with the current risk weighted capital adequacy ratio, subject to a proper identification of risks and determination of relevant risk weights. In the case of window operations, the risk weighted assets thereof shall be incorporated in the computation of the overall capital adequacy ratio for the institution. Similarly, the parallel run of the Standardized Approaches of Basel II framework shall apply to the operations of every IFI.

IV. General Governance Approach

8. Every IFI shall establish an appropriate governance framework for the management of its affairs in a manner that seeks to optimize value and benefits to all stakeholders. The Islamic approach to corporate governance broadly embraces concepts of fairness, transparency and accountability which align very closely to international standards of good governance. An IFI is accordingly required to adopt a code of best practices that promotes these ethical values by exercising a balanced and equitable outlook in respect of the interests of various stakeholders.

9. A primary undertaking of the governance framework shall be to ensure strict adherence and compliance with the rules and principles of Shari'ah. Compliance with Shari'ah is central in sustaining the integrity and credibility of an IFI. As such, an IFI shall be required to set up an appropriate mechanism for enforcement and monitoring of Shari'ah compliance in all aspects of its business operations.

10. *Organs of Corporate Governance*

The Board of Directors of an IFI shall set up a Governance Committee, comprising at least three members, to coordinate and integrate the implementation of the governance policy framework. The Governance Committee may comprise a member of the Audit Committee, a Shariah Scholar and a non-executive director based on their experience and ability to contribute to the governance process. Where an IFI decides to have more members on the Governance Committee, consideration should be given to independent non-executive directors.

11. *Powers and Roles of the Governance Committee*

The Governance Committee shall be empowered to oversee and monitor the implementation of the governance policy framework by working together with management, the Audit Committee and the Shariah Advisory Board; and provide the Board of Directors with reports and recommendations based on its findings in the exercise of its functions. The roles of the Governance Committee shall complement those of the Audit Committee in some of the governance functions, with primary focus on the specificities of the IFI. The Governance Committee shall be accorded special attention by the supervisory authorities.

12 *Rights of Investment Account Holders (IAH)*

An IFI shall acknowledge IAHs' right to monitor the performance of their investments and the associated risks, and put in place adequate means to ensure that these rights are observed and exercised. The Board shall take responsibility for protecting this right of the IAH by ensuring that relevant disclosures to IAH are made in a timely and effective manner, as well as ensuring proper implementation of the investment contracts. The IFI shall have an internal guideline that sets out: (I) the eligibility of the IFI employees who are responsible for managing investments accounts operated by the IFI; (II) the adequacy of the protection accorded to the IAH investments, including the case where the unrestricted IAHs' funds are commingled with shareholders' funds; (iii) the disclosure of relevant and material information to the IAH; and (iv) a proper and disclosed basis for profit allocation and investment policies to be based on the risk expectations of the IAH.

13. *Alignment of Risk and Return Expectations of IAH*

An IFI shall adopt a sound investment strategy which is appropriately aligned to the risk and return expectations of IAH, and be transparent in smoothing any returns by means of building up and drawing on reserves such as a Profit Equalization Reserve (PER). An IFI shall also inform the IAH whenever it transfers profits to such reserves, or draws on the reserves in order to enhance the profit distribution to the IAH. In order to ensure that utilization of PER is appropriate, the Governance Committee shall be mandated to scrutinize such utilization and make appropriate recommendations to the Board of Directors and any such report will be availed to the supervisory authority.

Establishment of an Operational Framework

14. The board of directors of an IFI shall:

(i) approve and establish a management and operational structure by clearly defining lines of responsibility and accountability;

(ii) adopt an internal control profile that ensures adherence to the corporate objective in providing a range of services that uphold the ethical values of Islamic finance;

(iii) review the adequacy of the established framework in the light of developments in the market environment or as per regulatory requirements and adopt the requisite changes; and

(iv) ensure that the established operational framework is formalized in a policy and procedures manual whose contents are clearly diffused at each level of operation.

Compliance with Shari'ah's Principles

15. Every IFI shall conduct its business on the premise that its operations and financial means are in consonance with the ethos and value system of Islam. The parameters defining financial intermediation as conducted by the IFI shall be drawn in compliance with Shari'ah rules and principles.

16. For the purposes of paragraph 15 above, every IFI shall either set up a Shari'ah advisory board or appoint a Shari'ah advisor.

17. As an interim measure, IFIs may, among themselves but with prior consent of the Bank of Zambia, set up a common Shari'ah advisory board, subject to the following conditions:

(i) The common Shari'ah advisory board shall be instituted at the initiative of IFIs that do not intend to have their own Shari'ah advisory board/Shari'ah advisor, or alternatively by the Bankers Association of Zambia;

(ii) The common Shari'ah advisory board shall provide advisory support in Shari'ah matters, including the validation of financial products, exclusively to the IFIs that do not have their own Shari'ah advisory board or Shari'ah advisor;

(iii) While ensuring that every member of the common Shari'ah advisory board abides by the principle of confidentiality, adequate measures shall be put in place to assess and deal with any conflict of interest that may arise out of the arrangements for the IFIs to have recourse to a common Shari'ah advisory board.

The Bank of Zambia shall review the feasibility of any such arrangement at appropriate times in light of future developments, more specifically, the growth of Islamic banking in Zambia.

18. The eligibility criteria for appointment as a member of the Shari'ah advisory board or Shari'ah advisor shall be:

(i) A scholar who is based either in Zambia or abroad;

(ii) An individual of highest integrity, honesty and ethical reliability;

(iii) An individual with proven experience or knowledge in the delivery of Shari'ah rulings and issuing scholarly opinions on matters of Islamic law;

(iv) The scholar should at least hold a bachelor's degree/Ijazah from a recognised university in the sciences of Shariah, including Islamic transaction/commercial law (Fiqh al- Muamalat), and be able to demonstrate adequate understanding of finance in general and Islamic finance in particular;

(v) Possess strong skills in the philosophy of Islamic law (Usul al-Fiqh) and must know the appropriate Fiqh methodologies for deriving juristic opinions;

(vi) Must have good knowledge of written Arabic, as s/he needs to be very conversant with primary sources of Shariah.

19. In the event that an IFI opts to appoint a single Shari'ah advisor, the eligibility criteria of the scholar in terms of both competence and qualification will be raised at a higher standard. The capability of the selected Shari'ah advisor will be assessed on the basis of either a strong track record of academic contributions to Shari'ah scholarships or a minimum period of 10 years of experience in Shari'ah advisory practices.

20. The appointment of the members of the Shari'ah advisory board or Shari'ah advisor, as the case may be, shall require the prior approval of the Bank of Zambia. Each member should also pass the fit and proper test prescribed in section 31(1) of the Banking and Financial Services Act. If the appointment of a Shari'ah advisory board or Shari'ah advisor has been approved by another regulator abroad, the Bank of Zambia may opt to go by the said approval upon satisfaction on the validity of such approvals.

21. Subject to paragraph 21 above, the Shari'ah advisory board or Shari'ah advisor, as the case may be, shall be responsible for:

(i) The validation of financial products and services to be offered by the IFI with respect to their conformity with Shari'ah ethics and standards;

(ii) The review of internal procedures prior to the launch of new Islamic products and services.

22. The Shari'ah advisory board or Shari'ah advisor, as the case may be, shall document the basis for authentication of any financial product or service and these documents shall be made available for internal control and audit purposes of the IFI and to the Bank of Zambia for supervisory reviews.

23. The Bank of Zambia may appoint an honorary advisor who will provide guidance, as required, on broad supervisory matters respecting Shari'ah rulings and compliance. However, the Bank of Zambia does not intend to undertake any ex ante review of the financial products to be offered by an IFI for the conformity of these products with Shari'ah principles.

24. An IFI shall have in place an appropriate mechanism for obtaining rulings from Shariah scholars, applying Fatwa and monitoring shariah compliance in all aspects of their products, operations and activities. The mechanism for obtaining rulings from Shariah scholars, applying fatwa and monitoring Shariah compliance shall cover: (a) both ex ante and ex post aspects of all financial transactions carried out by the IFI – that is to ensure Shariah compliance of the contracts and, later, the performance of obligations under contracts; and (b) operations of the IFI, including aspects such as Shariah compliance review, investment policies, disposal of non-shariah compliant income, charitable activities, etc.

25. An IFI shall make available to the public, upon request, an explanation of any decision to adopt a Fatwa issued by its Shariah scholars. Similarly, an IFI should be prepared to provide a transparent clarification to the public should they decide to abandon a Fatwa issued by Shariah scholars.

V. Accounting Standards and Financial Reporting

Disclosure of Information and Record Keeping

26. An IFI shall produce financial statements and make relevant disclosure along the same format, or reflecting as closely as possible on an item wise basis, the quarterly and annual financial statements, set out in section 56 of the Banking and Financial Services Act. The IFI shall also draw up a formal disclosure policy that is consistent with the above-mentioned section and the basis for financial reporting in terms of both content and transparency shall be established accordingly. The IFI shall, in addition, take into account the set of standards issued by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) which is an international body responsible for developing accounting, auditing, ethics, governance and Shari'ah' s standards for Islamic banking and finance industry. However, where a conflict arises between the Bank of Zambia prudential requirements and the standards prescribed by AAOIFI, the criteria set by AAOIFI, shall prevail.

27. The set of information to be provided in the financial statements shall be composed of accurate and relevant data with an appropriate level of disaggregation, prudent forecasting and projections in the Management Discussion and Analysis (MDA), and shall be subject to the concept of 'materiality' that gives a true and fair view of the financial position of the IFI. The standardized format as prescribed in the abovementioned guideline will ensure consistency in presentation of information and will facilitate comparability of financial performance among the institutions.

28. The financial statements shall reflect the activities specific to Islamic finance as classified on the basis of established accounting principles. In this respect, the Income Statement of banks holding an Islamic banking license shall be presented in the format set out in Annex 2. For IFIs offering Islamic banking through window operations, income derived and expenses incurred shall be incorporated in the data provided in the Income Statement, with relevant details provided in the *Notes to the Accounts* which form an integral part of the principal financial statements.

29. Operational specificities applicable to IFIs shall be disclosed in the *Notes to the Accounts* of financial statements. An IFI shall be required to give a general description of the methodology used for monitoring Shari'ah compliance in respect of systems and procedures supporting the financial services being offered, as well as validation of products.

30. An IFI shall disclose obligations towards the payment of zakat as a business entity. Additionally, it shall disclose the Zakat obligations it is required to meet in pursuance of any authorization given to it in that respect by the shareholders or depositors. Zakat, as used in this guideline, is broadly based on the terminology of the AAOIFI and is defined as a fixed annual obligation that is calculated by reference to net assets, including cash holdings of the obligor. For an IFI which is operating an Islamic window, Zakat shall be determined on the net assets held by the window.

31. The explanatory notes to the financial statements shall include a set of disclosures aimed at providing periodic information that enhances transparency and accountability of the IFI in the management of investment accounts held in its portfolio. In a summary form, the IFI shall report on the following:

(i) A review of the performance of each major business segment, together with comparative data on financial results of previous three years;

(ii) An outline of the methodology used for calculating distributable profit and the rates of return on deposits;

(iii) Any amount appropriated out of gross income in respect of Profit Equalization Reserve (PER) or any mechanism, as the case may be, for mitigating fluctuations in rates of return that arise from changes recorded in income, provisioning and total deposit placements. In this respect, the PER shall be understood as a technique for the smoothing of dividend payment and return to the investment account holder. It shall represent an appropriation that is shared by both the IFI and the investment account holders, in accordance with the terms governing the operations of the reserves;

(iv) Funds set aside as Investment Risk Reserve (IRR) as an allowance to meet potential but unexpected losses that may materialize. In this context, the IRR shall represent the amount that is appropriated and set aside by the IFI out of the share of income derived by the investment depositor;

(v) The degree of disclosure shall vary between the two types of Profit Sharing Investment Accounts (PSIA); unrestricted PSIA and restricted PSIA which shall be clearly segregated by the IFI

32. An IFI undertaking window operations shall maintain a separate set of books and records for all transactions carried under the window. In terms of both sources and uses of funds, the IFI undertaking window operations shall establish a system of strong firewalls in order to ensure that there is no co-mingling of funds relating to Islamic banking business with the conventional business activities of the entity. There shall be segregation between two portfolios so as to maintain the confidence placed by customers that all financial involvements under the window are Shari'ah compliant, and this will contribute to preserve the integrity of the Islamic financial system.

33. Furthermore, the board of directors of the IFI shall ensure that discussions of risk management strategies incorporate the specificities of the IFI and are duly presented in the financial overview in the MDA.

B. Audit Function and Compliance

34. An IFI shall have in place an internal audit structure which incorporates an independent assessment of control procedures addressing the specific profile of Islamic finance. In this respect, the IFI shall ensure that either—

(i) The terms of reference of the internal audit shall include Shari'ah compliance reviews to be undertaken in close collaboration with the Shari'ah advisory board or Shari'ah advisor(s) or reviewer(s) designated by the IFI, as the case may be; or

(ii) The internal audit function shall comprise professionals with the appropriate skills in conducting Shariah compliance reviews;

(iii) The internal Shariah Advisor or Compliance Officer shall ensure that all procedures, quality control and product development related matters are dealt with on a day to basis.

35. For IFIs operating Islamic windows, the scope and nature of the internal audit shall, in addition to the requirements of paragraph 28 above, include a review of the efficacy of established firewalls and the maintenance of a segregated set of accounting records pertaining to the operations of the unit. Any operational deficiency identified shall be reported to the Audit Committee and the board of directors shall have the oversight role for ensuring that timely remedial action is taken accordingly.

36. An IFI shall appoint its external auditors with the terms of reference set out in section 65 of the BFSA. The overall audit functions of the external auditors shall be clearly set out, with the latter working closely with the Audit Committee in the course of the review of accounting procedures established by the IFI. In accordance with internationally recognized accounting standards pertaining to Islamic financial services, the scope of the audit of external auditors shall include the conduct of reviews of Shari'ah compliance ex-post.

VI. Supervisory and Prudential Requirements

General Principles

37. The prudential requirements of this guideline in respect of IFIs shall primarily subscribe to the *Core Principles for Effective Banking Supervision* of the Basel Committee on Banking Supervision (BCBS), and build upon the international standards set by BCBS by accommodating for specificities of Islamic finance. The current framework as prescribed is broadly based on the global prudential standards and guiding principles advocated by the Islamic Financial Services Board (IFSB) which is an international standard setting organization that promotes and enhances the soundness and stability of the Islamic financial services industry.

B. *Risk Management Processes*

38. An IFI shall take an integrated and holistic approach in the management of risks that are borne on account of specificities of Islamic financial products offered by it. An IFI shall, in conformity with the Shari'ah principle of prohibition in generating profit without the bearing of the risks, implement a comprehensive risk management strategy in respect of the modes of financing which are essentially either—

(a) asset- based,

(b) profit-and-loss sharing, being partnership or joint venture agreements between two parties based on the Shari'ah principle of Musharakah, or

(c) profit-sharing and loss-bearing as defined under Mudarabah contracts. Accordingly, the IFI shall define and adopt risk mitigation techniques appropriate for each type of Islamic financial instrument held in its portfolio.

39. The IFI shall implement a sound investment strategy that is in harmony with its business objectives, while giving due consideration to the risk profile of its financial instruments and interests of its investment account holders. A comprehensive approach to the investment strategy shall be put in place and shall comprise:

(i) Feasibility studies of projects and appropriate due diligence of investment partners;
(ii) Adoption of consistent valuation methodologies applicable for each financial instrument;
(iii) Monitoring of transformation of risks inherent at each stage of the investment lifecycles;
(iv) The setting up of a well-designed management information system for reporting and monitoring risk exposures;
(v) Constant evaluation of market risk exposures arising from price fluctuations of the tradable assets held; and
(vi) Application of Shari'ah permissible risk mitigation techniques that will reduce the impact of any capital impairment on the investment projects.

40. The IFI shall develop instruments of risk mitigation techniques that are permissible and enforceable under Shari'ah rules. Such instruments may include collateral that shall be subject to regular valuation, insurance coverage for value of the assets, and compensation of claims from lessee following a loss that materializes due to negligence or breach of contract on the part of the lessee.

41. The IFI shall have an adequate process for determining allowances for impairment that include counterparty exposures, and for estimating impairment in the value of leased assets. Subject to relevance for each type of financial instrument held in its portfolio, the IFI shall set aside provisions for the losses in accordance with the requirements of the BFSA (Statutory Instrument No. 142 of 1994) on credit impairment measurement and income recognition.

42. An IFI shall establish a liquidity policy framework that primarily takes into account the liquidity exposures inherent in all deposit accounts which are placed in the custody of the institution and are payable on demand. An effective system of liquidity management shall be put in place such that cash flow projections incorporate all commitments and funding requirements pertaining to fiduciary duties of the IFI towards its investment contracts. In order to meet its overall liquidity requirements, the IFI shall ***a priori*** have recourse to Shari'ah compliant funds while having due consideration to the constraints existent in the financial market.

C. Transparency and Market Discipline

43. An IFI shall establish an effective disclosure regime that promotes and reinforces international standards on transparency of financial reporting by addressing elements that are specific to Islamic financial services. Transparency is a basic principle of Shari'ah which has a decree forbidding concealment of evidence. Lack of transparency is viewed as emanating from asymmetry of information which may give rise to unfair advantage in a transaction. Accordingly, an IFI shall make accurate, timely and meaningful disclosure with regard to the investment accounts held in its portfolio, while giving due recognition to the protection of propriety and confidential information.

44. An IFI shall adopt disclosure principles that will enable market participants to access relevant key information to enable them to monitor the performance of their investments, and to have an understanding of the methodologies used for calculation of profit, asset allocation, and whenever applicable, the mechanics of smoothing of returns.

45. It is a generally held view that disclosure of material information leads to market discipline in terms of prompt adjustment in price and quantity, and will provide incentives to the IFI to avoid excessive risk-taking in the pursuit of its activities. An IFI shall abide by transparent financial and non-financial reporting practices that will work towards promoting a sound and stable Islamic financial system.

ANNEX 1

Glossary of Arabic Terms

The following definitions of Arabic terms have been extracted from Guidance Notes issued by the **Islamic Financial Services Board** (IFSB). These are standard definitions drawn up by the IFSB to provide general understanding of Islamic Financial Instruments.

Arabic Term	*Definition*
Ijarah	A contract to lease a specified asset for an agreed period against specified instalments of lease rental.
Istisna	A contract to order the manufacturing of an asset according to the buyer's specifications at a predetermined selling price. The payment of the price and delivery of the asset will be on a specified future date.
Muarabah	A partnership contract between the capital provider (Rabb al Mal) and an entrepreneur (Mu arib) whereby the capital provider would contribute capital to an enterprise or activity, which is to be managed by the entrepreneur. Profits generated by that enterprise or activity are shared in accordance with the percentage specified in the contract, whilst losses are to borne solely by the capital provider unless losses are due to the entrepreneur's misconduct, negligence or breach of contracted terms.
Mudarabah	A **Mudarabah** is a contract between the capital provider and a skilled entrepreneur whereby the capital provider would contribute capital to an enterprise or activity which is to be managed by the entrepreneur as the **Mudarib** (or labour provider). Profits generated by the enterprise or activity are shared in accordance with the terms of the **Mudarabah** agreement, while losses are borne solely by the capital provider unless the losses are due to the **Mudarib**'s misconduct, negligence and breach of contract terms.
Murabaha	A contract to sell a specified asset at an agreed profit margin plus cost (selling price), whereby the cost and profit margin shall be disclosed. The asset must be under complete ownership of the seller.

Arabic Term	*Definition*
Musharakah	A partnership contract in which the partners (Shuraka', sing: Sharik) agree to contribute capital to an enterprise, whether existing or new, or towards the ownership of an asset, either on a temporary or permanent basis. Profits generated by that enterprise or asset are shared in accordance with percentage specified in Musharakah agreement, whilst losses are shared in proportion to each partner's share capital.
Salam	A contract to purchase an asset 9of which the price, quantity and quality are specified) to be delivered in future.
Sukuk	Certificates that represent a proportional undivided ownership right in tangible assets, or pool of assets that are compliant with Shariah rules and principles.
Takaful	Derived from an Arabic word which means solidarity, whereby a group of participants agree among themselves to support one another jointly against a specified loss. In Takaful arrangement, the participants contribute a sum of money as Tabarru 9donation) into a common fund, which will be used for mutual assistance of members against specified loss or damage.

ANNEX 2

Statement of Income(Template) for the years ended.................

			K'million	
	Note	Year 2	Year 1	Year 0
INCOME		X	X	X
Income from investment deposits		X	X	X
Income from investments of shareholder's funds		X	X	X
Allowance for losses		X	X	X
Provision for contingencies		X	X	X
Impairment loss		X	X	X
Profit equalization reserve		X	X	X
Expenses attributable to investment of deposits and shareholders' funds		X	X	X
Other Income		X	X	X
Total Distributable Income		X	X	X
Income attributable to depositors		X	X	X
EXPENSES		X	X	X
Personnel expenses		X	X	X
Other Overheads		X	X	X
Impairment loss from property, plant and equipment, and intangible assets		X	X	X
Finance costs		X	X	X
Zakat		X	X	X
Other		X	X	X
Net Income				
Net income before income taxes		X	X	X
Provision for income taxes		X	X	X
Net income after income taxes		X	X	X
Minority interests		X	X	X
		X	X	X
Net Income		X	X	X
Preferred dividends paid		X	X	X
Net income available to ordinary shareholders		X	X	X
Average number of ordinary share outstanding		X	X	X
Net income per ordinary share		X	X	X