

DA AFGHANISTAN BANK
(CENTRAL BANK OF AFGHANISTAN)
Guidelines on Outsourcing of Islamic Banking Operations

Guidelines on Outsourcing of Islamic Banking Operations

Accountable Executive & Custodian	Islamic Banking Division
Policy Owner	Head of Islamic Banking Division

Approved by		Date
DAB Management:

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**DA AFGHANISTAN BANK
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Guidelines on Outsourcing of Islamic Banking Operations

ISLAMIC REPUBLIC OF AFGHANISTAN

**DA AFGHANISTAN BANK, GUIDELINES ON OUTSOURCING OF
ISLAMIC BANKING OPERATIONS**

PART A: PREAMBLE

1. Background

- 1.1 These Guidelines on Outsourcing of Islamic Banking Operations (hereinafter referred to as "the Guidelines") is issued by the Da Afghanistan Bank (hereinafter referred to as "DAB") which shall be adopted and become the guiding principles for Islamic Financial Institutions, Financial Institutions operating with an Islamic Window and Financial Institutions operating with an Islamic Unit (collectively referred to as "the Bank") in the Islamic Republic of Afghanistan offering Islamic financial products.
- 1.2 The need for these Guidelines are mainly to provide confidence to the customers and stakeholders on the Shariah compliance of the Islamic banking activities of the Bank.
- 1.3 These Guidelines shall constitute an integral part of the general governance and operational procedures of the Bank and shall be read and interpreted in the light of the Shariah Governance Framework ("SGF") of the Bank.
- 1.4 The task of monitoring these Guidelines shall be upon the Management of the Bank.

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- 1.5 Any particular exemption to any of the provisions as provided herein shall only be permitted via a formal application being submitted by the Bank after prior consultation with its Shariah board (hereinafter referred to as "the Shariah Board"), to the Shariah Supervisory Board of DAB (hereinafter referred to as "the SSB") outlining the reasons and justifications for such requests.

2. Basis of ~~Approval~~—ProceduresOutsourcing from International Practices

- 2.1 The Islamic Financial Services Board ("IFSB"), an international standard-setting organization that functions to promote and enhance the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, had in its Guiding Principles on Shariah Governance Systems for Institutions Offering Islamic Financial Services in 2009 provided the requirement for outsourcing of Islamic functions to external parties.

Accordingly, item 31 of the Standard allows for the appointment of external Shariah advisory firms/companies to assist the Bank in carrying its governance functions if the Bank does not have the internal capacity and capabilities to perform such function. However, as a precautionary measure, the standard emphasizes on the proper selection of the external advisory firm which it should have the sufficient expertise and resources to undertake the engagement.

- 2.2 Practice and Standard of Malaysia where the directive on this requirement is encapsulated in Malaysia's regulation entitled "Guidelines on Outsourcing of Islamic Banking Operations" that was issued on the 23rd of June 2003 by Bank Negara Malaysia (the Malaysian Central Bank).

Accordingly, the reason for the issuance of these Guidelines in Malaysia was stated as to:

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"...improve operational flexibility, minimise the need for capital investment and enable the Banks to accord greater focus to their core business and enhance their efficiency levels."

3. Purpose and Application

- 3.1 These Guidelines shall be applicable to all Banks offering Islamic Banking and Financial products and instruments in the Islamic Republic of Afghanistan.
- 3.2 The principles as provided in these Guidelines shall constitute a general guideline for the guidance to Banks and all Banks may have their internal Guidelines on the subject matter which are explained in a more detailed manner, pursuant to their internal governance policies. Such specific guidelines as provided in the Banks' internal Guidelines shall be deemed acceptable so long that it does not explicitly contravene any of the provisions set out in these Guidelines hereto.

4. Legal Provision

- 4.1 This Manual is issued pursuant to Article 2.2 of the Afghanistan Bank Law gazetted on 12/17/2003 (corresponding to 30/10/1382) in relation to the powers of DAB to regulate and supervise Banks in the Islamic Republic of Afghanistan and any amendments thereto.
- 4.2 This Manual shall be read together with the following manuals/guidelines:
- i. National Shariah Governance Framework;
 - ii. Shariah Compliance Manual; and
 - iii. Shariah Review Manual;
 - iv. Other relevant regulations, manuals, guidelines or circulars that DAB may issue from time to time.

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PART B: POLICY REQUIREMENTS

5. General Practise

- 5.1 As a general rule, Banks are allowed to outsource their functions to an external third party if the Bank believes that it has no capacity or has a limited capacity to perform the function internally up to the standard required by DAB.
- 5.2 However, such outsourcing must be done in a regulated manner as it relates to the involvement of an outside party in the Bank's internal affairs.
- 5.3 The criteria of the Bank's functions that may be outsourced to a third party shall be as follows:
- a) Operations which do not constitute an integral part /core system of the Bank;
 - b) Processes that shall not prejudice the critical decision making function of the Bank;
 - c) Anything that shall not affect, tarnish or give negative perception to the image and reputation of the Bank;
 - d) Not done purely on a commercial reason such as to lower the cost that will be incurred by the Bank instead of developing its own infrastructure and capacity.
- 5.4 The list of the functions that may be outsourced by the Bank to an external party are as follows (non-exhaustive list):
- A. Governance framework functions:

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- i. Shariah advisory function;
- ii. Shariah compliance function;
- iii. Shariah review function;
- iv. Shariah risk management function;
- v. Shariah audit function;
- vi. Other Shariah governance functions.

B. Operational functions:

- i. Debt collection functions
- ii. Marketing and promotional functions
- iii. IT infrastructure and support systems
- iv. Security and surveillance systems
- v. Administration of staff remuneration systems;
- vi. Any other system or functions as deemed acceptable by the Bank and DAB.

5.5 It must be emphasized that outsourcing of functions which are integral components of the Bank's functioning system such as trading and investment mechanisms, internal audit function and financing approval administration is forbidden by DAB as these constitute critical functions and decision making process of a Bank and therefore they must be done within the Bank's internal capacity.

6. Conditions and Safeguards

- 6.1 Prior to the appointment of an external party for the outsourcing function, as a precautionary measure to protect its interest, Banks must conduct the following:
- a) Perform due diligence on the external party to confirm pertinent information such as its legality, capabilities, track record etc;
 - b) Obtain approval from the Bank's Board of Directors ("BOD") and Management; and

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- c) Verify that such proposed outsourced function does not contravene any of the existing laws or regulation in Afghanistan.
 - d) Obtain the approval of the Shariah Board when transferring a function listed under Clause 5.4A above to a third party of both the nominated third party provider and the transfer of the function to the third party.
- 6.2 After the conditions as laid down under clause 6.1 above have been satisfied, the Bank must enter into a service agreement with the external party which the terms, among others must provide as follows:
- a) Clearly define and stipulate the roles and responsibilities of the external party in performing the service;
 - b) The external party's undertaking to abide to professional code of ethics when performing their duties throughout the period of engagement;
 - c) Provide the rights of the Bank to terminate the service of the external party whenever the external party fails to comply or found to be in breach of any of the requirements provided under the agreement; and
 - d) Any other terms as deemed appropriate to protect and secure the interest of the Bank against the external party.
- 6.3 The Bank must put in proper reporting and monitoring mechanisms to ensure that the integrity and quality of work of the external party is guaranteed and maintained.
- 6.4 Wherever applicable, the Bank may conduct testing on the quality and substance of the work as delivered by the external party by either presenting the work to the Management/BOD for scrutiny (direct question and answer session may be conducted for this purpose) or appointing another external party to verify the quality of the work as done by that outsourced party.
- 6.5 Internal auditors of the Bank may also perform audit on the performance of the external party's work and highlight the strength or weaknesses of the external party's quality of work in its annual audit report. This is for the purpose of furthering the engagement with the external party if such continuous engagement is deemed necessary by the Management of the Bank.

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6.6 The Bank must appoint at least one (1) of its internal employees from whichever department/division that it deems appropriate to work closely with the external party mainly for the following reasons:

- a) To learn and build the capacity of the employee of the expertise of the external party from their scope of work; and
- b) As a contingency plan in the case of sudden termination of the contract by the external party due to any reasons. This serves as mitigating factor for the Bank in facing such unforeseen circumstances.

7. External Service Providers

Taking into account the early stages of the Islamic Banking and Finance industry in Afghanistan, Banks are permitted to outsource the functions to any suitably qualified firm, either local or international, provided that such appointment of the service provider must obtain approval from the Management and Shariah Board (if it relates to technical Shariah-related functions) of the Bank.

8. Custodian of the Document

These Guidelines shall be under the safe custody of the Islamic Banking Division ("IBD") of DAB. Any changes to these Guidelines shall be made by the IBD with prior consultation with the SSB, as reviewed by the DAB Executive Board and upon approval by DAB Supreme Council. A copy of the amended Guidelines shall be made available to all stakeholders and SSB members for reference and implementation.

9. Effective Date of the Document

The Effective date of these Guidelines is the _____ day of _____
20____