



BANK OF MAURITIUS

Guideline for Institutions Conducting Islamic Banking Business

June 2008

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I. Introduction

1. In terms of amendments brought to the Banking Act 2004 by the Finance Act 2007,
 - (i) existing banks licensed under the Banking Act 2004 are deemed to be licensed to carry on Islamic banking business through a window; and
 - (ii) banks may be granted an Islamic banking licence by the Bank of Mauritius to conduct Islamic banking business exclusively.
2. This guideline is accordingly issued to licensed banks offering Islamic banking through window operations and institutions which may be granted an Islamic banking licence to conduct Islamic banking business exclusively, hereinafter referred to as “Islamic banking institutions (IBIs)”.
3. The requirements of this guideline serve to complement the current regulatory framework applicable to financial institutions. Accordingly, in addition to this guideline, IBIs are required to adhere to the other guidelines and guidance notes issued by the Bank of Mauritius.

II. Interpretation

4. In this guideline,

“investment account holders” means persons who have effected placements of funds with an IBI on the basis of either sharing of the profits to be realized 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 persons with vested interest in the well-being of the IBI: 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 at Annex 1.



III. Regulatory Capital Requirements

5. In accordance with the provisions of Section 20 of the Banking Act 2004, a bank holding an Islamic banking licence shall maintain a paid up or assigned capital, as the case may be, of not less than 200 million rupees or an equivalent amount in any other currency as may be approved by the Bank of Mauritius. As regards Islamic banking services offered by banks operating Islamic windows, these shall be covered by the existing paid up or assigned capital of that bank.
6. Every IBI shall, in terms of the provisions of Section 20 of the Banking Act 2004, be subject to the prescribed capital adequacy ratio requirements.
7. An IBI shall be required to take into account the substance of **Shari'ah**'s principles in the treatment of financial instruments for deriving its regulatory capital requirements. The risk-weighted assets shall be categorized and computed as per the *Guidance Notes on Risk Weighted Capital Adequacy Ratio*, subject to a proper identification of risks and determination of the 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. In the same vein, the parallel run of the Standardised Approaches of Basel II framework shall apply to the operations of every IBI.

IV. General Governance Approach

8. Every IBI shall establish a governance policy framework for the management of its affairs in a manner that will optimize value and benefit 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 IBI is accordingly required to adopt a code of best practices that promote these ethical values by exercising a balanced and equitable outlook with regard to the interests of its various stakeholders.
9. A primary undertaking of the governance framework shall be to ensure strict compliance with rules and principles as advocated in the **Shari'ah**. Compliance with **Shari'ah** is pivotal in sustaining the integrity and credibility of an IBI. Accordingly, an IBI shall set up an appropriate mechanism for enforcement and monitoring of **Shari'ah** compliance in all aspects of its business operations.

A. Establishment of an Operational Framework

10. The board of directors of an IBI 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.

B. Compliance with Shari’ah’s Principles

- 11. Every IBI 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 IBI shall be drawn in compliance with **Shari’ah** rules and principles.
- 12. For the purposes of paragraph 11 above, every IBI shall either set up a **Shari’ah** advisory board comprising a minimum of 3 members or appoint a **Shari’ah** advisor.
- 13. As an interim measure, IBIs may, among themselves but with prior consent of the Bank of Mauritius, 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 the IBIs that do not intend to have their own **Shari’ah** advisory board/**Shari’ah** advisor, or alternatively by the Mauritius Bankers Association Limited.
 - (ii) the common **Shari’ah** advisory board shall provide advisory support in **Shari’ah** matters, including the validation of financial products, exclusively to the IBIs 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 made for the IBIs to have recourse to a common **Shari’ah** advisory board.

The Bank of Mauritius shall review the feasibility of continuing the above arrangement at an appropriate time in the light of future developments, more particularly the growth of Islamic banking in Mauritius.

- 14. 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 Mauritius 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.
15. In the case of an IBI opting 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.
 16. The appointment of the members of the Shari'ah advisory board or the Shari'ah advisor, as the case may be, shall require the prior approval of the Bank of Mauritius. Each member should also pass the Fit and Proper Person Test prescribed at section 3.2 of the *Guideline on Fit and Proper Person Criteria* issued by the Bank of Mauritius. If the appointment of a **Shari'ah** advisory board or a **Shari'ah** advisor has been approved by another regulator abroad, the Bank of Mauritius may choose to go by the said approval.
 17. Subject to paragraph 16 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 IBI with respect to their conformity with **Shari'ah**'s ethics and standards.
 - (ii) the review of internal procedures prior to the launch of new Islamic products and services.
 18. 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 IBI and to the Bank of Mauritius for supervisory reviews.
 19. The Bank of Mauritius shall have an honorary **Shari'ah** advisor who will provide guidance, as required, on broad supervisory matters respecting **Shari'ah** rulings and compliance. However, the Bank of Mauritius does not intend to undertake any ex ante review of the financial products to be offered by an IBI for the conformity of these products with **Shari'ah** principles.

V. Accounting Standards and Financial Reporting

A. Disclosure of Information and Record Keeping

20. An IBI 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 the *Guideline on Public Disclosure of Information* issued by the Bank of Mauritius. The IBI shall also draw up a formal disclosure policy that is consistent with the abovementioned guideline and the basis for financial reporting in terms of both content and



transparency shall be established accordingly. The IBI shall, in addition, take cognizance of 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 the Islamic banking and finance industry. However, in case of conflict between the *Guideline on Public Disclosure of Information* and the standards prescribed by AAOIFI, the criteria set by AAOIFI shall prevail.

21. 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 IBI. 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.
22. 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 licence shall be presented in the format set out in Annex 2. For IBIs offering Islamic banking through window operations, income derived and expenses incurred shall be incorporated in data provided in the Income Statement, with relevant details provided in the Notes to the Accounts that form an integral part of the principal financial statements.
23. Operational specificities applicable to IBIs shall be disclosed in the Notes to the Accounts of the financial statements. An IBI 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.
24. An IBI 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 IBI which is operating an Islamic window, **zakat** shall be determined on the net assets held by the window.
25. 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 IBI in the management of investment accounts held in its portfolio. In a summarized format, the IBI shall report on the following:
 - (i) a review of the performance of each major business segment, together with comparative data on financial results of the previous two 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 Equalisation 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 IBI 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 IBI out of the share of income derived by the investment depositor.
26. An IBI 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 IBI undertaking window operations shall establish a system of strong firewalls in order to ensure that there is no commingling of funds relating to the Islamic banking business with the conventional business activities of the entity. There shall be a segregation between the 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.
27. Furthermore, the board of directors of the IBI shall ensure that discussions of risk management strategies incorporate the specificities of the IBI and are duly presented in the financial overview in the MDA.

B. Audit Function and Compliance

28. An IBI 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 IBI 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 IBI, as the case may be; or
 - (ii) the internal audit function shall comprise professionals with the appropriate skills in conducting **Shari'ah** compliance reviews.
29. For IBIs 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 responsibility of overseeing that timely remedial action is taken accordingly.

30. An IBI shall appoint its external auditors with the terms of reference set out in the *Guideline on Transactions or Conditions Respecting Well-being of a Financial Institution Reportable by the External Auditor to the Bank of Mauritius*. 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 IBI. In accordance with internationally recognized accounting standards pertaining to Islamic financial services, the scope of the audit of the external auditors shall include the conduct of reviews of **Shari'ah** compliance ex-post.

VI. Supervisory and Prudential Requirements

A. General Principles

31. The prudential requirements of this guideline in respect of IBIs 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

32. An IBI shall take an integrated and holistic approach in the management of risks that are borne on account of specificities of the Islamic financial products offered by it. An IBI shall, in conformity with **Shari'ah's** principle of prohibition in generating profit without the bearing of 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 **Shari'ah's** principle of **Musharakah**, or (c) profit-sharing and loss-bearing as defined under **Mudarabah** contracts. Accordingly, the IBI shall define and adopt risk mitigation techniques appropriate for each type of Islamic financial instrument held in its portfolio.
33. The IBI 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 the 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 the 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 of 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.
34. The IBI shall develop instruments of risk mitigation 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 a lessee following a loss that materializes due to negligence or breach of contract on the part of the lessee.
35. The IBI shall have an adequate process for determining allowances for doubtful debts 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 IBI shall set aside provisions for the losses in accordance with the requirements of the *Guideline on Credit Impairment Measurement and Income Recognition*.
36. An IBI shall establish a liquidity policy framework that primarily takes into account the liquidity exposures inherent in current account deposits 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 IBI towards its investment contracts. In order to meet its overall liquidity requirements, the IBI 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

37. An IBI 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 an asymmetry of information which may give rise to unfair advantage in a transaction. Accordingly, an IBI shall make accurate, timely and meaningful disclosure with respect to the investment accounts held in its portfolio, while giving due recognition to the protection of propriety and confidential information.



38. An IBI shall adopt disclosure principles that will enable market participants to assess relevant key information to enable them to monitor the performance of their investments, and to have an understanding of the methodologies used for profit calculation, asset allocation, and whenever applicable, the mechanics of smoothing of returns.
39. It is viewed that disclosure of material information leads to market discipline in terms of prompt adjustment in price and quantity, and will provide incentives to the IBI to avoid excessive risk-taking in the pursuit of its activities. An IBI shall abide by transparent financial and non-financial reporting practices that will work towards promoting soundness and stability of Islamic financial system.

VII. Authority

40. This guideline is issued under the authority of Section 100 of the Banking Act 2004 and Section 50 of the Bank of Mauritius Act 2004 and shall come into operation on 27 June 2008.

**Bank of Mauritius
June 2008**



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). They are standard definitions drawn up by the IFSB which provide a general understanding of Islamic financial instruments.

Arabic Term	Definition
Ijarah	An Ijarah contract refers to an agreement made by the IBI to lease to a customer an asset specified by the customer for an agreed period against specified instalments of lease rental. An Ijarah contract commences with a promise to lease that is binding on the part of the potential lessee prior to entering the Ijarah contract.
Istisna	An Istisna contract refers to an agreement to sell to a customer a non-existent asset, which is to be manufactured or built according to the buyer's specifications and is to be delivered on a specified future date at a predetermined selling price.
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 to be borne solely by the capital provider unless the losses are due to the Mudarib 's misconduct, negligence and breach of contracted terms.
Murabaha	A Murabaha contract refers to a sale contract whereby the IBI sells to a customer at an agreed profit margin plus cost (selling price), a specified kind of asset that is already in their possession.
Musharakah	A Musharakah is a contract between the IBI and a customer to contribute capital to an enterprise, whether existing or new, or to ownership of a real estate or moveable asset, either on a temporary or permanent basis. Profits generated by that enterprise or real estate/asset are shared in accordance with the terms of Musharakah agreement whilst losses are shared in proportion to each partner's share of capital.
Salam	A Salam contract refers to an agreement to purchase, at a predetermined price, a specified kind of commodity not available with the seller, which is to be delivered on a specified future date in a specified quantity and quality. The IBI as the buyer makes full payment of the purchase price upon execution of a Salam contract. The commodity may or may not be traded over the counter or on an exchange.
Sukuk	A Sukuk (certificate) represents the holder's proportionate ownership in an undivided part of an underlying asset where the holder assumes all rights and obligations to such asset.
Takaful	An equivalent to the contemporary insurance contract whereby a group of persons agree to share a certain risk (for example, damage by fire) by collecting a specified sum from each person. In case of loss to any one of the group, the loss is met from the collected funds.



Annex 2

Statement of Income for the years ended

		<i>Rs 000</i>		
	Note	Year 2	Year 1	Year 0
INCOME				
- Income from investment deposits		X	X	X
- Income from investment of shareholders' funds		X	X	X
- Allowance for losses		X	X	X
- Provision for contingencies		X	X	X
- Impairment loss		X	X	X
- Profit equalisation 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 & equipment, and intangible assets		X	X	X
- Finance cost		X	X	X
- Zakat		X	X	X
- Other		X	X	X
Net income		X	X	X
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
Net income		X	X	X
Preferred dividends paid		X	X	X
Net income available to ordinary shareholders		X	X	X
Average number of ordinary shares				
Outstanding		X	X	X
Net income per ordinary share		X	X	X