



Da Afghanistan Bank
Islamic Banking and Finance Department

Islamic Banking Regulations

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Chapter 1: General Provisions

Article 1: Basis

This regulation is issued pursuant to Article 177 of Banking Law of Afghanistan in relation to the powers of DAB to regulate and supervise banks in the Islamic Republic of Afghanistan and any amendments thereto.

Article 2: Objectives

This document shall have the objectives herein assigned to them:

- (1) To collect reliable information on the total capital and assets of the bank, used for calculating economic normative regulating banking activities.
- (2) For the purpose of calculating the amount of provision for different categories of asset classification by Islamic Banking institutions.
- (3) Banks are encouraged to form a general reserve for losses on standard investments/financings to their clients.
- (4) Banks shall form a specific reserve for losses on watch, substandard doubtful, and loss assets.
- (5) Reserve for losses must be formed in sufficient amounts, based on the classification process and other relevant information.
- (6) Objective and subjective criteria for asset classification to be defined.
- (7) Based on the results of supervision, DAB can require banks to adjust its assets classification as well as its reserve for losses in accordance with provisions of this Regulation.
- (8) To provide a minimum set of requirements for the operation of Banks in Afghanistan that operates either as a full-fledged Islamic bank, subsidiary, window or a branch.

Article 3: Scope

This regulation is applicable on all Islamic banks, Islamic subsidiary of bank, Islamic banking window of conventional bank and Islamic branch of foreign bank licensed by Da Afghanistan Bank, unless the context otherwise require.

Article 4: Definitions

In the contract the following terms shall have the meanings herein assigned to them unless stated otherwise:

- (1) Asset: refers to credits extended to others from Banks perspective in the form of investment, financing, securities, contingent liabilities or other assets.
- (2) Bai-Jaizi: is temporarily transferring of the ownership right of collateral to the financier through legal process until the settlement of the facility. The financier can only sell the collateral through due judicial process in case the client defaults.
- (3) Collateral: is a property (movable/immovable) that a client offers as a way for a financier to secure the financings. If the client stops making the promised payments or installments, the financier can seize the collateral to recoup its losses.
- (4) Contingent Liability: also referred to as off-balance sheet items means:

1. A possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non- occurrence of one or more uncertain future events not wholly within the control of the enterprise; or
 2. A present obligation that arises from past events but is not recognized because:
 - a. it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
 - b. The amount of the obligation cannot be measured with sufficient reliability.
 3. And includes letters of credit, letters of guarantee, advance payment guarantees and underwriting commitments.
- (5) Credit: means any asset or off-balance sheet (contingent liability) item that contains credit risk. Including: placements and term deposits with other financial institutions, domestic or foreign.
 - (6) Eligible collateral (Readily Marketable Collateral): defined in this regulation as per Article 6, b, 29, paragraph 145 of International Convergence of Capital Measurement and Capital Standards – A Revised Framework, dated June 2006 and issued by the Basel Committee on Banking Supervision, is commonly referred to as Basel II.
 - (7) Immovable Property: means property that could not be moved without decomposition and change in shape and substance and include house, building, land and fixed assets.
 - (8) Items subject to classification: refers to claims on financial institutions, investment, financing, off-balance sheet items, securities, credit substitutes, placements and other assets.
 - (9) Investments and financings rescheduling/restructuring: a practice that involves rescheduling/restructuring the terms of an existing investments/financings that is classified as doubtful, in order to ease payment of investments/financings.
 - (10) Medium Credit: is a financing and investment that its amount is greater than AFN 5,000,000 and less than AFN 15,000,000 or equivalent in other currencies.
 - (12) Micro Credit: is a financing and investment which its amount is equal or less than AFN 500,000 or equivalent in other currencies;
 - (13) Movable Property: means property that could be moved without decomposition and any change in substance and form and include the tangible (goods) and the intangible such as documents of title, securities, receivables, copyrights, trademarks and patents.
 - (14) Non-Performing Asset (NPA): means an asset which is classified as doubtful and loss.
 - (15) Other form of security: means hypothecation of stock (Inventory), assignment of receivable, lease rentals, contract receivables.
 - (16) Past Due (Overdue) Assets: are financing or other assets that on which:
 - (17) Principal or profit payments are due and unpaid 31 days or more; or
 - (18) Financing without pre-established repayment schedules are considered past due when any of the following conditions are met:
 1. The amount advanced exceeds the customer's approved borrowing line for more than 30 days;
 2. Profit is due and unpaid for 31 days or more, or
 3. The account has been inactive for more than 30 days.
 - (19) Placement: is placement of bank funds at another bank in the form of Islamic demand deposit, interbank call money, time deposit, certificate of deposit, credit, and other similar fund placement.

- (20) Repossessed asset: is the asset or collateral which the financier takes possession of it through legal process in case of client's default.
- (21) Reserve for losses: a contra asset account that is intended to absorb estimated losses in the bank's portfolio of assets subject to classification, or a liability account that is intended to absorb estimated losses in off-balance sheet items subject to classification. (Reserve for losses means the same as provision for losses.)
- (22) Small Credit: is an investment / financings which its amount is greater than AFN 500,000 and less than AFN 5,000,000 or equivalent in other currencies;
- (23) Underwriting commitments: mean commitments given by commercial banks/depository financial institutions to the limited companies at the time of the issuing of equity/debt instrument, that in case the proposed issue of equity/debt instrument is not fully subscribed, the un-subscribed portion will be taken up by them (commercial banks/depository financial institutions).
- (24) Well Secured: A credit facility will be considered well secured (fully Secured) if the following characteristics are met:
1. All documentation is binding on all parties and is legally enforceable as Determined by sufficient legal review by the bank to verify this legal certainty.
 2. The bank has the right to liquidate or take legal possession of the collateral in a timely manner in the event of default, insolvency or bankruptcy.
 3. The bank has taken all necessary steps to perfect and maintain the bank's security interest in the collateral.
 4. The "estimated recoverable amount" of the collateral exceeds the amount of the credit exposure including the costs of liquidation.
 5. The collateral shall have market value equivalent to determined investment/financing to value (LTV) ratio or more of the principal amount of credit approved.
- (31) Unsound or imprudent manner - any action or inaction that is contrary to generally accepted standards of prudent operation and if continued would present an abnormal risk of loss or damage to an institution.
- (32) Well capitalized institution - a financial institution whose regulatory capital to risk-weighted assets ratio is greater than 14% and whose core capital to risk-weighted asset ratio is greater than 7%.
- (33) Advertisement: Refers to any communication directly or indirectly relating to Islamic financial service or product and intending to result in an eventual sale to customer, and shall include all forms of printed and published materials or any material using the print and/or electronic medium.
- (34) Customer: Refers to prospective and existing customer of the Bank, including financed parties and depositors
- (35) Financial Group: Refers to entities within the group of the Banks (within Afghanistan), which are involved in the promotion, sale, delivery, and distribution of Islamic financial products and services.
- (37) Intermediaries: Refers to both individuals (including the marketing staff of the bank) and institutions involved in the marketing and selling of Islamic financial products and services.

- (38) Risk is defined as the potential for loss, either directly through loss of earnings or capital or indirectly through the imposition of constraints on an organization's ability to meet its business objectives. Such constraints pose a risk by limiting a bank's ability to conduct its on-going business or to take advantage of opportunities to enhance its business.

Chapter 2: Asset Classification & Provisioning

Article 5: Provisions for Asset Classification

- (1) On monthly basis, all banks must self-classify each of their investments/financings, securities, contingent liabilities or off-balance sheet items and other assets to provide reserve for losses within one of the five categories set forth below. These self-classifications must be documented, with justifications given for the classifications, in the bank's files, and the classification documents must be signed by the individual responsible for performing the classifications and the individual responsible for reviewing their accuracy. In making the decision to classify an asset within one of the five classification categories listed below, a bank shall use its informed judgment but must be guided by the standards and components set forth below with respect to each such category.
- (2) Self-Classification of assets by banks shall be subject to review by DAB. Differences between classification decisions of DAB with respect to any asset and that of the classifying bank shall be subject to negotiation between them, but the classification decision of DAB shall be final for all purposes.
- (3) Where any part of a credit risk exposure, whether principal or profit, goes in arrears or its credit quality deteriorates to such an extent that it requires to be classified into a category other than Standard, the total amount of the credit risk exposure must be reclassified to the worst classification of any part of the credit risk exposure, and not merely the proportions which is/are in arrears.

Article 6: General Provisions of Classification of Investment/financings, Securities, Contingent Liability and other assets

- (1) Banks shall classify their investments/financings, securities, contingent liability and other assets by its maturity term and qualitative perspective.
- (2) In addition, banks should conduct thorough assessment of the client's capacity, character, capital, collateral and condition, and all necessary information on the client's credit worthiness before credit approval.
- (3) To estimate qualitative performance of any assets, Banks shall receive client's financial statements on annual basis and shall perform due analysis and evaluation.
- (4) For asset which is being investigated by legitimate detective authority because of it might be obtained through criminal offensive activities, provisioning shall be done for subjected asset. Amount of provision is subject to the discretion of bank's management.

Article 7: Source of Provisions for Losses

- (1) Islamic banks must revalue its receivables, financings and investment assets on monthly basis. However, if losses occurred relating to all above mentioned items, provision shall be made for such losses.
- (2) Reserve for all five categories of asset classification will be allocated from banks profit and capital.
- (3) In case of actual loss, bank can cover losses by the liquidation of collateral of particular financing/investment. However, if the collateral could not indemnify the loss, then the remaining amount will be taken from Investment Risk Reserve (IRR) only if:
 1. Bank was not negligible in the entire process of financing/investment.
 2. In case there was banks' negligence evolved in advancing financing/investment then the remaining loss after liquidation of collateral will be paid from banks' profit/capital.
 3. The IRR will be used only as stipulated above.

Article 8: Client's financial Solvency or Client's disability to meet the payment Schedule

- (1) For the reasons, client's financial solvency is being deteriorated or client is unable to meet the payment schedule (default occurs) according to initial contract/agreement, in this situation, the banks may take the following actions for initial conditions amended assets but after approval of the Shariah board of the bank:
 1. lower profit rate;
 2. forgive or deduct accrued profit payment;
 3. extend maturity date without increase in debt;
 4. decrease the limit of financings,

Article 9: Prohibition of change in Type of Credit

- (1) Banks cannot change the type of Credit, unless the customer closes the current credit and request for a new one. Banks should process the new credit request of customer in normal manner.
- (2) Banks cannot increase the financing limit of the existing customers without due diligence and proper analysis of the application.
- (3) If any assets to client and its related body in banks or their assets in other banks are qualified as nonperforming assets, banks shall perform reclassification on the assets attributable to that particular client and its related body. When doing so, reclassification should be only one class above the lowest class of the client's assets in particular bank and others.
- (4) In case, banks jointly provide credit to one particular client, one of the banks will take the lead of the credit. It must be clearly defined in the contract/agreement.

Article 10: Elimination of Potential Risk

- (1) In eliminating potential risks, movable collateral shall be insured by a reputable Takaful/ insurance company and insurance document shall be filed in related investments/financings file.
- (2) Ownership of all immovable collateral shall be transferred through Bai Jaizi (بيع جازي), to the bank.
- (3) Further requirements of both movable and immovable property shall be determined through DAB circular from time to time.

Article 11: Facility Disbursement in the Client's or on the Supplier's Accounts by Bank

- (1) Banks should disburse the facility in the client's current account or on the supplier's accounts (according to the type of products). All transactions and calculation of profit for the client should be recorded in that account only.
- (2) Banks are required to set "write-off" policy on their bad/loss investments/financings and submit the updated list of investments/financings written off from balance sheet and report their recovery status to DAB on regular basis.
- (3) A bank must accrue profit on profit-earning assets on a monthly basis if the frequency of actual payment by the obligor is less than monthly. Profit received on past due investments/financings shall be recognized as income.
- (4) In case, a portion of a credit is insured by an organization/donor (domestic or foreign) through guarantee scheme acceptable to DAB, the client shall insure the non-secured portion by additional collateral.

Article 12: Eligible Collateral Instruments

The following collateral instruments are eligible for recognition as eligible collateral (readily marketable collateral):

- (1) Cash (as well as certificates of deposit or comparable instruments issued by Islamic bank) on deposit with the bank which is incurring the counterparty exposure.
- (2) Gold.
- (3) Debt securities not rated by a recognized external credit assessment institution where these are:
 1. Issued by bank.
 2. Listed on a recognized exchange.
 3. Classified as senior debt; and
 4. All related issues of the same seniority by the issuing bank must be rated at least BBB- or A-3/p-3 by recognized external credit assessment institutions; and
 5. The bank holding securities as collateral has no information to suggest that the issue justifies a rating below BBB- or A-3/P-3 (as applicable); and
 6. The supervisor is sufficiently confident about the market liquidity of the security.
 7. Equities (including convertible bonds) that are included in a main index.
- (4) Undertakings for collective investments in transferable securities and Islamic mutual funds where:
 1. A price for the units is publicly quoted daily; and
 2. The transferable securities and mutual fund is limited to investing in the instruments listed in this paragraph.
 3. Acceptable guarantee or counter guarantee issued by a highly regarded and reputable financial institution.
 4. Acceptable guarantee or counter guarantees of countries which will be provided by the circulars of Da Afghanistan Bank from time to time.

Article 13: Investment / financing Classification Category-1 Standard

The provisions of the first type of investment/financing classification category as set forth below:

Standard: An asset classified as Standard is paying in a current manner or at most past due for the period of 1-30 days, fully secured and is supported by sound net worth, profitability, liquidity and cash flow of the obligor. Standard assets are sufficiently secured with respect to the repayment of both the principal amount and profit.

Article 14: Investment/financing Category-2 Watch

- (1) The provisions of the second type of Investment/financing classification category as Watch.
- (2) Watch: an asset should be classified as Watch if the principal and/or the profit remain outstanding for 31-60 days.
- (3) An asset classified as Watch is adequately protected, but is potentially weak. Such an asset constitutes an unwarranted credit risk, but not to the point of requiring a classification of Substandard. The credit risk may be minor, and most instances, bank management can correct the noted deficiencies with increased attention.
- (4) Assets must be classified no higher than Watch if any of the following are present:
 1. The bank credit officer's inability to properly supervise them due to lack of Expertise;
 2. The investment or financing was not made in compliance with the bank's internal policies;
 3. Failure to maintain adequate and enforceable documentation; or poor control over collateral.
 4. Assets that are past due 31-60 days for principal or profit payments.
 5. Under no circumstances should a Watch classification be utilized as a compromise between Standard and Substandard.

Article 15: Investment/financing Category-3 Substandard

- (1) An asset should be classified as Substandard if the principal and/or the profit remain outstanding for 61-120 days.
- (2) Substandard investments/financing show clear manifestations of credit weaknesses that jeopardize the liquidation of the credit.
- (3) Substandard investments/financings include investments/financings to clients whose cash flows are not sufficient to meet currently maturing debts, investments/financing to the customer which is significantly undercapitalized, and investments/financings to the customer with lacking sufficient working capital to meet their operating needs.
- (4) Assets must be classified no higher than Substandard if any of the following deficiencies of the obligor are present:
 1. Inadequate liquidity
 2. Cash flow less than repayment of principal and profit
 3. If the primary sources of repayment are insufficient to service the facility provided and the bank must look to secondary sources of repayment, including collateral.
 4. If the bank has acquired the asset without the types of adequate documentation of the obligor's net worth, profitability, liquidity, and cash flow that are required in the banking organization's credit policy or there are doubts about the validity of that documentation.

5. If default occurs to “initial conditions amended asset” the asset should be classified at least in Sub-standard class.

Article 16: Investment/financing Category-4 Doubtful

- (1) Defaulted assets for which the principal and/or the profit remain outstanding for 121-480 days shall be classified Doubtful.
- (2) Doubtful investments/financings display all the weakness inherent in credit classified as Substandard but with the added characteristics that they are not well secured and the weaknesses make collection or liquidation in full, on the basis of currently available information, highly questionable and improbable.
- (3) The possibility of loss is extremely high, but because of certain mitigating circumstances, which may work to the advantage and strengthening of the facility, its classification as an estimated loss is postponed until its more defined status is ascertained.
- (4) Assets must be classified no higher than Doubtful if any of the following deficiencies of the obligor are present:
 1. Operational losses, including the necessity to sell assets to meet operating Expenses.
 2. Illiquidity
 3. Cash flow less than required profit payments.
 4. Doubts about true ownership.
 5. Complete absence of faith in financial statements;
 6. If the advance amount exceeds the customer’s approved financing line for 121 consecutive days or more.
 7. If the account has been inactive for 121 days.
 8. If the market value of collateral has dropped to an extent that its coverage ratio is below 60% of payment of principal and accrued profit, the relevant asset shall be classified into Doubtful classification regardless of its terms performance when client’s solvency is being deteriorated or bankrupted.

Article 17: Investment/financing Category-5 Loss

- (1) Defaulted assets for which the principal and/or the profit remain outstanding for 481 or more days shall be classified as Loss.
- (2) Investments/financings shall be classified as Loss when they are considered uncollectible and of such little value that their continuation as recoverable facilities are not defensible. This classification does not imply that the facility has absolutely no recoverable value, but rather it is not practical or desirable to defer making full provisions for the facility even though partial recover in future may not be entirely ruled out.
- (3) Investments/financings classified as Loss include those to bankrupt companies and insolvent firms with negative working capital and cash flow or those to judgment debtors with no means or foreclosable collateral to settle the facility provided.
- (4) Banks should retain such facilities on their books for the period of no more than 12 months, while pursuing future recoveries and 100 percent investments/financings loss provisioning should be

made. After 12 months, they shall be written off immediately (via a credit to the asset balance on the balance sheet) against the investments/financings loss provisioning made.

(5) Assets must be classified no higher than Loss if any of the following deficiencies of the obligor are present:

1. The obligor seeks new investments to finance operational losses.
2. Location in an industry that is disappearing.
3. Is bankrupt or does not have physical existence.
4. Location in the bottom quartile of its industry in terms of profitability.
5. Technological obsolescence.
6. Very high losses.
7. Client resorts to sale assets at a loss to meet operational expenses.
8. Total revenue less than production costs.
9. No repayment source except liquidation.
10. Presence of money laundering, fraud, embezzlement, or other criminal activity.
11. Owners are not prepared to inject fresh capital.

(6) Asset classification criteria are summarized below:

Asset classification	Objective criteria	Reserve for loss required
Standard	A performing asset which is being repaid in accordance with the contract or at most past due for 1-30 days	1 percent (Optional)
Watch	31-60 days past due status (most favorable classification - Could be lower based on qualitative criteria).	At least 5 percent
Substandard	61-120 days past due status (most favorable classification - could be lower based on Qualitative criteria).	At least 25 percent
Doubtful	121-480 days past due status (most favorable classification - could be lower based on Qualitative criteria).	At least 50 percent
Loss	481 days or more past due status	(This category of investments/financings shall be retained in bank balance sheet for the period of 12 months for recovery purposes and 100 percent financing/investments loss provisioning Should be made. After the period, they shall be immediately written off with the provision made.

Article 18: Placement/deposits with other banks

- (1) Placements/deposits with other banks/financial institutions for fixed term to earn profit for period of 1 month or more, fall under credit definition and are subject to classification and provisioning.

Banks must prepare clear policies on this purpose by which they could assess and manage related risks. Classification and provisioning of placements would be determined by DAB circular.

Article 19: Classification of Micro and Small Credit

(1) The objective criteria for micro and small credits are as below:

Class	Past due	Provision
Standard	0-30 days	1 percent
Watch	31-60 days	5 percent
Sub standard	61-90 days	25 percent
Doubtful	91- 180 days	50 percent
Loss	181 - or above	percent

(2) Banks shall consider subjective criteria as elaborated in this regulation while classifying micro and small credits. Collateral requirements of these investments/financings would be determined by relevant circular.

Article 20: Suspension of profit on Nonperforming Assets

The following conditions shall apply to accrual and suspension of profit on all investments/financings classified as Doubtful or Loss, thus constituting them as NPA:

- (1) All categories of non-performing investments/financings classified as Doubtful and Loss shall be placed on non-accrual status and the profit shall not be taken as income when earned. However, claims on these credits can be recorded separately for future recoveries and legal purposes.
- (2) The previously accrued and uncollected profit on such assets but taken as income shall be reversed by debiting the income statement and crediting a “profit-In- Suspense” account. Subsequent accrual of profit shall be credited to the profit in suspense account until such investments/financings are brought current by full settlement of the delinquent principal and profit.
- (3) Profit can only be taken out of suspense when it has actually been paid by the debtor. However, the funds for the repayment of the delinquent investments/financings shall not be obtained through new investments/financings from the same financial institutions.
- (4) Payments made for repayment of the investment/financing should be applied first to penal and other charges, profit and then the principal.

Article 21: Provisions for investments/financings Losses

The provisions to be made against the investments and financings depend on the classification of each asset. Minimum provisions shall be made as follows:

- (1) Banks may establish reserves in amounts higher than the minimums required, if the facts warrant. The classification of assets and the concomitant determination of the sufficiency of the reserve must be reviewed not less than monthly.
- (2) All adjustments to classifications and the reserve for losses, and all accrued provisions and reintegrated provisions necessary to make these adjustments to the reserve, must be made in the same reporting period. In no case shall a bank adjust its classifications during one month and make the necessary provisions in a subsequent period.
- (3) The amount of the reserve must be based on facts and circumstances as of the evaluation date, and after charge-off of all assets or portions of assets classified Loss.
- (4) Banks must continue to make reasonable efforts to collect on assets that are charged off. The act of charging off does not eliminate the obligor's contractual responsibility to fully repay the principal balance and accrued but unpaid profit on the asset.
- (5) Any new investment/financing to a given client must be initially classified under the same category as the most adversely-classified previous outstanding investment/financing to the same client.
- (6) Banks may move an asset that is not classified below Sub-Standard to a more favorable classification category, and reintegrate the provision and reduce the reserve for losses, only if the bank can satisfactorily demonstrate that the asset's quality has improved significantly, and an explicit, written decision of the bank's credit committee outlining the justifications for the more favorable classification is placed in the asset's file.

Article 22: Repossessed Assets

Banks can repossess assets as per Article 67.2 of Banking Law with prior authorization of DAB. They shall repossess collaterals of their clients that are classified nonperforming assets as below:

- (1) To foreclose the collateral, banks shall sell the property through court process. If they fail to find the competent buyer, banks can repossess the property following legal processes.
- (2) The property repossessed by bank, shall be recorded in the books of the bank at the date the title deed is transferred to the bank.
- (3) Banks shall transfer the determined value (final Mahzar value) of collateral from investment/financing account to repossessed account on the balance sheet.
- (4) Repossessed assets are neither held for business purposes nor for bank usage and are only kept for the purpose of reselling and banks shall have unrestricted physical possession of property.
- (5) Property selling timeline shall not exceed four (4) years and major portion of repossessed assets shall be sold out in first two years. In case, banks fail to sell the property within the given timeline, the property shall be written off from the balance sheet.
- (6) Banks supervisory board shall collect reliable information on the quality of these assets and monitor them periodically.
- (7) The reserved provisions for repossessed assets shall be recorded under deferred income on the liability side until the actual realization through sale of property occurs.

- (8) Banks' risk management (committee) should identify, assess, monitor and analyze the risks associated with repossessing assets for the sake of settlement of investments/financings already classified as doubtful and loss and inform supervisory and management boards.
- (9) Banks are required to have written policies on repossessing assets associated with IFRS 5 'Non-Current Assets held for sale and discounted operations.

Article 23: Rescheduled and Restructured Credit

Banks must have in place written policies which define the circumstances and conditions under which a credit may be rescheduled or restructured. The policies should address the controls to avoid "ever-greening" of credit, including situations where credit may be rescheduled or restructured more than once, and provisioning policies with respect to such credit. In addition:

- (1) Banks must reassess the customer's financial position, having regard to all relevant circumstances surrounding the customer's financial condition and prospects for repayment, before a credit can be rescheduled or restructured. In addition, adequate resources must be allocated to closely monitor and follow up on the performance of rescheduled and restructured credit.
- (2) Banks shall appropriately classify the rescheduled and restructured facilities based on the assessment of the financial condition of the customer and the ability of the customer to repay based on the restructured terms. Credit that have been rescheduled and restructured shall not lead to improved classification immediately upon perfection of the relevant documentation in relation to the rescheduling and restructuring exercise.
- (3) Da Afghanistan Bank acknowledges that in specific and exceptional circumstances, such as when customers are affected by natural disasters, rescheduling and restructuring exercises may involve the granting of moratorium on credit repayments.
- (4) As part of sound credit management practices, banks are expected to establish clear parameters and internal processes for the consideration of moratorium on credit repayments, including proper authority for the approval of the moratorium. These processes should also be subject to adequate monitoring and review by an independent function.
- (5) Senior management or Credit Committee should receive periodic reports on the performance of rescheduled and restructured credit facilities. The reports should provide adequate information, including default status and the frequency of rescheduling or restructuring for the same customer, to facilitate management's or the committee's oversight of compliance with the bank's internal policies on rescheduling and restructuring and assessment of risks associated with the credit portfolio. Any material impact on the risk profile of the bank should be raised to the Board of Supervisor's attention in a timely manner.
- (6) Investments and financings cannot be restructured or/and rescheduled more than once. Restructured/rescheduled investments/financings shall not be upgraded into a better classification category unless the client:
 1. In case of investments/financings by repayments of lump sum amount at the end of the contract, has satisfactorily performed for a minimum of two consecutive months; or

2. In case of investments/financings with monthly repayments, have timely paid two consecutive instalments.
- (7) Once investments/financings are classified as Doubtful, they shall be reclassified or upgraded merely on the ground of rescheduling or roll-over of payment of profit and principal. The investments/financings shall only be renewed, rolled over or returned to accrual status if the client repays all the delinquent profit or/and principle from his own funds prior to the rollover or renewal.
- (8) If a client subsequently defaults after the rescheduled/restructured investments/financings that has been upgraded to a better category by the bank; the investments/financings shall be declassified in the same category as it was at the time of rescheduling /restructuring. However, banks at their discretion may further downgrade the classification taking into account the subjective criteria. The unrealized profit on such investments/financings taken to income account shall be reversed.
- (9) According to the types and nature of the Islamic banking products, bank must have proper policy for rescheduling and restructuring of the Islamic banking investment/ financings.

Article 24: Reporting Requirements

Banks shall submit to Da Afghanistan Bank on monthly basis the following statements, but not limited to:

- (1) Classification of investments/ financings and provisioning and movement in provisions and profit in suspense.
- (2) List of recovery and charged-off investments and financing.
- (3) List of adversely classified assets (an asset that has been classified as Substandard, Doubtful or Loss).
- (4) Classification of off-balance items.
- (5) Classification of investments and other assets.
- (6) And any other information required by DAB.

Article 25: Classification of Off-balance Sheet Items

- (1) Banks are required to review their off-balance sheet items monthly, classify them with adequate provisioning.
- (2) Banks are obliged to have written policies for classification of Off Balance sheet commitments containing criteria for each category of classification on their own judgment.
- (3) The factors analyzed in evaluating financings and investments (financial performance, ability and willingness to pay, collateral protection, and future prospects) are applicable to the review of off-balance sheet items. When evaluating off-balance sheet credit transactions for determining a credit-quality rating, consideration must be first given to whether the bank is irrevocably committed to advance additional funds under the credit arrangement.
- (4) The appropriate classification must be determined and applied if the bank should continue to fund the commitment and:

1. A potential weakness exists that, if left uncorrected, may at some future date result in The deterioration of repayment prospects or the bank's credit position, or
 2. There is a well-defined weakness that jeopardizes repayment of a commitment.
- (5) The reserve for losses on off-balance sheet items, which is reported as an "other liability" rather than as a contra-asset, must adequately reflect the associated risks. While classification, off-balance sheet items with 100 % cash margin are not subject to provisioning. Where the off-balance sheet items are partially secured by cash margin, banks shall only allocate provision for the unsecured portion.
- (6) Banks should issue a written notice of expiry of off-balance sheet commitments to its beneficiary, containing that bank does not have any responsibility after expiry of the commitment and a copy of such notice shall be filed subsequently.
- (7) After expiry of off-balance sheet items and if terms and conditions of commitments (LG and/or LC) are not met, banks do not have further obligation and the off-balance sheet items shall be immediately written off from off-balance sheet of the banks.

Article 26: Classification of Investments and Other Assets

- (1) Banks are required to classify their investments and other assets monthly.
- (2) They shall have written policies on classification and provisioning of investments and other assets containing criteria for each category of classification on their own judgment.

Article 27: Monitoring of Adversely-Classified, past due, Non-performing Assets and Charged-off investments and financings

Banks must strictly monitor and keep accurate records of their adversely classified, past due, nonperforming assets and charged-off investments and financings, in the aggregate and by type of asset, and submit to their Board of Supervisors (or, for a permitted branch of a foreign bank, to the next-higher level of authority outside of Afghanistan) for each of their regularly scheduled meetings, and anytime upon their request, detailed information and analysis concerning these trends.

Article 28: Enforcement of Additional Requirements through Circulars

In order to properly enforce this regulation, if needed DAB will provide specific interpretations and impose additional requirements through circulars.

Chapter 1: General Provisions

Article 1: Basis

This regulation is issued pursuant to Article 177 of Banking Law of Afghanistan in relation to the powers of DAB to regulate and supervise banks in the Islamic Republic of Afghanistan and any amendments thereto.

Article 2: Objectives

This document shall have the objectives herein assigned to them:

- (1) To provide a framework of Profit Distribution principles as part of the effort to standardised the method on the calculation on the profit distribution in terms of rate of return and the approached, practices and processes to guide for the Banks,
- (2) Set the minimum standard in calculating the rate of return;
- (3) Serve as a tool for the Banks to assess and monitor their business strategies and financial performance; and
- (4) Provide the Banks with better means of assessing the efficiency of the Banks as well as their profitability; prudent management and fairness.

Article 3: Scope

This regulation is applicable on all Islamic banks, Islamic subsidiary of bank, Islamic banking window of conventional bank and Islamic branch of foreign bank licensed by Da Afghanistan Bank, unless the context otherwise require.

Chapter 2: Profit Distribution

Article 4: General Requirement for Profit Distribution

- (1) Islamic banking institutions mobilise a large proportion of their deposits, of which a preponderant portion of investment funds raised by the Bank in the form of mudharabah (profit-sharing and loss-bearing) contract. Under the mudharabah contract, depositors (hereinafter known as investment account holders or IAH) agree to participate in the financial activities undertaken by the Islamic banking institutions (as mudharib) and share the profit generated from financing and/or investment activities based on an agreed profit-sharing ratio. The IAH shall bear the losses arising from the assets funded under the mudharabah contract or commonly known as profit-sharing investment account (PSIA), except in the case of fraud, misconduct, negligence or breach of contracted terms by the Banks. The contract thus involves profit-sharing for both partners and loss-bearing for the provider of capital.
- (2) An important element in the risk management capability of the Banks is managing risks that are peculiar to Islamic finance transactions. A dominant contractual relationship in Islamic banking, the case of mudharabah contract is an example of the distinct risk in Islamic finance that would require adherence to strong risk management governance and a high degree of transparency. Unlike conventional deposits where the interest rate is fixed at the point of placement of the deposits, the return of the mudharabah contract can only be ascertained at the end of the

investment period. Consequently, the mudharabah contract exposes the Banks to the impact of cyclical of returns generated from assets funded by the IAH, the stability of the rates of return to the IAH and the level of the Bank's competitiveness within the Islamic finance industry.

- (3) In order to maintain comparable rates of return, the Banks are exposed to Displaced Commercial Risk (DCR). DCR refers to the risk arising from the assets managed on behalf of the IAH which may be borne by the Bank's own capital, when the Banks foregoes part or all of its share of profits on the IAH funds, and/or make transfer to IAH out of the shareholders' fund investment profits as a result of commercial and/or supervisory concerns in order to increase the return to the IAH.
- (4) The application of DCR requires the Banks to displace the credit and market risk losses to themselves by paying a return that exceeds the actual return that was supposedly to be earned by the IAH on the assets based on the contractual profit sharing ratio. The rate of return paid to the IAH is thus given at the expense of the profits belonging to the Bank's shareholders. Hence, under this arrangement, the Bank would be expected to manage DCR in order to safeguard the Bank's own capital and to mitigate potential withdrawals and inflow of funds by the IAHs.
- (5) Given the unique relationship where the depositors would have a direct financial interest in the Banks, a standard calculation of the profit distribution is imperative to ensure that depositors will receive their portion of the investment profits in a fair and equitable manner. It will also address the information asymmetry between the Bank and its depositor by enhancing the level of transparency of Islamic banking operations.
- (6) The broad concept of the framework is based on the return on assets (ROA) approach, which calculates the income of the balance sheet assets. The framework prescribes the methodology in calculating income generated from the balance sheet assets, including other income such as trading income. It also incorporates the type of expenses to be deducted from the total income such as impairment loss, income-in-suspense and profit distributable to other related parties i.e. specific investment deposit holders, bank capital and interbank placements.
- (7) The framework includes the prohibition of application of weightage in the allocation of income, introduction of principal recognition of eligible income and expenditure with a negative list for direct expenses. The fundamental objective of the framework aims to promote a higher level of capacity and efficiency of the Banks in managing their Islamic Banking operations while strengthening Shariah application in mudharabah contract.

Article 5: Framework and Tables of Profit Distribution

- (1) The underlying principle of the framework is that all deposits accepted by the Banks shall only be utilised in the provision of finance (financing, advances and loans), investment in securities, inter-bank placements and other business prescribed by DAB that complies with Shariah. In other words, the deposits cannot be used or utilised in other than these activities such as acquisition of fixed assets and investment in subsidiary or associate companies.
- (2) The framework encompasses two types of tables:
 1. Calculation table (CT):
 - a. Objective: To guide the Banks in deriving the net distributable income to the depositors and the Banks by incorporating the income generated from the assets, the relevant shared

- expenses and allowances between the Banks and the depositors, and income attributable to the various types of depositors. Income generated is to be recognised on an accrual basis.
- b. Features: Comprises income generated from balance sheet assets; trading and other income; provisions; profit equalisation reserves; other expenses; income attributable to Islamic banking capital funds/ shareholders' funds (IBCF/SHF); specific investment deposits (SID); amount due to designated financial institutions; Islamic negotiable instruments and other deposits.
2. Distribution table (OT):
 - a. Objective: To guide the Banks on the proper distribution of the net distributable income posted from CT among other deposits or funds not included in the CT i.e. current, savings and general investment deposits. It requires the Banks to segregate between mudharabah and non-mudharabah deposits to reflect the different risk profiles and to ensure fair distribution of profit between these two categories of deposits.
 - b. Features: Reports the respective weightage, profit sharing ratio and distributable profit to depositors and the Banks for each type of deposits, tenures and agreed profit sharing ratios.

Article 6: Calculation Table (CT)

The methodology in deriving the net distributable income in the CT comprises two levels:

(1) First Level:

1. Reports the income generated by all Islamic banking assets and calculates the weighted average rate of return (WAR) of each asset.
2. The WAR reflects the percentage of income generated by each asset in a specific month. It also serves as a tool to evaluate the performance of the assets and to assist the Banks in strategising their future activities. For example, a lower WAR for the current month as compared to the previous month implies that efforts should be intensified to enhance the performance of the assets.
3. The WAR per annum of each asset is derived as below:

$$\text{WAR} = \frac{\text{Income}}{\text{Average daily amount Of asset}} \times \frac{365}{\text{Number of days for the month}} \times 100\%$$

(2) Second Level:

1. This level prescribes the relevant allowances (such as general allowance, specific allowance, impairment loss and provisions for commitment and contingencies), profit equalisation reserves, direct expenses, other expenses and income attributable to the Banks and various depositors in arriving at the net distributable income.
2. In terms of direct expenses, handling fee for hire-purchase financing and brokerage fee for trading of securities are eligible to form part of direct expenses for the purpose of deduction from total gross income.

3. In addition, commission payable to sales officers for introducing new financing activities approved to the customers are also recognised as an eligible direct expense subject to the following conditions:
4. The commission is to be recognised after the new financing agreement has been completed by both the customer and the Banks and
 - a. Each payment of commission to the sales person must be documented.
 - b. Other direct expenses shall be specified by DAB from time to time.
5. The WAR of net income represents the percentage of income attributable to funds other than SID and IBCF/SHF and is derived as follows:

WAR of net income

$$= \frac{\text{Net income}}{\text{Average daily amount of (Total funds 1 - SID - IBCF/SHF)}} \times \frac{365 \times 100\%}{\text{Number of days for the month}}$$

- (3) The WAR of the net distributable income reflects the percentage of income over other deposits or funds not included in the CT. Normally, the deposits include current, savings and general investment deposits (inclusive of special general investment deposits (SGID) if any).

Article 7: Distribution Table (DT)

- (1) The Banks are required to classify the current, savings and general investment deposits into Mudharabah or non-Mudharabah deposits.
- (2) For each current, savings, and general investment deposit, the Banks are required to report the followings:
 1. Average daily amount of deposit;
 2. Distributable profit (amount and percentage); and
 3. Depositors' and IBI's portion of distributable profit (amount and percentage)
- (3) SGID, if any, shall be reported in the DT under a separate item if such deposit is not reported in any tenure of general investment deposits (GID). Weighted is Not Permitted.
- (4) The application of weightage (to represent the varying risk reward attached to the different tenures) in determining the allocation of the net income to the different tenures of the deposits is not permitted. Profit sharing ratio (PSR) shall be the sole determinant of the distributable profit to depositor and the Banks.

Article 8: Distributable Profit

- (1) In arriving at the distributable profit for Mudharabah and non-mudharabah deposits, the total average daily amount of each category of deposits is divided by the total average daily amount and multiplied by the total distributable profit.

- (2) The distributable profit of each category of deposit (Mudharabah and non-mudharabah) shall be used to determine the distributable profit of each type of deposits (current, savings, and general investment). The average daily amount of a type of deposit is divided by the total average daily amount of each category of deposits and multiplied by the distributable profit of each category.
- (3) Percentage of distributable profit for each type of deposits per annum (referred as gross rate of return) is derived as follows:

Gross rate of return

$$= \frac{\text{Distributable Profit}}{\text{Average daily amount Of Deposits}} \times \frac{365}{\text{Number of days for the month}} \times 100\%$$

Article 9: Profit Distributable to depositor and the Bank

- (1) The distributable profit is apportioned to the depositors and the Banks according to the PSR of the respective deposit types and tenures. The total amount of depositors' and the Banks's profit portions must be equal to the total distributable profit.
- (2) The percentage of profit distributable profit to depositors and the Banks per annum (net rate of return) is derived as follows:

$$\text{Net Rate of return} = \text{Gross Rate} \times \text{PSR}$$

Article 10: General and Compliance Requirements

- (1) Management of Funds: The funds of Islamic banking operations are classified into two categories i.e. restricted and unrestricted funds.
- (2) Income and Expenses: Income and expenses of the Islamic banking operation are categorised based on the management of funds in relations to the restricted and unrestricted funds. The classification of the Trading income, Fee-based income, and direct expenses will be guided by the general principles to be circulated by DAB.
- (3) Provisioning: The Banks are required to observe the relevant guidelines and circulars issued by DAB on the classification and provisioning of non-performing financing and securities.
- (4) Profit Sharing Ratio (PSR): PSR refers to the portion of profit distributable to depositors and the Banks. For example, PSR of 70:30 refers to 70% of profit distributable to the depositors and the remaining 30% distributable to the Bank.
- (5) Dividend/Hibah – An accurate calculation of dividend/hibah is imperative to ensure that the mudharabah depositors receive a fair portion of their investment profit. The calculation based on the average rate of each investment deposit reflects the risk exposure of each deposit to the yield of the bank's assets.
- (6) Declaration of Rates of Return (ROR) and Board Rates—As a minimum requirement, the Banks are required to prominently display the effective period, types of deposits, PSR and ROR (in percentage) for respective deposits at their premises; and notice to the depositors that other information not displayed on the board is available at the counters.

- (7) The Banks are required to declare their monthly ROR on a specified date and the subsequent one month will be the effective period of the declared ROR.
- (8) The framework is to regulate and monitor the prudence and fairness of the Banks in deriving their ROR to depositors. The Banks are required to maintain the records of both tables to facilitate examination by DAB from time to time. The relevant authority of the Banks shall endorse such records, at least the Head of Islamic Banking Department or the relevant department such as Finance or Treasury Department.

Chapter 1: General Provisions

Article 1: Basis

This regulation is issued pursuant to Article 177 of Banking Law of Afghanistan in relation to the powers of DAB to regulate and supervise banks in the Islamic Republic of Afghanistan and any amendments thereto.

Article 2: Objectives

This document shall have the objectives herein assigned to them:

- (1) Sets out the expectations of DAB on the Bank's Shariah governance structures, processes and arrangements to ensure that all its operations and business activities are in accordance with the principles of Shariah;
- (2) Provides a comprehensive guidance to the Board of Supervisors (hereinafter referred to as "the Board"), the Shariah Board and the Management Board of the Bank in discharging their duties in matters relating to Shariah.
- (3) Outlines the functions of the Bank relating Shariah Compliance.

Article 3: Scope

This regulation is applicable on all Islamic banks, Islamic subsidiary of bank licensed by Da Afghanistan Bank, unless the context otherwise require.

Article 4: Introduction

- (1) This policy outlines the Shariah Governance principles (the "SG" or "the Framework") by Da Afghanistan Bank (hereinafter referred to as "DAB") which shall be the guiding principles for the Shariah Governance Framework structure of every full-fledged Islamic Financial Institution (hereinafter referred to as "IFI"), operating within the Islamic Republic of Afghanistan.

For the purpose of this policy manual and all other documents concerning Islamic finance issued by DAB, all provisions as provided herein shall refer to IFIs "the Bank").

- (2) The SG shall, be read in conjunction with other related laws, regulations and guidelines, as issued by the Islamic Republic of Afghanistan and the DAB.

- (3) All relevant stakeholders in DAB and in the Bank are expected to be familiar with the SG and understand their roles and responsibilities in order to comply with the SG in the letter and spirit of the SG.
- (4) Given the early stage of development for Islamic Banking activities in the Islamic Republic of Afghanistan, the proposed SG is to be viewed as a basic reference document to be further expanded and refined by relevant stakeholders in future. It is anticipated that the DAB Shariah Supervisory Board (hereinafter referred to as “the SSB”) will give some exceptions within the SG to accommodate some unavoidable or excessive difficulties (*al-mashaqqah*).
- (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 SSB outlining the reasons and justifications for such requests.

Article 5: Review and update of Shariah Governance

- (1) The SG, may be reviewed by the DAB Islamic Banking & Finance Department (hereinafter referred to as “the IBFD”) in consultation with the SSB, on an as needed basis. The IBFD will consult with the Bank’s Shariah Board and the Bank’s management to take into account market conditions, risk mitigation strategies and to align with the strategy of the Bank.
- (2) Any proposed amendment to be made to the SG by DAB, may be permitted as a result of one or more of the following reasons (which are not exhaustive):
 1. Changes in laws and regulations;
 2. Changes in functions and activities of the Bank;
 3. Changes in business processes;
 4. Changes in the organizational structure of the Bank;
 5. Changes in job roles, duties, and descriptions;
 6. Any other changes, where the IBFD deem necessary to update the Bank’s policies and procedures; or
 7. Any significant modifications arising out of the review of the SG by the IBFD, as approved by the SSB.

Article 6: Sources of Shariah Law

- (1) Primary Sources of the Shariah are the Qur’an (the Holy Book of Islam revealed to the Prophet Muhammad (SAW) and the Sunnah (Traditions) of the Prophet Muhammad (SAW).
- (2) Secondary sources of the Shariah include, but are not limited to:
 1. Ijma’ - Consensus of the scholars on certain rules of Islamic law;
 2. Qiyas – Juridical analogy (based on a clear injunction passed on previous incident);
 3. Istihsan – Juristic preference for stronger evidence over juridical analogy;
 4. Al Masalih al-Mursalah – No definite judgment in the Shariah but allowed due to it being of general benefit to the community; and
 5. Ijtihad - the process of making a legal decision by independent interpretation of the primary sources.

Article 7: Governance and Oversight

- (1) Board of supervisory (the Board), Board Risk Policy Committee and Management Board: Adoption of the SG at the Bank level shall be undertaken by the Bank's Policy committee or other relevant supervisory authority on behalf of the Shariah Board, the Board and subject to the Board's endorsement and/or ratification.
- (2) Chief Executive Officer ("the CEO"): The CEO of the Bank shall be the SG owner for the Bank providing, in consultation with the Management Board and the Bank's Shariah Board, the necessary oversight which shall consider the following:
 1. Ensuring the current business strategy, risk appetite, risk universe, governance framework and business structures are in line with the Bank's framework and objectives;
 2. Ensuring that detailed procedures are in place across the Bank to ensure compliance with the SG;
 3. Assisting in providing subject matter expertise, support and technical guidance to the business; and
 4. Communicating the SG to the business unit and concerned functions and ensuring it is understood.
- (3) The CEO and the Management Board shall be consulted on dealing with executive decisions and/or actionable issues arising from the implementation of SG process and any deficiencies.
- (4) The Management Board ("the Management"):
 1. The Management shall be the Accountable Executive (hereinafter referred to as "AE") of the SG for the Bank.
 2. The Management assumes oversight and supervisory responsibilities for the functions specified in the SG, and ultimate responsibility for the ongoing review and for any application for exemption to the provision of SG.
 3. Any deviations or exemptions to the SG must be based on a proposal by the Management to the DAB SSB. The Management shall, prior to that application, discuss and deliberate on same thoroughly in consultation with the Bank's Shariah Board to seek for guidance or approval on the subject matter.

Article 8: Compliance with Shariah Principles

- (1) The Shariah, literally, translates to "*the guided way*". It is the Divine framework and guidance that outlines the principles of Islamic beliefs and covers the basic tenets for how man is to conduct his social and economic activities. In dealing with economic or any business activities the elements of usury ("*Riba*"), gambling ("*Maisir*"), uncertainty ("*Gharar*") and matters which are not permissible ("*Haram*") are prohibited.
- (2) It is a prerequisite for the validity of an IFI, Islamic Window and Islamic Unit that none of its contracts or business aspects should contravene any express or implied Shariah sanctions. Shariah provides the Divine guidance by Allah Almighty and, therefore, it is necessary for any transaction to be in conformity with the Divine rules and regulations. Any transaction, which fails to be practiced in conformity with such rules and regulations, will therefore become invalid.

- (3) DAB places great importance in ensuring that the overall Islamic financial system of the Banks in the Islamic Republic of Afghanistan operate in accordance with Shariah principles. This is to be achieved through the wholesale adoption of Shariah Board International Islamic best practices.
- (4) DAB also requires that all Banks operating in the Islamic Republic of Afghanistan must operate in accordance with the highest ethical standards. DAB leaves Shariah compliance aspects of the Bank to be a matter under the purview of the Shariah Board of the Bank.
- (5) Each Bank must adopt the guiding principles as provided in the SG with the primary objective of enhancing the role of the Bank's Board, the Shariah Board and the Management in relation to Shariah matters, including enhancing the relevant key business functions having the responsibility to execute the Shariah research and compliance functions aimed at the attainment of a Shariah based operating environment.
- (6) DAB, taking into consideration the nascent stage of Islamic Finance in the Islamic Republic of Afghanistan, hereby temporarily authorises the Banks to outsource any of its Shariah Governance or operational functions as well as its Shariah Board to an external Shariah board or a third-party Shariah consultancy/service provider or a previously approved Shariah scholar who sits on the Shariah Board of other Banks in the Islamic Republic of Afghanistan (hereinafter referred to as "the Outsourced Scholar") provided that this complies with the requirements as provided under the Guidelines on Outsourcing of Islamic Banking Operations as issued by DAB. DAB may authorise the Outsourced Scholar to sit on any number of Shariah Boards in the Islamic Republic of Afghanistan for any period that it deems reasonable.
- (7) It is recommended that at least one (1) competent Shariah expert be retained by the Bank to head its Shariah Department and be tasked with the responsibility of Shariah-compliance.
- (8) The Bank's Shariah Board shall be an independent entity of the Bank which shall consist of qualified Shariah scholars appointed by the Management on behalf of the Bank's Board. The Shariah Board members shall comprise of persons with appropriate qualifications and experience in Shariah who are able to deliberate Islamic Finance issues brought before them and provide sound Shariah decisions to the Bank.
- (9) The SSB hereby reserves the right to interview all proposed members of the Shariah Board and the proposed head of the Management of the Bank (hereinafter referred to as "the Proposed Person") to satisfy itself that the Proposed Person is suitable for the appointment. This interview may take place in person or via electronic means that are acceptable to the SSB. Confirmation of the mode of interview shall be issued by the SSB two (2) weeks in advance of the proposed interview to the Bank.
- (10) The Bank shall notify the SSB at least ten (10) weeks in advance of the proposed appointment to either their Shariah Board or Head of the Management and shall furnish the Curricular Vitae of the Proposed Person to the SSB and any other material requested in writing by the SSB. Upon receipt of all information requested by the SSB, the SSB shall confirm to the Bank in writing that it has sufficient information to come to a determination (hereinafter referred to as "the Sufficient Information Letter"). For the avoidance of doubt, the issuance of a Sufficient Information Letter does not preclude the SSB from asking questions of the Proposed Person outside the contents of the information supplied to it.

- (11) The SSB may then hold the interview in a manner of its choosing pursuant to clause 9 of this article (above) and may elect to confirm the Proposed Person as suitable for the Bank to hire or the SSB shall confirm that the person is not suitable. The decision of the SSB in this matter is final and the Proposed Person shall have no recourse to the courts of the Islamic Republic of Afghanistan to appeal this decision.
- (12) In the event that the Proposed Person is found not suitable, the SSB may, in its absolute discretion furnish reasons for this decision and /or suggest certain personal development programmes that the Proposed Person may undertake in order to re-apply to be a Proposed Person.
- (13) The Bank may send a panel of Proposed Persons to be considered by the SSB subject to the proviso that the Bank cannot send more than 3 names forward per vacant position. The final decision whether to hire an SSB approved Proposed Person shall be a matter for the Bank.
- (14) Notwithstanding the above, the SSB may waive the requirement set out in clause 9 of this article for individual Proposed Persons. It shall inform the Bank of its waiver in writing and such waiver shall be deemed confirmation that the Proposed Person is suitable pursuant to clause 11 of this article (above).
- (15) In the event that an application to confirm a Proposed Person rests with the SSB for in excess of three (3) months after the issuance of the Sufficient Information Letter, the Bank may use the Sufficient Information Letter as deemed acceptance of the Proposed Person and the Bank may proceed to hire the Proposed Person in its absolute discretion.

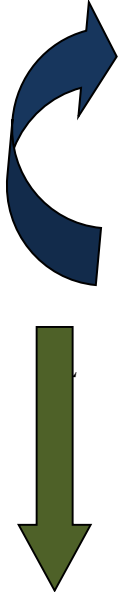
Article 9: Structure of the Shariah Governance

(1) The Shariah Governance is divided into six (6) sections, with each section focusing on one governing principle, as follows:

Section	Key Areas	Explanation
I	General Requirement of the Framework	<p>This section outlines the general requirements of the Framework, which describes the essential key functions or key organs.</p> <p>Note: For the purposes of this Framework, key functions or key organs refer to the functions in implementing Shariah governance at the Bank.</p>
II	Rights, Duties and Accountabilities	<p>This section outlines the level of accountability and responsibility expected of the Bank's Board, Bank's Shariah Board and the Management.</p>
III	Independence	<p>This section aims to safeguard the independence of the Shariah Board in ensuring sound Shariah decision-making and emphasis on the role of the Board in recognizing the independence of the Shariah Board.</p>
IV	Competency	<p>This section highlights requirements and expected competencies to ensure key functions are capable of implementing Shariah governance.</p>
V	Confidentiality and Consistency	<p>This section outlines the minimum set of rules that emphasizes the importance of observing and preserving confidentiality, and improving the level of consistency in decision-making by the Shariah Board.</p>
VI	Internal Shariah Functions	<p>This section prescribes the internal Shariah Functions.</p>

Article 10: Requirements of the Bank Shariah Governance Structure

- (1) It is the duty and responsibility of the Bank to establish a sound and robust internal Shariah Governance Framework (“SG”) for its Islamic Banking activities and such framework shall be adopted based on the guiding principles as enshrined by this SG as issued by DAB with emphasis placed on the roles of key functionalities in ensuring effective adaptation and implementation of the SG.
- (2) The Bank shall ensure that the aims and operations of its business activities are in compliance with Shariah principles at all times. An end-to-end control mechanism shall be established in all aspects of its business operations to ensure that its overall activities are Shariah compliant.
Note: Shariah compliant refers to compliance to Shariah rulings and decisions issued by the Bank’s Shariah Board or by other relevant bodies such as the SSB.
- (3) A sound and robust SG is reflected by effective and responsible Board of Directors and the Management Board, an independent Shariah Board that is both competent and accountable, supported by a strong Internal Shariah Management
- (4) The end-to-end Shariah compliant control mechanism will be executed through four (4) lines of defense that cater for both pre-execution and post-execution stages. Table 1.0 overleaf illustrates a model structure and respective functions that are involved in each line of defence.



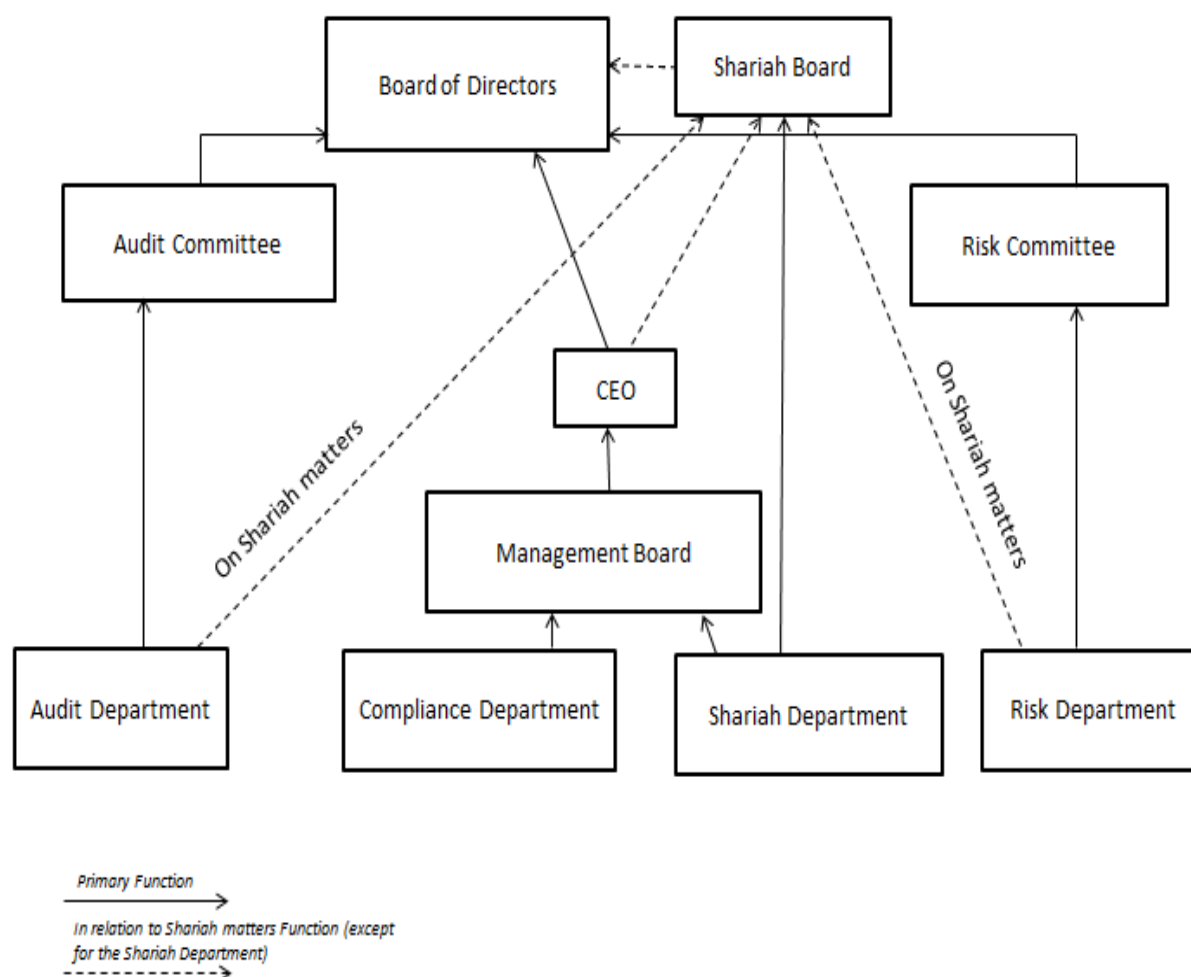
High Level Committees	
Board Level Oversight	<ul style="list-style-type: none"> • Board of Directors • Board Risk Policy Committees ➤ Risk Committee ➤ Audit Committee
Special Committee Oversight	<ul style="list-style-type: none"> • Management Board
Working Level	
Line of Defence 1: Business units and Support units	<ul style="list-style-type: none"> • Departments that are involved in product development, services and activities
Line of Defence 2: Shariah Management	<ul style="list-style-type: none"> • Shariah Department

Table 1.0: Tow (2) Lines of Defence in the Bank’s Shariah Governance

Note: Reporting line of working level to inform high level committees of the status of the Bank's Shariah compliance

Line of defence /execution of working committees

Illustration 1.0: Shariah Governance Framework Model for Banks



Article 11: The Shariah Governance document comprises of the following Shariah key components

- (1) The Bank's Shariah Board overseeing the Shariah compliance aspects of the Bank's overall operations and the other relevant committees' overseeing the operational aspects of the Bank's operations. The Bank's Shariah Board with qualified members who are able to deliberate Islamic finance issues brought before them and provides sound Shariah decisions.
- (2) The Management's responsibilities include providing adequate resources and capable manpower support to every function involved in the implementation of Shariah governance, in order to ensure that the execution of all operations are in accordance with the Shariah principles.

- (3) The Bank's Shariah Department which shall be responsible for conducting ground works on all Shariah-related matters of the Islamic business activities of the Bank. This department shall consist of officer(s) who holds at least a bachelor's degree in Shariah which includes the study in Usul Fiqh (the origin of Islamic law) and Fiqh Muamalat (Islamic transaction/commercial law)
- (4) Over time a capacity shall be developed within the Bank's Shariah Department's to include the following broad responsibilities:
 1. Shariah Research Unit/function will conduct research on Shariah issues and ensuring that all structures, terms and conditions, legal documentation and operational process flow and procedures are Shariah compliant.
 2. The Shariah Review Unit/function will provide regular assessment on Shariah compliance in the activities and operations of the Bank with the objective of ensuring that the activities and operations carried out by the Bank does not contravene Shariah principles.
 3. The Shariah Advisory Unit/function will provide advisory support to the Management in relation to the Bank's Shariah compliant operations in accordance to decisions and rulings issued by the Bank's Shariah Board.
 4. The Shariah Compliance Unit/function will provide continuous assessment from the local laws and regulatory purview of the Shariah Compliant activities to ensure compliance at the regulatory level and inform the Management Board immediately in situation where there may be a conflict between the Shariah and regulatory laws to avoid regulatory sanctions.
 5. The Shariah Risk Management Unit / function will identify all possible Shariah non-compliance risks and, where appropriate, remedial measures that need to be taken to reduce the risks and a continuous Shariah Audit of processes and deliverables, as well as determining that such processes and outcomes satisfy the needs of the Shariah.
 6. The Shariah Audit Unit / function will undertake periodical assessment to provide an independent assessment and objective assurance designed to add value and improve the degree of compliance of the Bank's business operations.
 7. The Shariah Secretariat Unit / function with its responsibilities include coordinating meetings, compiling proposal papers, disseminating Shariah decisions to stakeholders and engaging with relevant parties who wish to seek further deliberations of issues from the Shariah Board.
- (5) The timetable for the development of the functions outlined above shall be determined by the SSB taking into account the development of the Islamic business activities of the Bank and Islamic Finance in the Islamic Republic of Afghanistan in general.

Article 12: Rights, Duties and Accountabilities

- (1) Board of Directors (hereinafter referred to as "the Board"):
 1. The Board shall ultimately be accountable and responsible on the adaptation and implementation of the SG within the Bank's governance structure, by putting in place the appropriate mechanisms to discharge the responsibilities. The Board shall perform diligent oversight over the effective functioning of the SG.
 2. Notwithstanding the final decisions and instructions from the Shariah key functions, the Board may intervene or enquire into the operations of the Bank and in the case where the Board has

any reason to believe that the Bank has carried on any activity that is non-compliant to Shariah principles, it may order or direct that a prompt rectification measure to be taken by the Bank. The Bank shall, in consultation with the Bank's Shariah Board, comply with such order.

(2) Shariah Board of the Bank:

1. The Bank's Shariah Board shall be the highest authority in making the final decision on matters related to the Shariah in the Bank's course of business operation at the Bank's level. Therefore, the Bank's Shariah Board is responsible for the views, decisions and advices provided to the Bank and is expected to deliberate every arising issue extensively and in-depth before arriving at any decision. In doing so, the Bank's Shariah Board has the right to call upon any relevant party in the Bank or convene a meeting with the identified relevant parties to facilitate the decision making.
2. The Bank's Shariah Board is expected to perform an oversight role on Shariah matters related to the Bank's operations and activities through the observations and reports from the Shariah Department by identifying possible Shariah issues, if any, and propose the necessary corrective measures.
3. The Shariah Board is expected to provide assistance to the Management or any related party thereof in overseeing the enforcement and implementation of the Shariah Board resolutions. The Shariah Board has the responsibility to disclose sufficient information on the Bank's state of compliance in its annual financial report as per the requirements under applicable laws during the tenor of the Shariah Board's appointment.
4. Other duties and accountabilities of the Shariah Board and the governing operation procedures for the Shariah Board shall further be spelt out in the terms of reference (hereinafter referred to as "TOR") of the Shariah Board of the Bank.
5. In addition to the abovementioned duties and accountabilities, the members of the Shariah Board are expected to observe other relevant provisions herein contained.

(3) Management Board

1. The Management shall assume the duty of ensuring the operative execution of the Framework by the Bank by monitoring the performance of the relevant parties as prescribed herein and the discharge of such duties satisfies the minimum requirements of the Framework. The Management is ultimately accountable for the establishment and overall governance of the Framework and the abidance thereof by the relevant parties. The Management shall also assume the duty of overseeing that the implementation of the resolutions (religious decree/edict from a qualified scholar) issued by the Shariah Board are managed by its various reporting lines and that the provisions in the Framework are complied with.
2. The Management is expected to understand the Shariah non-compliance risks. Shariah non-compliance risks refer to possible failures to meet the obligation to satisfy the Shariah principles or in other words, possible incidences of Shariah non-compliance associated with Islamic finance business and the issues relating to such risks, as well as its potential implications to the Bank arising from such failures to comply.

3. Alongside a sound Shariah governance structure, the Management is under the obligation to ensure that other relevant policies and strategies that may enhance the Shariah compliance environment including effective communications, sufficient and impartial disclosures and others are well administered throughout the relevant units.
4. The Management is expected to make available or take all reasonable measures to make available to the Shariah Board the relevant information, records and other related documents of the Bank in a prompt and timely manner to assist the Shariah Board in arriving at informed resolution, advice and decision in a prompt and timely manner.
5. The Management shall endeavour to provide continuous learning and training programs to the Bank's key internal stakeholders and relevant staff involved in the Shariah and finance matters to enable sufficient exposure to the current developments in Shariah related matters.
6. The Management shall develop and adopt a holistic culture of Shariah compliance within the organization of the Bank. In an effort to create coherence in the understanding and execution of the Shariah principles between the Shariah key functions and the frontline staff, the Management shall also provide sufficient information to the frontline staff via briefings, training and any other suitable means.
7. It is the duty of the Management to ensure that the Shariah policies and procedures provide clarity on matters related to the end-to-end process of Shariah governance in the overall business operation of the Bank and that the Shariah Board resolutions are accessible to the relevant parties at all times. The Management shall also be responsible in ensuring that the Bank's operations are executed in accordance with Shariah compliant policies and procedures, and to constantly review and update the Shariah compliant policies and procedures to reflect current market practices and developments.
8. In the event that it is resolved by the Shariah Board that certain operations of the Bank are carried out in a manner that is not Shariah compliant, the Shariah Board shall specify whether it deems the breach to be a minor or accidental breach of Shariah compliance or it deems the breach to be a serious, deliberate or fundamental breach of Shariah compliance.
 - a. In the event that the Shariah Board deems the breach to be a minor or accidental breach of Shariah compliance, the Management shall (and is not restricted to):
 - Take immediate steps to isolate and eliminate this Shariah non-compliance (up to and including ceasing to taking on new business of the Shariah non-compliant product or service;
 - Purify any tainted income;
 - within 90 (ninety) days of becoming aware of such Shariah non-compliance or such further period as may be permitted by the CEO, prepare a report to the Shariah Board as the case may be outlining how this Shariah non-compliance occurred and how the Bank dealt with the matter; and
 - Provide additional training to staff involved in the Shariah non-compliance to reduce the likelihood of its reoccurrence. Notwithstanding the above, any repetition of Shariah non-compliant event although minor in nature, may be regarded by the Shariah Board as a serious deliberate or fundamental breach of compliance.

- b. In the event that the Bank's Shariah Board deems the non-compliance to be a serious deliberate or fundamental breach of Shariah compliance, the Management shall:
 - Immediately notify the Board of Directors of the fact;
 - Immediately cease to take on any new business related to the Shariah non-compliant business;
 - Within thirty (30) days of becoming aware of such Shariah non-compliance or such further period as may be permitted by the Shariah Board, furnish a plan to rectify the state of Shariah non-compliance, to be endorsed by the Shariah Board and duly approved by the Board;
 - Purify the tainted income arising out of such non-compliance;
 - Provide additional training to staff involved in the Shariah non-compliance to eliminate the likelihood of its re-occurrence;
 - Notify the IBFD of DAB of the breach which may, if the IBFD deems necessary, inform the DAB SSB of the breach and request that the SSB deliberate on how to rectify the matter. For the avoidance of doubt the SSB may not impose sanctions on any employee of the Bank for such non-compliance. The Bank shall deal with the employee(s) responsible for the breach internally.
 - The SSB may, however, suggest administrative and or oversight procedures to the Bank to avoid similar breaches in future.
9. The Management may nominate and delegate the duties and responsibilities to a particular unit but the delegation thereof shall not obviate the oversight accountability assumed by the Management.
10. In addition to the abovementioned duties and accountabilities, the Management shall observe other related provisions herein contained.

Article 13: Independence

- (1) Independence of the Shariah Board shall be observed at all times in exercising their duties to make objective and informed judgment.
- (2) The Board of Directors shall recognize the independence of the Shariah Board and ensure that the Shariah Board is free from any undue influence that would hamper the Shariah Board from exercising objective judgment in deliberating issues brought before them. Correspondingly, the Shariah Board is expected to make sound decisions on Shariah matters in an independent and objective manner.
- (3) The Shariah Board shall report to the Board of Directors and regularly inform the Board on relevant Shariah matters.
- (4) The Board, through the Management, shall ensure that all decisions made by the Shariah Board are duly observed and implemented by the Bank. Decisions made by the Shariah Board should not be set aside or modified without its consent.

- (5) The Shariah Board shall have access to accurate, timely and complete information from the Management. If the information provided is insufficient, the Shariah Board may request for additional information which shall be duly provided by the Management.
- (6) In the event where the Shariah Board is not provided with the required information, the Board of Directors shall be informed of the fact and appropriate action shall be taken to rectify the situation. Where appropriate, the Board shall consider taking the necessary punitive measures against parties who intentionally fail to extend the required information.
- (7) Where the Shariah Board has reason to believe that the Bank has been carrying on Shariah non-compliant activities, the Shariah Board shall inform the Board and to recommend suitable measures to rectify the situation.

Article 14: Competency

- (1) The key management and other relevant parties, engaged in the activities of the Bank, shall possess adequate competency on the Shariah compliant banking. Every party shall strive towards enhancing the acquired Shariah knowledge by attending internal and external training provided.
- (2) Besides meeting the requirements of a qualified member of the Shariah Board, the Shariah Board members are expected to equip themselves with relevant knowledge on the current Shariah issues and development as well as to attend relevant training programs provided by key Shariah bodies such as Islamic Fiqh Academy, Accounting and Auditing of Islamic Financial Institutions (“AAOIFI”), Islamic Financial Services Board (“IFSB”) and their successor organisations and other similarly renowned organisations. The Bank may impose more stringent requirements in the Terms of Reference it agrees with its Shariah Board in particular in relation to qualifications, but same shall not be more lenient than of the SSB TOR (or other related documents) which shall be taken as a reference document when drafting the Bank’s TOR with its Shariah Board.
- (3) The Shariah Board members shall be individually assessed and reviewed on the level of competency and overall contribution based on their Shariah deliberations and this shall be done on an annual basis. The assessment methodology and criteria shall be in accordance with the Shariah Board Members’ Assessment Manual as issued by DAB.

Article 15: Confidentiality and Consistency

- (1) The Shariah Board shall have the necessary access to both confidential and non-confidential files, records, conversations and draft materials to the extent that are required to facilitate the Shariah Board in making their decisions, views and opinions. Any sensitive information obtained by any member of the Shariah Board shall not be disclosed or used in any manner that may be detrimental to the Bank. Every member of the Shariah Board is entrusted with individual responsibility to observe the principle of confidentiality at all times.
- (2) Confidential information is information received by the members of the Shariah Board that is not public in nature and has not been authorised to be made public. Confidential information includes, but is not limited to, the following:
 1. Information on the development of new products and services;
 2. Decisions of the Board of Directors or the Management;

3. International memorandums or reports prepared in connection with matters presented, or to be presented to the Shariah Board;
 4. The content or occurrence of conversations among members of the Shariah Board concerning matters deliberated in the meeting and representatives of the Bank;
 5. The progress status on a business transaction or action that has not been made public;
 6. Views expressed by various parties in the course of discussions on a particular matter deliberated by the Shariah Board; and
 7. Any subject matter that the Bank has indicated should not be revealed, such as internal policies and procedures.
- (3) Notwithstanding the above, the disclosure of sensitive information by the Shariah Board in good faith when reporting a serious Shariah breach to the CEO and the Board as the case may be does not constitute a breach of the confidentiality and consistency code.
 - (4) In order to ensure consistency and quality in the Shariah decisions and resolutions, the Shariah Board is expected to develop a structured process of the decision making that is documented, adopted and maintained at all times to secure credibility of the Shariah Board.
 - (5) The Shariah Board shall use international Islamic Finance best practices for Shariah Boards.
 - (6) In cases where there are uncertainties and material differences of opinions between the Shariah Board members, the Bank may seek advice and refer for a ruling from the DAB SSB.
 - (7) In cases of disputes and court proceedings relating to Islamic financial businesses or any Shariah issue arising from the Bank's business operations, both the court and the arbitrator shall take into consideration the published rulings and standards as issued by the DAB SSB or in the absence of any such, upon reference and after deliberation by the SSB. Any rulings made by the SSB arising from a reference made in such proceedings shall be binding on the Bank. In the event where the decision given by the Shariah Board is different from the rulings given by the SSB, the rulings of the SSB shall prevail. However, the Bank's Shariah Board shall be allowed to adopt a more stringent Shariah decision subject to an approval granted by the SSB based on solid reasoning and justification as presented.

Chapter 1: General Provisions

Article 1: Basis

This regulation is issued pursuant to Article 177 of Banking Law of Afghanistan in relation to the powers of DAB to regulate and supervise banks in the Islamic Republic of Afghanistan and any amendments thereto.

Article 2: Objectives

This document shall have the objectives herein assigned to them:

- (1) Sets out the expectations of DAB on the Bank's Shariah governance structures, processes and arrangements to ensure that all its operations and business activities are in accordance with the principles of Shariah;
- (2) Provides a comprehensive guidance to the Board of Supervisors (hereinafter referred to as "the Board"), the Shariah Board and the Management Board of the Bank in discharging their duties in matters relating to Shariah.
- (3) Outlines the functions of the Bank relating Shariah Compliance.

Article 3: Scope

This regulation is applicable on all Islamic banking window of conventional banks licensed by Da Afghanistan Bank, unless the context otherwise require.

Chapter 2: Shariah Governance for Islamic Window

Article 4: Introduction

- (1) This policy outlines the Shariah Governance (the "SG" or "the Framework") by Da Afghanistan Bank (hereinafter referred to as "DAB") which shall be the guiding principles for the Shariah Governance Framework structure of every Financial Institution operating with Islamic Window (hereinafter referred to as "Islamic Window") or Financial Institution operating with Islamic Units (hereinafter referred to as "Islamic Unit") operating within the Islamic Republic of Afghanistan. For the purpose of this policy manual and all other documents concerning Islamic finance issued by DAB, all provisions as provided herein shall refer to Financial Institutions as "the Bank").
- (2) The SG shall, be read in conjunction with other related laws, regulations and guidelines, as issued by the Islamic Republic of Afghanistan and the DAB.
- (3) All relevant stakeholders in DAB and in the Bank are expected to be familiar with the SG and understand their roles and responsibilities in order to comply with the SG in the letter and spirit of the SG.
- (4) Given the early stage of development for Islamic Banking activities in the Islamic Republic of Afghanistan, the proposed SG is to be viewed as a basic reference document to be further expanded and refined by relevant stakeholders in future. It is anticipated that the DAB Shariah Supervisory Board (hereinafter referred to as "the SSB") will give some exceptions within the SG to accommodate some unavoidable or excessive difficulties (*al-mashaqqah*).

- (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 SSB outlining the reasons and justifications for such requests.

Article 5: Review and update of Shariah Governance

- (1) The SG, may be reviewed by the DAB in consultation with the SSB, on an as needed basis. The IBFD will consult with the Bank’s Shariah Board and the Bank’s management to take into account market conditions, risk mitigation strategies and to align with the strategy of the Bank.
- (2) Any proposed amendment to be made to the SG by DAB, may be permitted as a result of one or more of the following reasons (which are not exhaustive):
 1. Changes in laws and regulations;
 2. Changes in functions and activities of the Bank;
 3. Changes in business processes;
 4. Changes in the organizational structure of the Bank;
 5. Changes in job roles, duties, and descriptions;
 6. Any other changes, where the IBFD deem necessary to update the Bank’s policies and procedures; or
 7. Any significant modifications arising out of the review of the SG by the IBFD, as approved by the SSB.

Article 6: Sources of Shariah Law

- (2) Primary Sources of the Shariah are the Qur’an (the Holy Book of Islam revealed to the Prophet Muhammad (SAW) and the Sunnah (Traditions) of the Prophet Muhammad (SAW).
- (2) Secondary sources of the Shariah include, but are not limited to:
 1. Ijma’ - Consensus of the scholars on certain rules of Islamic law;
 2. Qiyas – Juridical analogy (based on a clear injunction passed on previous incident);
 3. Istihsan – Juristic preference for stronger evidence over juridical analogy;
 4. Al Masalih al-Mursalah – No definite judgment in the Shariah but allowed due to it being of general benefit to the community; and
 5. Ijtihad - the process of making a legal decision by independent interpretation of the primary sources.

Article 7 : Governance and Oversight

- (1) Board of supervisory (the Board), Board Risk Policy Committee and Management Board: Adoption of the SG at the Bank level shall be undertaken by the Bank’s Policy committee or other relevant supervisory authority on behalf of the Shariah Board, the Board and subject to the Board’s endorsement and/or ratification.
- (2) Chief Executive Officer (“the CEO”): The CEO of the Bank shall be the SG owner for the Bank providing, in consultation with the Management Board and the Bank’s Shariah Board, the necessary oversight which shall consider the following:
 1. Ensuring the current business strategy, risk appetite, risk universe, governance framework and business structures are in line with the Bank’s framework and objectives;

2. Ensuring that detailed procedures are in place across the Bank to ensure compliance with the SG;
 3. Assisting in providing subject matter expertise, support and technical guidance to the business; and
 4. Communicating the SG to the business unit and concerned functions and ensuring it is understood.
- (3) The CEO and the Management Board shall be consulted on dealing with executive decisions and/or actionable issues arising from the implementation of SG process and any deficiencies.

Article 8: The Management Board (the Management)

- (1) The Management shall be the Accountable Executive (hereinafter referred to as “AE”) of the SG for the Bank.
- (2) The Management assumes oversight and supervisory responsibilities for the functions specified in the SG, and ultimate responsibility for the ongoing review and for any application for exemption to the provision of SG.
- (3) Any deviations or exemptions to the SG must be based on a proposal by the Management to the DAB SSB. The Management shall, prior to that application, discuss and deliberate on same thoroughly in consultation with the Bank’s Shariah Board to seek for guidance or approval on the subject matter.

Article 9: Compliance with Shariah Principles

- (1) The Shariah, literally, translates to “*the guided way*”. It is the Divine framework and guidance that outlines the principles of Islamic beliefs and covers the basic tenets for how man is to conduct his social and economic activities. In dealing with economic or any business activities the elements of usury (“*Riba*”), gambling (“*Maisir*”), uncertainty (“*Gharar*”) and matters which are not permissible (“*Haram*”) are prohibited.
- (2) It is a prerequisite for the validity of an IFI, Islamic Window and Islamic Unit that none of its contracts or business aspects should contravene any express or implied Shariah sanctions. Shariah provides the Divine guidance by Allah Almighty and, therefore, it is necessary for any transaction to be in conformity with the Divine rules and regulations. Any transaction, which fails to be practiced in conformity with such rules and regulations, will therefore become invalid.
- (3) Da Afghanistan Bank places great importance in ensuring that the overall Islamic financial system of the Banks in the Islamic Republic of Afghanistan operates in accordance with Shariah principles. This is to be achieved through the wholesale adoption of Shariah Board International Islamic best practices.
- (4) DAB also requires that all Banks operating in the Islamic Republic of Afghanistan must operate in accordance with the highest ethical standards. DAB leaves Shariah compliance aspects of the Bank to be a matter under the purview of the Shariah Board of the Bank.
- (5) Each Bank must adopt the guiding principles as provided in the SG with the primary objective of enhancing the role of the Bank’s Board, the Shariah Board and the Management in relation to Shariah matters, including enhancing the relevant key business functions having the responsibility

to execute the Shariah research and compliance functions aimed at the attainment of a Shariah based operating environment.

- (6) DAB, taking into consideration the nascent stage of Islamic Finance in the Islamic Republic of Afghanistan, hereby temporarily authorises the Banks to outsource any of its Shariah Governance or operational functions as well as its Shariah Board to an external Shariah board or a third-party Shariah consultancy/service provider or a previously approved Shariah scholar who sits on the Shariah Board of other Banks in the Islamic Republic of Afghanistan (hereinafter referred to as “the Outsourced Scholar”) provided that this complies with the requirements as provided under the Guidelines on Outsourcing of Islamic Banking Operations as issued by DAB. DAB may authorise the Outsourced Scholar to sit on any number of Shariah Boards in the Islamic Republic of Afghanistan for any period that it deems reasonable.
- (7) It is recommended that at least one (1) competent Shariah-qualified officer be retained by the Bank to head its Islamic Banking Unit and be tasked with the responsibility of Shariah-compliance.
- (8) Pursuant to article 90 of Banking Law of Afghanistan, that a conventional bank operating an Islamic banking window shall establish a Shariah Board. The Bank’s Shariah Board shall be an independent entity of the Bank which shall consist of qualified Shariah scholars appointed by the Management on behalf of the Bank’s Board. The Shariah Board members shall comprise of persons with appropriate qualifications and experience in Shariah who are able to deliberate Islamic Finance issues brought before them and provide sound Shariah decisions to the Bank.
- (9) The Bank shall segregate all conventional monies (if any) from its Islamic Deposits and may only utilise its Islamic deposits for Shariah-compliant business activities. The balance sheet of the Bank’s conventional assets and liabilities and the Bank’s Islamic assets and liabilities shall be prepared separately but may be reported in consolidated accounts.
- (10) Da Afghanistan Bank hereby reserves the right to interview all proposed members of Shariah Boards and the proposed Shariah Adviser of an Islamic Banking Department/Unit (“IBD”) of a Bank (hereinafter referred to as “the Proposed Person”) to satisfy itself that the Proposed Person is suitable for the appointment. This interview may take place in person or via electronic means that are acceptable to Da Afghanistan Bank. Confirmation of the mode of interview shall be issued by Da Afghanistan Bank two (2) weeks in advance of the proposed interview to the Bank. Meanwhile, Da Afghanistan Bank shall reserve the right to interview all proposed head of Islamic Banking, deputy head of Islamic Banking and investment/financing manager of Islamic Banking Department/Unit. DAB shall reserve the right to chair the panel of all proposed above mentioned persons for interview, where one person from SSB members will be included in interview panel.
- (11) The Bank shall notify Da Afghanistan Bank at least ten (10) weeks in advance of the proposed appointment to either their Shariah Board or Shariah Adviser of the IBD and shall furnish the Curricular Vitae of the Proposed Person to DAB and any other material requested in writing by Da Afghanistan Bank. Upon receipt of all information requested by Da Afghanistan Bank, Da Afghanistan Bank shall confirm to the Bank in writing that it has sufficient information to come to a determination (hereinafter referred to as “the Sufficient Information Letter”). For the avoidance of doubt, the issuance of a Sufficient Information Letter does not preclude Da Afghanistan Bank

from asking questions of the Proposed Person outside the contents of the information supplied to it.

- (12) Da Afghanistan Bank may then hold the interview in a manner of its choosing pursuant to Clause 10 of this article (above) and may elect to confirm the proposed person as suitable for the Bank to hire or Da Afghanistan Bank shall confirm that the person is not suitable. The decision of DAB in this matter is final and the Proposed Person shall have no recourse to the courts of the Islamic Republic of Afghanistan to appeal this decision.
- (13) In the event that the Proposed Person is found not suitable, Da Afghanistan Bank may, in its absolute discretion furnish reasons for this decision and /or suggest certain personal development programmes that the Proposed Person may undertake in order to re-apply to be a Proposed Person.
- (14) The Bank may send a panel of Proposed Persons to be considered by Da Afghanistan Bank subject to the proviso that the Bank cannot send more than 3 names forward per vacant position. The final decision whether to hire a Da Afghanistan Bank approved Proposed Person shall be a matter for the Bank.
- (15) Notwithstanding the above, Da Afghanistan Bank may waive the requirement set out in clause 10 of this article for individual Proposed Persons. It shall inform the Bank of its waiver in writing and such waiver shall be deemed confirmation that the Proposed Person is suitable pursuant to clause 12 of this article (above).
- (16) In the event that an application to confirm a Proposed Person rests with Da Afghanistan Bank for in excess of three (3) months after the issuance of the Sufficient Information Letter, the Bank may use the Sufficient Information Letter as deemed acceptance of the Proposed Person and the Bank may proceed to hire the Proposed Person in its absolute discretion.

Article 10: Structure of the Shariah Governance Framework

- (1) The Framework is divided into six (6) sections, with each section focusing on one governing principle, as follows:

Section	Key Areas	Explanation
I	General Requirement of the Framework	This section outlines the general requirements of the Framework, which describes the Essential key functions or key organs. Note: For the purposes of this Framework, key functions or key organs refer to the functions in implementing Shariah governance at the Bank.
II	Rights, Duties and Accountabilities	This section outlines the level of accountability and responsibility expected of the Bank's Board, Bank's Shariah Board and The Management.
III	Independence	This section aims to safeguard the independence of the Shariah Board in ensuring sound Shariah decision-making and emphasis on the role of the Board in recognizing the independence of the Shariah Board.
IV	Competency	This section highlights requirements and expected competencies to ensure key functions are capable of implementing Shariah governance.
V	Confidentiality and Consistency	This section outlines the minimum set of rules that emphasizes the importance of observing and preserving confidentiality, and improving the level of consistency in decision-making By the Shariah Board.
VI	Internal Shariah Functions	This section prescribes the internal Shariah Functions.


Article 11: Requirements of the Bank Shariah Governance Structure

- (1) It is the duty and responsibility of the Bank to establish a sound and robust internal Shariah Governance Framework ("SG") for its Islamic Banking activities and such framework shall be adopted based on the guiding principles as enshrined by the SG as issued by DAB with emphasis

placed on the roles of key functionalities in ensuring effective adaptation and implementation of the SG.


- (2) The Bank shall ensure that the aims and operations of its business activities are in compliance with Shariah principles at all times. An end-to-end control mechanism shall be established in all aspects of its business operations to ensure that its overall activities are Shariah compliant. Note: Shariah compliant refers to compliance to Shariah rulings and decisions issued by the Bank's Shariah Board or by other relevant bodies such as the SSB.
- (3) A sound and robust SG is reflected by effective and responsible Board of Directors and the Management, an independent Shariah Board that is both competent and accountable, supported by a strong Internal Islamic Banking Department.
- (4) The end-to-end Shariah compliant control mechanism will be executed through four (4) lines of defense that cater for both pre-execution and post-execution stages.

Table 1.0 overleaf illustrates a model structure and respective functions that are involved in each line of defense.



High Level Committees	
Board Oversight	Level Board of Directors Board Risk Policy Committees <ul style="list-style-type: none"> ➤ Risk Committee ➤ Audit Committee
Special Committee Oversight	Management Board
Working Level	
Line of Defence 1: Business units and Support units	Departments that are involved in product development, services and activities
Line of Defence 2: Shariah Management	Islamic Banking Department/Unit

Table 1.0: Two (2) Lines of Defence in the Bank's Shariah Governance Framework

Note:  Reporting line of working level to inform high level committees of the status of the Bank's Shariah compliance


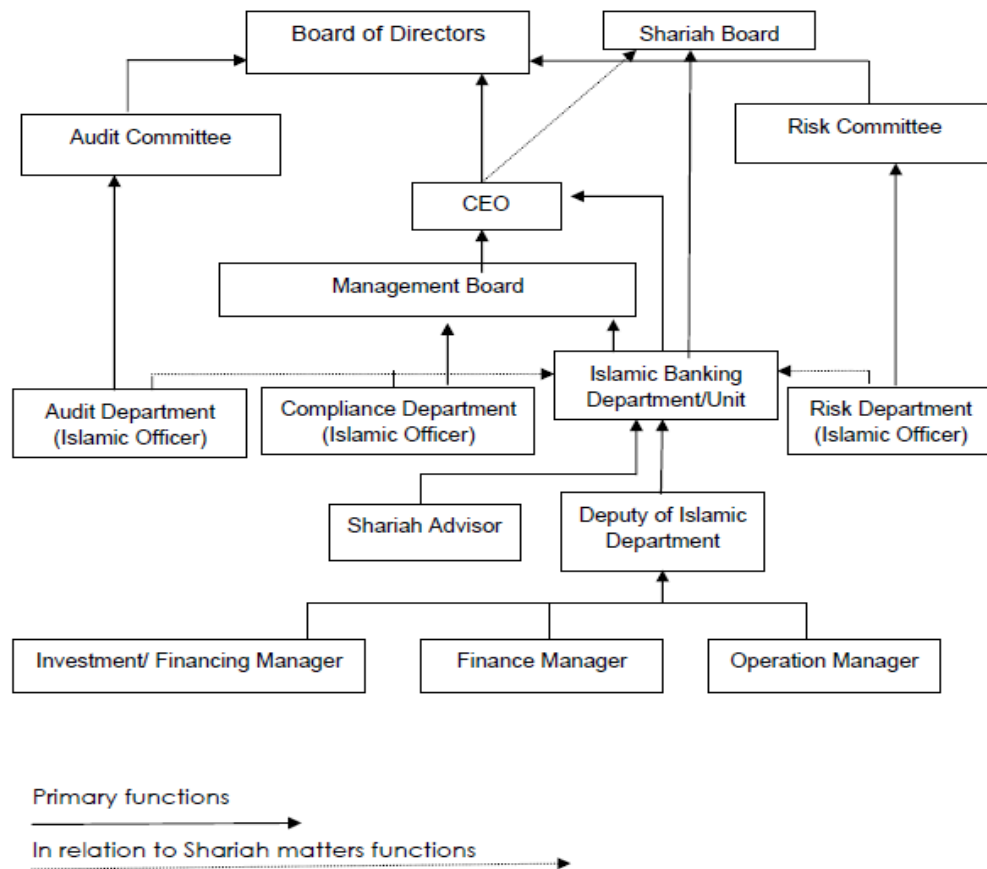
 Line of defence /execution of working committees

Illustration 1.0: Shariah Governance Framework Model for Banks



(5) The Framework comprises of the following:

1. The Bank's Shariah Board overseeing the Shariah compliance aspects of the Bank's Islamic Banking activities and operations and the other relevant committees' oversees the operational aspects of the Bank's operations. The Bank's Shariah Board with qualified members who are able to deliberate Islamic finance issues brought before them and provides sound Shariah decisions.
2. The Management's responsibilities include providing adequate resources and capable manpower support to every function involved in the implementation of Shariah governance, in order to ensure that the execution of all operations are in accordance with the Shariah principles.
3. The Bank's Islamic Banking Department which shall perform the Shariah related functions of the Bank such as Shariah Research, Shariah Review, Shariah Advisory, Shariah Compliance, Shariah Risk Management, Shariah Audit, Shariah Secretariat and any other related-Shariah functions in relation to the Islamic business activities of the Bank depending on the Bank's internal framework and business strategy.

Article 12: Rights, Duties and Accountabilities

(1) Board of Supervisors of the Bank (hereinafter referred to as “the Board”):

1. The Board shall ultimately be accountable and responsible on the adaptation and implementation of the SG within the Bank’s governance structure, by putting in place the appropriate mechanisms to discharge the responsibilities. The Board shall perform diligent oversight over the effective functioning of the SG.
2. Notwithstanding the final decisions and instructions from the Management, the Board may intervene or enquire into the operations of the Bank and in the case where the Board has any reason to believe that the Bank has carried on any activity that is non-compliant to Shariah principles under its Islamic business activities, it may order or direct that a prompt rectification measure to be taken by the Bank. The Bank shall, in consultation with the Bank’s Shariah Board, comply with such order.

(2) Shariah Board of the Bank:

1. The Bank’s Shariah Board is the highest authority in making the final decision on matters related to the Shariah in the Bank’s course of business operation. Therefore, the Bank’s Shariah Board is responsible for the views, decisions and advices provided to the Bank and is expected to deliberate every arising issue extensively and in-depth before arriving at any decision. In doing so, the Shariah Board has the right to call upon any relevant party in the Bank or convene a meeting with the identified relevant parties to facilitate the decision making.
2. The Shariah Board is expected to perform an oversight role on Shariah matters related to the Bank’s Islamic operations and activities through the observations and reports from the IBD by identifying possible Shariah issues, if any, and propose the necessary corrective measures.
3. The Shariah Board is expected to provide assistance to the Management or any related party thereof in overseeing the enforcement and implementation of the Shariah Board resolutions. The Shariah Board has the responsibility to disclose sufficient information on the Bank’s state of compliance in its annual financial report as per the requirements under applicable laws during the tenor of the Shariah Board’s appointment.
4. Other duties and accountabilities of the Shariah Board and the governing operation procedures for the Shariah Board shall further be spelt out in the terms of reference (hereinafter referred to as “TOR”) of the Shariah Board and the Bank.
5. In addition to the above mentioned duties and accountabilities, the members Shariah Board shall observe other relevant provisions herein contained. In addit pursuant to article 90.8 (banking law) an Islamic banking windw shall appoint an experienced scholar with required qualifications Shariah Advisor to conduct Shariah Research, Shariah Review and any other related-Shariah functions in relation to the Islamic business activities of the bank depending on the bank's internal framework and business strategy.

(3) Management Board:

1. The Management shall assume the duty of ensuring the operative execution of the Framework by the Bank by monitoring the performance of the relevant parties as prescribed herein and the discharge of such duties satisfies the minimum requirements of the Framework. The Management is ultimately accountable for the establishment and overall governance of the

Framework and the abidance thereof by the relevant parties. The Management shall also assume the duty of overseeing that the implementation of the resolutions (religious decree/edict from a qualified scholar) issued by the Shariah Board are managed by its various reporting lines and that the provisions in the Framework are complied with.

2. The Management is expected to understand the Shariah non-compliance risks for the purpose of the Islamic business activities of the Bank. Shariah non-compliance risks refer to possible failures to meet the obligation to satisfy the Shariah principles or in other words, possible incidences of Shariah non-compliance associated with Islamic finance business and the issues relating to such risks, as well as its potential implications to the Bank arising from such failures to comply.
3. Alongside a sound Shariah governance structure, the Management is under the obligation to ensure that other relevant policies and strategies that may enhance the Shariah compliance environment including effective communications, sufficient and impartial disclosures and others are well administered throughout the relevant units.
4. The Management is expected to make available or take all reasonable measures to make available to the Shariah Board the relevant information, records and other related documents of the Bank in a prompt and timely manner to assist the Shariah Board in arriving at informed resolution, advice and decision in a prompt and timely manner.
5. The Management shall endeavor to provide continuous learning and training programs to the Bank's key internal stakeholders and relevant staff involved in the Shariah and finance matters to enable sufficient exposure to the current developments in Shariah related matters.
6. In an effort to create coherence in the understanding and execution of the Shariah principles between the IBD and the frontline staff, the Management shall also provide sufficient information to the frontline staff via briefings, training and any other suitable means.
7. It is the duty of the Management to ensure that the Shariah policies and procedures (under IBD) provide clarity on matters related to the end-to-end process of Shariah governance in the Islamic business activities and operations of the Bank and that the Shariah Board's resolutions are accessible to the relevant parties at all times. The Management shall also be responsible in ensuring that the Bank's operations are executed in accordance with Shariah compliant policies and procedures, and to constantly review and update the Shariah compliant policies and procedures to reflect current market practices and developments.
8. In the event that it is resolved by the Shariah Board that certain activities or operations of the Bank are carried out in a manner that is not Shariah compliant, the Shariah Board shall specify whether it deems the breach to be a minor or accidental breach of Shariah compliance or it deems the breach to be a serious, deliberate or fundamental breach of Shariah compliance:
 - a. In the event that the Shariah Board deems the breach to be a minor or accidental breach of Shariah compliance, the Management shall (and is not restricted to):
 - Take immediate steps to isolate and eliminate this Shariah non-compliance (up to and including ceasing to taking on new business of the Shariah non-compliant product or service;
 - Purify any tainted income;

- Within 90 (ninety) days of becoming aware of such Shariah non-compliance or such further period as may be permitted by the CEO, prepare a report to the Shariah Board as the case may be outlining how this Shariah non-compliance occurred and how the Bank dealt with the matter;
 - Provide additional training to staff involved in the Shariah non-compliance to reduce the likelihood of its reoccurrence; and
 - Notwithstanding the above, any repetition of Shariah non-compliant event although minor in nature, may be regarded by the Shariah Board as a serious deliberate or fundamental breach of compliance.
- b. In the event that the Shariah Board deems the non-compliance to be a serious deliberate or fundamental breach of Shariah compliance, the Management shall:
- Immediately notify the Board of Directors of the fact;
 - Immediately cease to take on any new business related to the Shariah non-compliant business;
 - Within thirty (30) days of becoming aware of such Shariah non-compliance or such further period as may be permitted by the Shariah Board, furnish a plan to rectify the state of Shariah non-compliance, to be endorsed by the Shariah Board and duly approved by the Board;
 - Purify the tainted income arising out of such non-compliance;
 - Provide additional training to staff involved in the Shariah non-compliance to eliminate the likelihood of its reoccurrence;
 - Notify the IBFD of DAB of the breach which may, if the IBFD deems necessary, inform the DAB's SSB of the breach and request that the SSB deliberate on how to rectify the matter. For the avoidance of doubt the SSB may not impose sanctions on any employee of the Bank for such non-compliance. The Bank shall deal with the employee(s) responsible for the breach internally.
 - The SSB may, however, suggest administrative and or oversight procedures to the Bank to avoid similar breaches in future.
9. The Management may nominate and delegate the duties and responsibilities to a particular unit but the delegation thereof shall not obviate the oversight accountability assumed by the Management. Meanwhile, the Head of Islamic Banking Department/Unit as chief Islamic Banking Officer should attend as a voting member regarding Islamic banking issues in all related committees, including (but not limited to) asset and liability Committee(ALCO), credit committee, risk committee, Human Resource committee, charity committee and profit distribution committee.
10. In addition to the abovementioned duties and accountabilities, the Management shall observe other related provisions herein contained.

Article 13: Independence

- (1) Independence of the Shariah Board shall be observed at all times in exercising their duties to make objective and informed judgment.
- (2) The Board of Directors shall recognize the independence of the Shariah Board and ensure that the Shariah Board is free from any undue influence that would hamper the Shariah Board from exercising objective judgment in deliberating issues brought before them. Correspondingly, the Shariah Board is expected to make sound decisions on Shariah matters in an independent and objective manner.
- (3) The Shariah Board shall report to the Board of Directors and regularly inform the Board on relevant Shariah matters.
- (4) The Board of Directors, through the Management, shall ensure that all decisions made by the Shariah Board are duly observed and implemented by the Bank. Decisions made by the Shariah Board should not be set aside or modified without its consent.
- (5) The Shariah Board shall have access to accurate, timely and complete information from the Management. If the information provided is insufficient, the Shariah Board may request for additional information which shall be duly provided by the Management.
- (6) In the event where the Shariah Board is not provided with the required information, the Board of Directors shall be informed of the fact and appropriate action shall be taken to rectify the situation. Where appropriate, the Board shall consider taking the necessary punitive measures against parties who intentionally fail to extend the required information.
- (7) Where the Shariah Board has reason to believe that the Bank has been carrying on Shariah non-compliant activities, the Shariah Board shall inform the Board and to recommend suitable measures to rectify the situation.

Article 14: Competency

- (1) The key management and other relevant parties, engaged in the Islamic business activities of the Bank, shall possess adequate competency on the Shariah compliant banking. Every party shall at their best effort strive towards enhancing the acquired Shariah knowledge by attending internal and external training provided.
- (2) Besides meeting the requirements of a qualified member of the Shariah Board, the Shariah Board members are expected to equip themselves with relevant knowledge on the current Shariah issues and development as well as to attend relevant training programs provided by key Shariah bodies such as Islamic Fiqh Academy, Accounting and Auditing of Islamic Financial Institutions (“AAOIFI”), Islamic Financial Services Board (“IFSB”) and their successor organisations and other similarly renowned organisations.
- (3) The Bank may impose more stringent requirements in any Terms of Reference it agrees with its Shariah Board in particular in relation to qualifications, but same shall not be more lenient than of the SSB TOR (or related document) which shall be taken as a reference document when drafting the Bank’s TOR with its Shariah Board.
- (4) The Bank’s Shariah Board members shall be individually assessed and reviewed on the level of competency and overall contribution based on their Shariah deliberations and this shall be done on

an annual basis. The assessment methodology and criteria shall be in accordance with the Shariah Board Members' Assessment Manual as issued by DAB.

Article 15: Confidentiality and Consistency

- (1) The Shariah Board shall have the necessary access to both confidential and non- confidential files, records, conversations and draft materials to the extent that are required to facilitate the Shariah Board in making their decisions, views and opinions. Any sensitive information obtained by any member of the Shariah Board shall not be disclosed or used in any manner that may be detrimental to the Bank. Every member of the Shariah Board is entrusted with individual responsibility to observe the principle of confidentiality at all times.
- (2) Confidential information is information received by the members of the Shariah Board that is not public in nature and has not been authorized to be made public. Confidential information includes, but is not limited to, the following:
 1. Information on the development of new products and services;
 2. Decisions of the Board of Directors or the Management;
 3. Internal memorandums or reports prepared in connection with matters presented, or to be presented to the Shariah Board;
 4. The content or occurrence of conversations among members of the Shariah Board concerning matters deliberated in the meeting and representatives of the Bank;
 5. The progress status on a business transaction or action that has not been made public;
 6. Views expressed by various parties in the course of discussions on a particular matter deliberated by the Shariah Board; and
 7. Any subject matter that the Bank has indicated should not be revealed, such as internal policies and procedures.
- (3) Notwithstanding the above, the disclosure of sensitive information by the Shariah Board in good faith when reporting a serious Shariah breach to the CEO and the Board as the case may be does not constitute a breach of the confidentiality and consistency code.
- (4) In order to ensure consistency and quality in the Shariah decisions and resolutions, the Shariah Board is expected to develop a structured process of the decision making that is documented, adopted and maintained at all times to secure credibility of the Shariah Board.
- (5) The Shariah Board shall use international Islamic Finance best practices for Shariah Board.
- (6) In cases where there are uncertainties and material differences of opinions between the Shariah Board members, the Bank may seek advice and refer for a ruling from the DAB SSB.
- (7) In cases of disputes and court proceedings relating to Islamic financial businesses or any Shariah issue arising from the Bank's business operations, both the court and the arbitrator shall take into consideration the published rulings and standards as issued by the DAB SSB or in the absence of any such, upon reference and after deliberation by the SSB. Any rulings made by the SSB arising from a reference made in such proceedings shall be binding on the Bank. In the event where the decision given by the Shariah Board is different from the rulings given by the SSB, the rulings of the SSB shall prevail. However, the Shariah Board shall be allowed to adopt a more stringent

Shariah decision subject to an approval granted by the SSB based on solid reasoning and justification as presented.

Chapter 1: General Provisions

Article 1: Basis

This regulation is issued pursuant to Article 177 and 1.2 of Banking Law of Afghanistan in relation to the powers of DAB to regulate and supervise and promote Islamic banks in the Islamic Republic of Afghanistan and any amendments thereto.

Article 2: Objectives:

The main objectives of regulation are to encourage, promote and support Islamic banking in Afghanistan through setting up legal and regulatory framework for Islamic banking industry.

Article 3: Scope

This regulation is applicable on all banks, subsidiary of bank, Islamic banking window of conventional bank and Islamic branch of foreign bank licensed by Da Afghanistan Bank, unless the context otherwise require.

Chapter 2: Conversion of a Conventional Bank into an Islamic Bank

Article 4: Eligibility Criteria

The eligibility criteria for conversion of conventional bank into Islamic bank shall be as follows:

- (1) Only Conventional banks having Islamic banking windows can apply for conversion into full-fledged Islamic bank.
- (2) The bank which not yet has Islamic banking window shall first obtain DAB's approval for opening Islamic banking window and provide Islamic banking products and services through window at least 2 years before applying for conversion into full-fledged Islamic bank.
- (3) To be eligible for conversion, the conventional banks must have CAMEL rating not lower than 3 in latest DAB on-site financial supervision.
- (4) The Non-performing assets (classified in doubtful and loss category) must be lower than 10% of all classified assets by latest on-site financial supervision and latest off-site financial inspection. In addition, the bank must have appropriate plan for disposal of such asset as these assets will not be qualified to convert to Islamic banking products.
- (5) The asset classified in Sub-Standard category must not exceed 10% of total classified assets and the bank must provide appropriate plan for disposal or improvement of the quality of this category to be converted to Islamic banking products.
- (6) The bank must suggest Islamic banking mechanisms through which the asset classified under standard and watch-list would be converted to Islamic banking products.

- (7) The impaired and non-performing LCs and BGs should not exceed 5% of the total LCs and BGs. In addition, the bank must propose appropriate plan for disposal of non-performing LCs and BGs.
- (8) The applicant bank shall be compliant with Minimum Capital Requirements (MCR), Capital Adequacy Ratio (CAR) and all other requirements as applicable on full-fledged Islamic banks, from time to time.
- (9) The bank capital must be equal or more than required level as stipulated by Da Afghanistan Bank related regulations.

Article 5: Necessary Measures for Conversion

The conventional bank will only be eligible to start the process of conversion into Islamic bank and proceed with this section (article) if it can fulfill the eligibility criteria as stipulated in the preceded section (article 4). In addition:

- (1) The bank shall develop a comprehensive conversion strategy with clear milestones and defined timelines for conversion duly approved by bank's Supervisory Board.
- (2) The bank shall start conversion process in line with Shariah rules and principles within maximum six months from the grant of in-principle approval, failure to do so will lead to revocation of the in-principle approval.
- (3) The bank shall notify the plan of conversion to the public at least one month before the initiation of conversion process.
- (4) The bank shall complete the conversion process within a maximum period of two years from the date of in-principle approval. In case of delay, the bank shall justify extension request with reasons and evidence, duly approved by its Shariah Board and Supervisory Board.
- (5) The bank should form Shariah Committee and internal Shariah compliance department in accordance the Shariah Governance Framework (SG) and governance standards issued by AAOIFI for Islamic financial institutions wherever applicable.
- (6) The bank shall also train and develop the personnel required for proper implementation of the procedures of conversion and train the personnel to deal with the application of Islamic banking practice.
- (7) The bank shall dispose all assets classified under loss and doubtful to third party and dispose or improve the assets classified under sub-standard category during the first quarter after starting the conversion process.
- (8) The bank shall set up all necessary procedures, create the required tools, and explore alternatives to Shariah non-permissible products & services, operations & arrangements.
- (9) The bank shall open accounts with local or international Islamic banks and revamping of the accounts that are maintained with local or corresponding conventional banks during the first quarter after starting the conversion. Any dealing with conventional banks must be limited the magnitude of the need to do so and subject to Bank's Shariah committee approval.

Article 6: Process of Conversion

The Conversion process shall consist of three steps:

- (1) In-principle approval from Da Afghanistan Bank (DAB) for initiating full-fledged conversion of the conventional bank into an Islamic Bank;
- (2) Conversion of conventional bank into Islamic bank; and
- (3) Issuance of Islamic Bank license.

Article 7: In principle approval

- (1) Prior to application for in principle approval, the bank should fulfill the eligibility criteria as stipulated in article 4.
- (2) By fulfilling the eligibility criteria, the bank shall submit their application to the Da Afghanistan Bank. The application shall comprise of the comprehensive conversion plan duly approved by bank's supervisory board and bank's Shariah committee. The conversion plan shall contain detailed process and procedures along with well thought-out timelines and milestones regarding conversion of all products and services and segments etc. The bank should submit the following documents along with its application:
 1. Supporting documents:
 - a. Resolution of bank's board of supervisors for conversion of the bank into an Islamic bank;
 - b. Proposed changes in by-laws (Memorandum and articles of Association), along with an opinion of an external legal consultant;
 - c. Information about the controlling / major shareholders / sister concerns / group companies / subsidiaries;
 - d. Profiles of members of Supervisory Board & Key Executives of the bank;
 - e. Existing and proposed organizational structure;
 - f. Strategic conversion plan;
 - g. Financial model/ feasibility study along with assumptions and projected key financial figures & ratios;
 - h. Risk management policies;
 - i. Product plan;
 - j. Shariah compliance mechanism;
 - k. Details of existing branches and Islamic banking windows network and employee strength;
 - l. Latest audited financial statements; and
 - m. Other documents deemed relevant and important by DAB from time to time.
 2. Strategic Business Plan:
 - a. Mission and Vision for conversion of the conventional bank into an Islamic bank;
 - b. Five years' business plan of the bank including at least: human resource plan, marketing plan, operational plan, overall business model and capital structure, internal controls mechanism and governance structure which include Shariah Governance framework;
 - c. Feasibility study on market opportunity and economic potential;
 - d. Operational / execution plan for mobilization and channeling of funds, and steps to be taken to carry out conversion;

- e. Capital adequacy compliance plan; and
 - f. Plan for conversion of Asset and Liability side products along with off-balance sheet items.
3. Position and treatment of Shariah impermissible items:
- a. Position and proposed treatment of all Shariah impermissible existing assets and liabilities with corresponding Shariah compliant solutions.
 - b. Position and proposed treatment of all off balance sheet items with corresponding Shariah compliant solutions.
 - c. Position of non-performing assets (i.e. classified in Sub-standard, doubtful and loss categories) and proposed treatment of the same.
 - d. Details of Shariah non-compliant income / earnings and mechanism adopted for its disposal.
 - e. Details and treatment of Shariah non-compliant collaterals / securities.
 - f. Details of all the existing products and services being offered by the bank including deposits, loan/advances, trade finance, treasury, export refinance, liquidity management, online services, third party products like bancassurance etc., alongwith methodology adopted for their conversion into Shariah compliant forms including treatment of collaterals i.e. lien, hypothecation, pledge, mortgage, any form of encumbrance / charge.
 - g. Details and proposed treatment of investment portfolio such as T-Bills, bonds, shares etc. alongwith existing position such as amount, nature, maturity, payments, accruals etc.
 - h. Information on all conventional financing arrangements with Da Afghanistan Bank.
 - i. Details and proposed treatment of Nostro / Vostro Accounts and Shariah compliant alternatives.
 - j. Wherever necessary, before submitting the documents to DAB, the Shariah approval of the Shariah Committee of the Bank shall be obtained.
4. Training and Capacity Building:
- a. The bank should provide details of preliminary training provided to all or selected employees of key departments of the bank, prior to applying for conversion.
 - b. A complete list of Islamic Banking certification / training programs to be conducted in local and international institutions shall be submitted to DAB with a comprehensive training plan (specifying contents, trainers, schedule etc.). The training will be provided for the bank's staff designated at the Head Office including: Risk, Audit, Compliance, Business, Operations, Regional / Area Offices and at the branch level including Branch Managers, Operation Managers and Relationship Managers.
 - c. In the same manner, the bank shall specify arrangements / plan for training and capacity building of BOS, Key Executives, staff of Head Office and other bank officials to be entrusted with the execution of conversion process.
5. Policies and procedures:
- a. The bank should develop relevant policies and procedures/ manuals related to all main functions of the Islamic banking business including by not limited to; Islamic Financing Policy. Deposit policy, Internal Shariah Audit Policy, Risk management policy, Operations Policy and Procedures, Marketing policy, Profit Distribution Policy, Shariah

Compliance Policy, Investment Policy, Liquidity and Treasury Management Policy, Human Resource Policy, Letter of Credit Manual, Bank Guarantee Manual and Product manuals for Islamic products and services.

- b. All these policies and manuals must be duly approved by Shariah Board and Board of Supervisors. In addition, the bank should provide plan for contingency funding and plan for IT integration / migration from conventional bank into Islamic bank.
6. Core Banking System and controls:
 - a. A specialized core banking system for Islamic banking is required to offer full fledged Islamic banking services, hence the applicant bank shall submit information about the availability of systems and applications, with controls, for conducting full-scale Islamic banking operations including profit distribution & pool management and other required specialized tools for Islamic banking.
 - b. The bank shall ensure that proper systems and controls are in place to protect the interest of customers and minimize the risks arising from banking operations.
7. Audit and Review:
 - a. The bank shall submit plans for resolution of adverse findings of internal, external and Da Afghanistan Bank Supervision reports; especially regarding NPL, fraud, forgery, money laundering and terrorist financing (if any) before conversion.
 - b. The banks shall submit plans to undertake comprehensive internal audit on the operations of the bank both at pre and post conversion stages.
 - c. The bank shall set up Shariah Compliance Department and the Shariah compliance department of the bank shall arrange for periodic internal Shariah review and prepare a report in coordination with Monitoring Committee. The report shall be submitted to BoS on a quarterly basis till the completion of conversion process.
8. Public Awareness and Marketing Arrangements:
 - a. The bank shall submit a comprehensive marketing plan such as (if any) brand name, logo and tagline for launching full-fledged Islamic banking business and related details.
 - b. The marketing plan shall be inclusive of strategy for informing bank's customers and general public about conversion through direct contact, print and electronic media and other public awareness arrangements that deemed necessary for conversion.
 - c. The plan shall highlight the process for obtaining consent from existing customers for conversion to Islamic banking products and services (assets and liabilities) both locally and internationally (if applicable).
 - d. The marketing plan shall be inclusive for settlement of all assets and liabilities of customers unwilling to continue relationship with the bank on new terms and conditions and suggest alternatives if any.
9. Other requirements:
 - a. The bank shall provide the list of proposed Shariah committee members and seek approval from the Da Afghanistan Bank.
 - b. The bank shall provide details about bank's subsidiaries such as branch network, nature of business, management structure, major shareholding, staff strength etc.

- c. The bank shall provide the future strategy / plan for conversion of bank's conventional subsidiaries (if any).
 - d. Plans for conversion of Shariah non-compliant employee benefits / facilities into Shariah compliant modes.
 - e. Information about activities / cases which do not have corresponding Shariah compliant solutions and where the income has to be channeled to charity if any.
 - f. Summary of the court cases under litigation and the bank's plan for settlement of customers' and shareholders' rights and obligations. The bank shall also provide a legal opinion that the cases under litigation (if any) will have no effect on the conversion process.
- (3) By fulfilling all the above requirements and submitting the required documents, Da Afghanistan Bank will evaluate the proposal of the bank keeping in view merits of the case and upon its satisfaction, will grant an in-principle approval to the bank to initiate the conversion process.
 - (4) The bank shall be prohibited from expanding its conventional banking network from the date of grant of in-principle approval.
 - (5) The bank shall set up a helpdesk & a well-defined complaint handling mechanism with respect to customers' queries regarding conversion of the bank, with proper record keeping and reporting to appropriate predefined level.
 - (6) For smooth streamlining of business operations and conversion of conventional banking portfolio, the bank shall identify / hire experienced and trained key staff to handle the conversion process.
 - (7) The bank shall form two core committees i.e. Implementation Committee (IC) and Monitoring Committee (MC) and submit their Terms of Reference (ToRs) to Da Afghanistan Bank, duly approved by bank's Board of Supervisors. The committees shall present a report on the conversion progress and related details, on a quarterly basis, to the bank's Board of Supervisors.
 - (8) The bank shall submit a quarterly report on conversion progress and related matters duly signed by the CEO / President along with Shariah Board's certificate to Da Afghanistan Bank till the completion of entire conversion process.

Article 8: Conversion of Conventional Bank into Islamic Bank

- (1) Once the in-principle approval is granted to the bank by Da Afghanistan Bank, the bank shall immediately start conversion process within a month time (maximum 6 months' time) after receiving in-principle approval.
- (2) The bank will have a maximum of two-years from the date of in-principle approval to fully convert its activities from the conventional banking into Islamic banking.
- (3) The bank will strictly follow the commitments and plans submitted to the DAB for in-principle approval.
- (4) The implementation Committee (IC) and Monitoring Committee (MC) will submit report on the conversion progress and related details duly approved by the bank's Shariah Committee and Board of Supervisors to Da Afghanistan Bank on quarterly basis.
- (5) The bank shall follow the AAOIFI Shariah standard no. (6): for conversion of a conventional bank to an Islamic Bank, during the process of conversion.

Article 9: Issuance of Islamic Banking license

- (1) Once the bank has successfully completed all requirements in light of conversion plan and as stipulated in-principle approval, this successful completion will be fully approved by the bank Shariah committee and Board of Supervisors. The bank shall then apply for the issuance of full-fledged Islamic Banking license. The application will be supported and accompanied by the following documents:
 1. Comprehensive list of Islamic banking asset and liability side Shariah compliant products with details and modus operandi duly approved by Shariah committee and BoS of the Bank;
 2. Revised Memorandum & Articles of Association of Islamic Bank along with summary of changes made;
 3. Shariah Review Report and Shariah committee's Certificate confirming that the whole conversion process has been undertaken in conformity with Shariah;
 4. A comprehensive post-conversion report containing status on areas mentioned in the preceding sections, duly certified by bank's Shariah committee and Board of Supervisors;
 5. Evidence that policies and procedure/process manuals as mentioned in preceding articles (preceding articles of this chapter) including but not limited to; Operations, Credit & Risk Management, Treasury, Internal Control including Shariah Compliance, Shariah Audit, Information Technology Systems and all products have been prepared / revised and approved by the Shariah Committee and the Board of Supervisors of the bank;
 6. Confirmation that all HR policies including employee benefits and facilities have been converted from conventional modes into Shariah compliant modes;
 7. Summary of changes made in the systems & controls and policies & procedures for conducting Islamic banking operations;
 8. Detailed report about the initiatives taken for capacity building / training of human resource regarding Islamic Banking;
- (2) The relevant authorities of Da Afghanistan bank will review the documents provided, based on satisfactory review, the bank shall issue a full license of an Islamic Bank while the conventional banking license shall be surrendered by the bank to Da Afghanistan Bank.
- (3) Once the bank received Islamic banking license from Da Afghanistan Bank, the bank shall only engage in Shariah compliant banking operations.
- (4) The conversion from an Islamic bank into conventional bank is not permissible and will not take place.
- (5) The newly licensed Islamic bank is subjected to all prevalent banking and other laws, Islamic banking guidelines and regulations and circulars issued by Da Afghanistan Bank from time to time.
- (6) The new Islamic bank will be given six months' interim period after issuing Islamic banking license. Within this six months' timeframe, the bank will familiarize its staff with new core banking system, Islamic banking operations and financial reporting formats.

Article 10: Circulars: In order to properly enforce provisions of this chapter, if needed DAB will provide specific interpretations and impose additional requirements through circulars.

Chapter 1: General Provisions

Article 1: Basis

This regulation is issued pursuant to Article 177 of Banking Law of Afghanistan in relation to the powers of DAB to regulate and supervise banks in the Islamic Republic of Afghanistan and any amendments thereto.

Article 2: Objectives

The Regulation had imposed the requirements on the Bank to observe sufficient and effective risk controls that ensure their assets are diversified as to risk of loss; and establishes limitations on large exposures pursuant to the Banking Law.

Article 3: Scope

This regulation is applicable on all Islamic banks, Islamic subsidiary of bank, Islamic banking window of conventional bank and Islamic branch of foreign bank licensed by Da Afghanistan Bank, unless the context otherwise require

Chapter 2: Reweiw on Asset Risk Diversification and Limitations on Large Exposure

Article 4: Shariah Context

From Islamic perspective, the benefit of the society as a whole prevails over the benefit/interest of an individual or a minority group in the society. The Regulation is in line with this Shariah maxim in that the Regulation is to protect the interest of the Islamic banking industry in Afghanistan from collapsing or exposed to undue risks due to possible default by a single client or in a single sector.

Article 5: Shariah Review Findings

- (1) Pursuant to the Consortium's review of the Regulation, the same is consistent with the Shariah maxim as stated in article 4 above. The objectives and aims of the Regulation are to put forth measures as general guidance towards safeguarding the Banks against risk of loss due to over exposure to a small group of obligors or due to asset concentration in certain sectors only rather than in diversified sectors.
- (2) The matters being encapsulated in the Regulation are Shariah neutral in nature as it relates to imposing on the Banks requirements to observe sufficient and effective risk controls in relation to asset risk diversification and limitations on large exposures. Risk management of these aspects as stipulated in the Regulation is in line with Shariah and does not contravene any Shariah principles.
- (3) The Regulation does not expressly mention that it is applicable to Islamic financial institutions, however, we believe that since this is to be adopted by all banks licensed by the DAB, both local and foreign banks, this will include both conventional and Islamic financial institutions under DAB's purview.
- (4) The Regulation contains conventional terminologies which may not be suitable for the Bank. In order to avoid substantial amendments to the wordings of the Regulation, we propose that there

be an insertion of a clause into the Regulation to state as follows: - “This Regulation shall be adopted by both conventional and Islamic financial institutions in Afghanistan. Pursuant thereto, in so far as the terminologies herein contained are inconsistent with Shariah terminologies, the said terminology shall mean the Shariah equivalent of the same within that context”.

Article 6: Risk Control

- (1) The Regulation had imposed the requirements on the Bank to observe sufficient and effective risk controls that ensure their assets are diversified as to risk of loss; and establishes limitations on large exposures pursuant to the Banking Law.
- (2) The Consortium has been tasked to review the Regulation to provide Shariah input on the Regulation and to provide recommendations as to any Shariah gaps or Shariah inconsistencies within the Regulation.

Chapter 1: General Provisions

Article 1: Basis

This regulation is issued pursuant to Article 177 of Banking Law of Afghanistan in relation to the powers of DAB to regulate and supervise banks in the Islamic Republic of Afghanistan and any amendments thereto.

Article 2: Objectives

This document shall have the objectives herein assigned to them:

- (1) The objective of the Regulation is to provide a minimum set of requirements for the operation of Banks in Afghanistan that operates either as a full-fledged Islamic bank, subsidiary or a branch.
- (2) The principal regulatory objectives of the Decree Law of Banking are to promote financial stability and compliance objectives with the Shariah principles. In pursuing these objectives,
 1. DAB shall foster:
 - a. the safety and soundness of Banks;
 - b. the integrity and orderly functioning of the Islamic money market and Islamic foreign exchange market;
 - c. safe, efficient and reliable payment systems and Islamic payment instruments;
 - d. fair, responsible and professional business conduct of Banks;
 2. Strive to protect the rights and interests of consumers of Islamic financial services products.

Article 3: Scope

This regulation is applicable on all Islamic banks, Islamic subsidiary of bank, Islamic banking window of conventional bank and Islamic branch of foreign bank licensed by Da Afghanistan Bank, unless the context otherwise require.

Chapter 2: Review on Asset Risk Diversification and Limitations on Large Exposure

Article 4 : Introduction

- (1) The following are DAB's requirements for the licencing process and other related matters to guide new entities that wish to apply for a license to conduct Islamic business activities in the Islamic Republic of Afghanistan.
- (2) In general, any entity that wishes to offer regulated financial services in the Islamic Republic of Afghanistan on a commercial basis will require a licence from DAB. Each financial institution/bank will be governed by the existing Decree Law of Banking.
- (3) The Regulation as applicable hereto shall be the additional requirements to the Afghanistan Licencing Regulations that shall be applicable for new Islamic banking set-ups either full-fledged Islamic Banks or conventional banks operating with an Islamic Window/Unit services.
- (4) DAB as the regulatory authority for the banking industry in Afghanistan has the right to observe higher regulatory and prudential standards and ensure that the observed standards are in line with internationally accepted standards and best practices.
- (5) Internationally accepted standards and best practices refer to the standards issued by the Bank for International Settlements ("BIS"), the Islamic Financial Services Board ("IFSB"), the Accounting and Auditing Organization for Islamic Financial Institutions ("AAOIFI") and other bodies of equal standing.

Article 5: General Requirements

- (1) Application to conduct Islamic banking business activities is open to any qualified foreign-based financial institutions and Afghan local financial institutions.
- (2) Where the foreign financial institution is a branch of an overseas bank, in deciding whether to grant a license, DAB shall pay close regards to its activities elsewhere and how these activities are regulated. If the financial institution is not regulated elsewhere or in a jurisdiction not substantially compliant with Basel Core Principles, then an application for licensing can only be considered after exhaustive enquiries into the Bank's shareholders, management structure and financial position.
- (3) Upon licensing under the Decree Law of Banking in Afghanistan, the new entity shall be known as Islamic Financial Institution/Islamic Window/Unit operation (hereinafter referred to as "the Bank") and allowed to conduct Islamic commercial banking, investment banking and other banking businesses specified by DAB in its guidelines and procedures.

Article 6: Regulatory Objectives and Functions

- (1) The objective of the Regulation is to provide a minimum set of requirements for the operation of Banks in Afghanistan that operates either as a full-fledged Islamic bank, subsidiary or a branch.
- (2) The principal regulatory objectives of the Decree Law of Banking are to promote financial stability and compliance objectives with the Shariah principles. In pursuing these objectives, DAB shall: -
 1. Foster:
 - a. the safety and soundness of Banks;

- b. the integrity and orderly functioning of the Islamic money market and Islamic foreign exchange market;
 - c. safe, efficient and reliable payment systems and Islamic payment instruments;
 - d. air, responsible and professional business conduct of Banks; and
- 2. Strive to protect the rights and interests of consumers of Islamic financial services products.
- (3) Banks shall exercise their powers and perform the functions under the Regulation in a way which it considers most appropriate for the purpose of meeting the regulatory objectives of the Regulation.
- (4) Banks may assign a specific officer to exercise any of its powers or perform any of its functions under the Regulation.
- (5) Banks may establish a Special Committee and may authorize that Committee to undertake actions for the purpose of exercising any of the powers or performing any of the functions of the Bank under the Regulation.
- (6) Banks may, either generally or in a particular case, appoint a person, whether in or outside the Islamic Republic of Afghanistan, who is not its own officer to: -
 - 1. Render such assistance in the exercise of any of the Bank's powers or performance of any of its functions under this Act; or
 - 2. Exercise any of the Bank's powers or perform any of its functions on behalf of and in the name of the Bank.

Article 7: Application for Licence

- (1) Any entity that wishes to apply for a licence to conduct Islamic business activities, must apply a licence/approval from DAB.
- (2) The application must contain all the relevant particulars and information and accompanied by documents as specified by DAB. The minimum documents that shall be furnished by the Bank for the application are as follows:
 - 1. Business plan (including at least human resource plan, marketing plan, operational plan, overall business model and capital structure, internal controls mechanism and governance structure);
 - 2. Strategic conversion plan (where applicable);
 - 3. Financial model/feasibility study;
 - 4. Risk management policies;
 - 5. Product plan;
 - 6. Shariah compliance mechanism; and
 - 7. Other documents as deemed relevant and important by DAB from time to time.

- (3) The Regulation hereto sets the requirements for the issuance of a licence. Such requirements shall include the legal form of the applicant bank, the location of its head office, the minimum capital and reserve requirements and the limits of capital adequacy requirements.
- (4) DAB shall conduct verification process on the application and its related documents to ensure that the applicant bank satisfies all the rules and conditions required. DAB may also require amendments to the documents submitted or make requests for additional information to enable it to make a decision regarding the application.
- (5) The applicant bank may, at any time before a decision has been made regarding its application, withdraw its application or make amendments to any errors therein or in the supporting documents in accordance with the Regulation issued by DAB in this respect.
- (6) DAB shall grant a licence to the applicant bank if DAB is satisfied that all the rules and conditions as set out in the Regulation and Decree Law of Banking are duly fulfilled and observed by the applicant bank.
- (7) DAB may specify in the license the venue(s) of where the Islamic banking activities may be offered and impose other specific terms and conditions on the Bank as it deems necessary for the purpose of ensuring good performance of the Islamic business activities of the Bank.
- (8) DAB shall have in its records a specific section on the "Registration of Licensed Islamic Financial Institutions/Banks in the Islamic Republic of Afghanistan" whereby all applications together with their supporting documents for the respective license application are kept intact. Also, the section shall note all actions taken by DAB towards the Banks (if any) in the course of conducting its Islamic business activities.

Article 8: Eligibility

- (1) The Banks shall comply with the following criteria before they become eligible to apply for a license to conduct Islamic business activities:
 1. The Bank has to be a well-capitalised and be of a reputable licensed financial institution;
 2. For a foreign financial institution, it has to adopt the international banking standards formulated by international standard-setting bodies;
 3. For a local financial institution, it has to be regulated and supervised by a competent home regulatory authority; and
 4. The Bank must possess a sound track record.
- (2) The application for the license are governed by the Decree Law of Banking and the Bank is allowed to conduct Islamic business activities in the Afghani local currency or other international currencies within the amount approved by DAB.
- (3) Islamic banking business activities in international currencies include:
 1. Commercial banking business;
 2. Investment banking business; and
 3. Other banking businesses in Afghanistan, as may be specified by DAB.
- (4) All entities that wish to apply for a license to conduct Islamic business activities shall ensure that in its Memorandum or Articles of Association, it is stated that its Islamic business activities shall strictly comply with the internationally accepted principles of Shariah.

Article 9: The Grant of the License

- (1) Further to the provisions under article 8(above), DAB shall review the application and duly advise the applicant bank in writing when it has:
 1. granted the application without condition(s);
 2. Granted the application subject to the fulfilment of certain condition(s) specified by DAB;
or
 3. Refused the application, stating the ground(s) on which the application has been refused and the process for appealing against that decision.
- (2) DAB will provide a formal decision on the licence application within sixty (60) days after all the required documentation has been submitted in a form acceptable to DAB.

Article 10: Islamic Financing Modes and Instruments

- (1) Subject to the requirement that a license has been duly granted to the Bank to conduct Islamic business activities, the Bank shall only be permitted to conduct business activities using financing modes or instruments that are compliant with the Shariah principles and such structures must be approved by DAB.
- (2) Establishment and operation of an Islamic subsidiary, window or branch of a conventional bank:
 1. Conventional banks and other financial institutions operating in Afghanistan may offer or sell products and services in line with the Shariah principles through subsidiaries, windows or branches only.
 2. An Islamic subsidiary, window or branch of a conventional bank shall be established and operated in line with the guidelines on windows/branches issued by the DAB.
- (3) Cross-selling of products/services and shared facilities: The Islamic subsidiaries, windows or branches may operate using the existing facilities or branch network of the conventional bank. The subsidiary, window or branch shall however, not sell products/services that do not comply with the Shariah principles.
- (4) Execution of Service Level Agreements in respect of shared services:

Conventional banks or other financial institutions with Islamic subsidiaries, branches or windows shall execute a Service Level Agreements (“SLA”) in respect of shared services between Islamic subsidiaries, branches or windows and the conventional banks.
- (5) Separate banking operation:
 1. For the Islamic business activities, the parent conventional bank must have an adequate firewall process to ensure absolute separation of banking operations to avoid co-mingling between the Islamic and conventional funds. This is to ensure the integrity of Islamic business activities and sanctity of Islamic funds.
 2. The firewall process shall include separate capital funds, cheque clearing systems, clearing accounts with the Central Bank, settlement account and reporting systems.
- (6) Shariah governance: All Banks conducting Islamic business activities whether through full-fledged or window/unit operation must comply with the guidelines and requirements as enshrined under the National Shariah Governance Framework (“NSGF”) as issued by DAB.

Article 11: The Approved Islamic Business Activities

The following activities are the Islamic business activities approved by DAB:

- (1) Accepting Shariah compliant money placements/deposits: Accepting money placements/deposits for safe-keeping (Wadi'ah/ Qard) in a Shariah compliant framework, under which it will be paid/repaid, either on demand or in circumstances agreed by the parties, and does not require the provision of security.
- (2) Offering Shariah compliant financing products: Entering into or making arrangement for another person to enter into, a contract to provide financing in accordance with Shariah contracts and principles such as Murabahah, Salam, Ijarah and Istisna'.
- (3) Managing unrestricted Shariah profit sharing investment accounts: Managing account, portfolio or fund, whereby a sum of money is placed with the service provider on terms that a return will be made according to an agreed Shariah compliant profit-sharing arrangement, such as a Mudarabah or Musharakah partnership without the customer laying down any restrictions as to where, how and for what purpose the funds should be invested. Such equity of unrestricted investment account holders shall be recorded in the books of the bank (AAOIFI Standard FAS 6).
- (4) Managing restricted Shariah profit sharing investment accounts: Managing an account, portfolio or fund whereby a sum of money is placed with the service provider on terms that a return will be made according to an agreed Shariah compliant profit sharing arrangement, such as Mudarabah and Musharakah partnership where the customer imposes certain restrictions as to where, how and for what purpose the funds should be invested. Such assets and liabilities relating to the equity of restricted investment account holder shall be treated separately from the bank's assets and liabilities (AAOIFI Standard FAS 6).
- (5) Dealing in Shariah compliant financial instruments as principal: Dealing in Shariah compliant financial instruments as principal means buying, selling, subscribing for or underwriting any Shariah-compliant financial instrument on its own account.
- (6) Dealing in Shariah compliant financial instruments as agent: Buying, selling, subscribing for or underwriting Shariah compliant financial instruments on behalf of a client. A licensee that carries out these activities does not use its own financial resources for the purpose of funding the transaction. It may however receive or hold assets in connection with the transaction, in its capacity as an agent of its client.
- (7) Managing Shariah compliant financial instruments: Managing on a discretionary basis Shariah compliant financial instruments on behalf of another person.
- (8) Safeguarding Shariah compliant financial instruments: Safeguarding of Shariah compliant financial instruments for the account of clients.
- (9) Arranging deals in Shariah compliant financial instruments: Making arrangements for the benefit of another person, whether as principal or agent such as buying, selling, subscribing for or underwriting deals in Shariah compliant financial instruments.
- (10) Advising on Shariah compliant financial instruments: Giving advice to an investor or potential investor (or a person in his capacity as an agent to the investor or potential investor) on the

merits of buying, selling, subscribing for or underwriting a particular Shariah compliant financial instrument or exercising any rights conferred by such financial instrument. The advices may include the suitability of the financial instrument, or the characteristics or performance of the financial instrument or credit facility concerned.

- (11) Providing money exchange/remittance services between currencies and the provision of wire transfer or other remittance services.
- (12) Issuing/ administering means of payment: Dealing or issuing of payment instruments, or the selling or issuing of stored value (e.g credit cards, travellers' cheque etc).

Article 12: Shariah Requirements for the Banks

- (1) Duties of the Banks:
 - 1. Banks that apply for the license to conduct Islamic business activities have to ensure that it shall comply with the Shariah principles.
 - 2. Banks that conduct Islamic business activities shall ensure that the aims and operations of its business are in compliance with Shariah principle at all times. An end to end Shariah compliant control mechanism shall be established in all aspects of its business operations to ensure that all activities are fully Shariah compliant.
- (2) Establishment of a Shariah Board: Banks conducting Islamic business activities must establish a Shariah Board consisting of not less than three (3) members with appropriate qualifications and experience in Shariah. The Shariah Board members shall consist of qualified scholars who are able to deliberate Islamic finance issues brought before them and provide sound Shariah decisions. The requirements for selecting the Shariah Board members must comply with the NSGF and Terms of Reference of the Shariah Board as issued by DAB.
- (3) Shariah Governance Framework: Banks that are granted a licence to conduct Islamic business activities must establish a sound and robust Shariah Governance Framework (hereinafter referred to as "SGF"). The Bank's SGF must comply with the guidelines and requirements as set out under DAB's National Shariah Governance Framework. This is to ensure that the overall Islamic business activities of the Bank shall operate in accordance with Shariah principles. The DAB NSGF shall be the first layer of the two-tier Shariah governance infrastructure in the Islamic Republic of Afghanistan which consists of the DAB Shariah Supervisory Board (hereinafter referred to as the "SSB") sitting at the national level and the Shariah Board of each bank sitting at the institution level.
- (4) Audit on Shariah compliance: Subject to the requirements as provided under the NSGF, Banks shall ensure that a Shariah audit is conducted on at least an annual basis on the Islamic business activities of the Bank. This shall be a periodical assessment conducted from time to time to provide an independent assessment and objective assurance in ensuring that a sound and effective internal control system for Shariah compliance is established within the Bank's internal framework.
- (5) The function shall be performed by the Internal Audit team with the assistance of the Shariah Department (for full-fledged Islamic banks) or the Islamic Banking Department/Unit (conventional banks with an Islamic Window/Unit operation), who have acquired adequate

Shariah-related and audit knowledge and training. If the Bank still has not developed its internal capacity to conduct Shariah audit, it may outsource such function to an external party provided that this complies with the requirement as set out under the Guidelines on Outsourcing of Islamic Banking Operations and Guidelines on External Audit of Islamic Bank/Window as issued by DAB in respect to this matter.

Chapter 1: General Provisions

Article 1: Basis

This regulation is issued pursuant to Article 177 of Banking Law of Afghanistan in relation to the powers of DAB to regulate and supervise banks in the Islamic Republic of Afghanistan and any amendments thereto.

Article 2: Objectives

Objectives of this Regulation are as follows:

- (1) The purpose of this Guideline contained in this document is to provide a framework of principles on liquidity risk management approached, practices and processes to guide The Banks in performing its liquidity risk management function. This Liquidity Framework is intended to:
 1. Ensure that the Banks have robust management of liquidity risk by Banks, as well as the awareness among Banks of their funding structure and their ability to handle short to medium-term liquidity problems;
 2. Adopt a more efficient and on-going liquidity measurement and management for the Banks; and provide the Banks with a better means of assessing the present and future liquidity position of banking Banks.
 3. Address both the Banks and market liquidity concerns on the ability of the Banks to meet all maturing obligations is assessed through the projection of the banking Banks' inflows; and gauges the ability of banking Banks to access funding from the market particularly under stress scenarios.
- (2) The principles as provided in this Guideline shall constitute a general guideline for the guidance to Banks and all Banks are expected to develop methodologies for managing and controlling liquidity risk suited to its business needs and capabilities, as well as the needs and interests of its customers and other stakeholders. The guidelines do fundamentally address what the management of liquidity risk should accomplish. Each Bank should have maximum flexibility to design a program to meet its needs within this Framework.

Article 3: Scope

This regulation is applicable on all Islamic banks, Islamic subsidiary of bank, Islamic banking window of conventional bank and Islamic branch of foreign bank licensed by Da Afghanistan Bank, unless the context otherwise require.

Article 4: Introduction Liquidity Risk Management

- (1) Liquidity risk is the potential that the Banks will be unable to meet its obligations as they come due because of an inability to obtain adequate funding or liquidate assets, without incurring unacceptable costs and losses.
- (2) Liquidity risk can be categorized into two major types: funding and market liquidity risk. Funding liquidity risk is the risk that the Bank will not be able to meet efficiently both its expected and unexpected current and future cash flow and collateral needs without affecting either daily operations or the financial condition of the Bank. Market liquidity risk is the risk that the Bank cannot easily offset or eliminate a position at the market price because of inadequate market depth or market disruption.
- (3) Liquidity risk can arise due to funding or market risk, or various factors arising due to a combination of these risks, which might be linked to changes in Banking or systemic behavior. The Bank may face funding liquidity risk due to unexpected withdrawals or transfers of funds by its investment account holders and depositors for several reasons, including reduced creditworthiness, displaced commercial risk, Shariah non-compliance risk or reputational risk. On the assets side, the Bank may face funding strain due to problems in its financing and investment portfolio for example, a fall in value of marketable assets held for trading or in the banking book, lack of liquid markets for holdings of Sukuk and other Shariah -compliant instruments, the impairment of Islamic financing assets due to the financial distress of customers, and large drawdowns under committed line-of-credit agreements. The bank may also face increased liquidity risk due to operational and information system failures of counterparties, or because of problems in a payment and settlement system resulting in late payment or non-payment of funds due.
- (4) In stressed conditions, deterioration in market liquidity may either impact the liquidity of a particular type of instrument or affect a wide range of assets in the market. All other risks of the Bank culminate in liquidity stress before ultimately resulting in insolvency. A bank could fail if its cash inflows from new investment accounts and deposits, repayment of financing, sale of assets and mobilization of new funds are unable to meet its cash outflow obligations such as mandatory cash reserves, investment account and deposit withdrawals, operating expenses and payments to creditors.
- (5) From a funding liquidity risk perspective, the Bank cannot take an interest-based loan from the interbank market or other sources, and it is also not allowed to transfer its debt, other than at its face value. Shortage or unavailability of Shariah compliant securities in may add to these problems, compelling the Bank to maintain a higher level of cash and non-earning liquid assets than conventional Banks. These factors affect the performance and competitiveness of IIFS vis-à-vis conventional financial Banks in several jurisdictions.

Article 5: Liquidity Risk Management

- (1) Liquidity risk may not be seen in isolation, because financial risk is not mutually exclusive and liquidity risk often triggered by consequence of these other financial risks such as credit risk, market risk etc. For instance, a bank increasing its credit risk through asset concentration etc. may be increasing its liquidity risk as well. Similarly, a large financing default or changes in interest/profit rate can adversely impact a bank's liquidity position. Further if management misjudges the impact on liquidity of entering into a new business or product line, the Bank's strategic risk would increase.
- (2) A liquidity risk management involves not only analyzing banks on and off-balance sheet positions to forecast future cash flows but also how the funding requirement would be met. The later involves identifying the funding market the bank has access, understanding the nature

of those markets, evaluating banks current and future use of the market and monitor signs of confidence erosion.

- (3) The formality and sophistication of risk management processes established to manage liquidity risk should reflect the nature, size and complexity of a Bank's activities. Sound liquidity risk management employed in measuring, monitoring and controlling liquidity risk is critical to the viability of any Bank. Banks should have a thorough understanding of the factors that could give rise to liquidity risk and put in place mitigating controls.
- (4) The following twelve principles are central to the management of liquidity risk across a bank, within its business lines, and within specific risk categories. They include:
 1. Board of Directors and Senior Management responsibility
 2. Liquidity Risk Strategy
 3. ALCO/Investment Committee
 4. Liquidity Risk Management Process
 5. Management Information System
 6. Liquidity Risk Measurement and Monitoring
 7. Early Warning Indicators of Liquidity Risk.
 8. Contingency Funding Plan
 9. Cash flow Projections.
 10. Liquidity Ratios and Limits.
 11. Internal Control
 12. Monitoring and Reporting Risk Exposures.

Article 6: Board Directors and Senior Management Oversight

- (1) The prerequisites of an effective liquidity risk management include an informed Board, capable management, staff having relevant expertise and efficient systems and procedures. It is primarily the duty of board of directors to understand the liquidity risk profile of the bank and the tools used to manage liquidity risk. The Board has to ensure that the bank has necessary liquidity risk management framework and bank is capable of confronting uneven liquidity scenarios. Generally speaking, the board of a bank is responsible:
- (2) To position bank's strategic direction and tolerance level for liquidity risk.
- (3) To appoint senior managers who have ability to manage liquidity risk and delegate them the required authority to accomplish the job.
- (4) To continuously monitors the bank's performance and overall liquidity risk profile.
- (5) To ensure that liquidity risk is identified, measured, monitored, and controlled.
- (6) Senior management is responsible for the implementation of sound policies and procedures keeping in view the strategic direction and risk appetite specified by Board. To effectively oversee the daily and long-term management of liquidity risks senior managers should:
 1. Develop and implement procedures and practices that translate the Board's goals, objectives, and risk tolerances into operating standards that are well understood by the Bank's personnel and consistent with the Board's intent.
 2. Adhere to the lines of authority and responsibility that the board has established for managing liquidity risk.
 3. Oversee the implementation and maintenance of management information and other systems that identify, measure, monitor, and control the bank's liquidity risk.
 4. Establish effective internal controls over the liquidity risk management process.

Article 7: Liquidity Risk Strategy

- (1) The liquidity risk strategy defined by Board should enunciate specific policies on particular aspects of liquidity risk management, such as:

1. **Composition of Assets and Liabilities:** The strategy should outline the mix of assets and liabilities to maintain liquidity. Liquidity risk management and asset/liability management should be integrated to avoid steep costs associated with having to rapidly reconfigure the asset liability profile from maximum profitability to increased liquidity.
2. **Diversification and Stability of Liabilities:** A funding concentration exists when a single decision or a single factor has the potential to result in a significant and sudden withdrawal of funds. Since such a situation could lead to an increased risk, the Board of Directors and senior management should specify guidance relating to funding sources and ensure that the bank have a diversified sources of funding day-to-day liquidity requirements. An Bank would be more resilient to tight market liquidity conditions if its liabilities were derived from more stable sources. To comprehensively analyse the stability of liabilities/funding sources the Bank need to identify:
 - a. Liabilities that would stay with the Bank under any circumstances;
 - b. Liabilities that run-off gradually if problems arise; and
 - c. That run-off immediately at the first sign of problems.
3. **Access to Inter-Bank Market:** The inter-bank market can be important source of liquidity. However, the strategies should take into account the fact that in crisis situations access to inter-bank market could be difficult as well as costly.
4. The liquidity strategy must be documented in a liquidity policy, and communicated throughout the Bank. The strategy should be evaluated periodically to ensure that it remains valid.
5. The Banks should formulate liquidity policies, which are recommended by senior management/Asset and Liability Management Committee (ALCO) and approved by the Board of Directors. While specific details vary across Banks according to the nature of their business, the key elements of any liquidity policy include:
 - a. General liquidity strategy (short- and long-term), specific goals and objectives in relation to liquidity risk management, process for strategy formulation and the level within the Bank it is approved;
 - b. Roles and responsibilities of individuals performing liquidity risk management functions, including structural balance sheet management, pricing, marketing, contingency planning, management reporting, lines of authority and responsibility for liquidity decisions;
 - c. Liquidity risk management structure for monitoring, reporting and reviewing liquidity; Liquidity risk management tools for identifying, measuring, monitoring and controlling liquidity risk (including the types of liquidity limits and ratios in place and rationale for establishing limits and ratios);
 - d. Contingency plan for handling liquidity crises.
6. To be effective, the liquidity policy must be communicated down the line throughout in the organization. It is important that the Board and senior management/ALCO review these policies at least annually and when there are any material changes in the Bank's current and prospective liquidity risk profile. Such changes could stem from internal circumstances (e.g. changes in business focus) or external circumstances (e.g. changes in economic conditions). Reviews provide the opportunity to fine tune the Bank's liquidity policies in light of the Bank's liquidity management experience and development of its business. Any significant or frequent exception to the policy is an important barometer to gauge its effectiveness and any potential impact on the bank's liquidity risk profile. The Bank should establish appropriate procedures and processes to implement their liquidity policies. The procedural manual should explicitly narrate the necessary operational steps and processes to execute the relevant liquidity risk controls. The manual should be periodically reviewed and updated to take into account new activities, changes in risk management approaches and systems.

Article 8: ALCO/Investment Committee

- (1) The responsibility for managing the overall liquidity of the bank should be delegated to a specific, identified group within the bank. This might be in the form of an Asset Liability Management Committee (ALCO) comprised of senior management, the treasury function or the risk management department. However, usually the liquidity risk management is performed by an ALCO. Ideally, the ALCO should comprise of senior management from each key area of the Bank that assumes and/or manages liquidity risk. It is important that these members have clear authority over the units responsible for executing liquidity-related transactions so that ALCO directives reach these line units unimpeded. The ALCO should meet monthly, if not on a more frequent basis. Generally, responsibilities of ALCO include developing and maintaining appropriate risk management policies and procedures, Management information system reporting, limits, and oversight programs. ALCO usually delegates day-to-day operating responsibilities to the Bank's treasury department. However, ALCO should establish specific procedures and limits governing treasury operations before making such delegation.
- (2) Since liquidity risk management is a technical job requiring specialized knowledge and expertise, it is important that senior management/ALCO not only have relevant expertise but also have a good understanding of the nature and level of liquidity risk assumed by the Bank and the means to manage that risk.
- (3) To ensure that ALCO can control the liquidity risk arising from new products and future business activities, the committee members should interact regularly with the bank's risk managers and strategic planners.

Article 9: Liquidity Risk Management Process

- (1) Besides the organizational structure discussed earlier, an effective liquidity risk management include systems to identify, measure, monitor and control its liquidity exposures. Management should be able to accurately identify and quantify the primary sources of a bank's liquidity risk in a timely manner. To properly identify the sources, management should understand both existing as well as future risk that the Bank can be exposed to. Management should always be alert for new sources of liquidity risk at both the transaction and portfolio levels.
- (2) Key elements of an effective risk management process include an efficient management information system to measure, monitor and control existing as well as future liquidity risks and reporting them to senior management.

Article 10: Management Information System

- (1) An effective management information system (MIS) is essential for sound liquidity management decisions. Information should be readily available for day to-day liquidity management and risk control, as well as during times of stress. Data should be appropriately consolidated, comprehensive yet succinct, focused, and available in a timely manner. Ideally, the regular reports a bank generates will enable it to monitor liquidity during a crisis; managers would simply have to prepare the reports more frequently. Managers should keep crisis monitoring in mind when developing liquidity MIS. There is usually a trade-off between Managing liquidity risk accuracy and timeliness. Liquidity problems can arise very quickly, and effective liquidity management may require daily internal reporting. Since bank liquidity is primarily affected by large, aggregate principal cash flows, detailed information on every transaction may not improve analysis.
- (2) Management should develop systems that can capture significant information. The content and format of reports depend on a bank's liquidity management practices, risks, and other characteristics. However, certain information can be effectively presented through standard reports such as "Funds Flow Analysis, "and "Contingency Funding Plan Summary". These

reports should be tailored to the bank's needs. Other routine reports may include a list of large funds providers, a cash flow or funding gap report, a funding maturity schedule, and a limit monitoring and exception report. Day-to-day management may require more detailed information, depending on the complexity of the bank and the risks it undertakes. Management should regularly consider how best to summarize complex or detailed issues for senior management or the board. Besides other types of information important for managing day-to-day activities and for understanding the bank's inherent liquidity risk profile include:

1. Asset quality and its trends.
 2. Earnings projections.
 3. The bank's general reputation in the market and the condition of the market itself.
 4. The type and composition of the overall balance sheet structure.
 5. The type of new deposits being obtained, as well as its source, maturity, and price.
- (3) As far as information system is concerned, various units related to treasury activities, the dealing, the treasury operation and risk management department should be integrated. Furthermore, management should ensure proper and timely flow of information among front office, back office and middle office in an integrated manner; however, their reporting lines should be kept separate to ensure independence of these functions.

Article 11: Liquidity Risk Measurement and Monitoring

- (1) An effective measurement and monitoring system is essential for adequate management of liquidity risk. Consequently, banks should institute systems that enable them to capture liquidity risk ahead of time, so that appropriate remedial measures could be prompted to avoid any significant losses. It needs not mention that banks vary in relation to their liquidity risk (depending upon their size and complexity of business) and require liquidity risk measurement techniques accordingly. For instance, banks having large networks may have access to low cost stable deposit, while small banks have significant reliance on large size Bank deposits. However, abundant liquidity does not obviate the need for a mechanism to measure and monitor liquidity profile of the bank. An effective liquidity risk measurement and monitoring system not only helps in managing liquidity in times of crisis but also optimize return through efficient utilization of available funds. Discussed below are some (but not all) commonly used liquidity measurement and monitoring techniques that may be adopted by the banks.

Article 12: Early Warning Indicators of Liquidity Risk

- (1) An incipient liquidity problem may initially reveal in the Bank's financial monitoring system as a downward trend with potential long-term consequences for earnings or capital. Given below are some early warning indicators that not necessarily always lead to liquidity problem for a bank; however, these have potential to ignite such a problem. Consequently, management needs to watch carefully such indicators and exercise further scrutiny/analysis wherever it deems appropriate. Examples of such internal indicators are:
1. A negative trend or significantly increased risk in any area or product line.
 2. Concentrations in either assets or liabilities.
 3. Deterioration in quality of credit portfolio.
 4. A decline in earnings performance or projections.
 5. Rapid asset growth funded by volatile large deposit.
 6. A large size of off-balance sheet exposure.
 7. Deteriorating third party evaluation about the bank

Article 13: Contingency Funding Plans

- (1) In order to develop a comprehensive liquidity risk management framework, Banks should have way out plans for stress scenarios. Such a plan commonly known as Contingency Funding Plan (CFP) is a set of policies and procedures that serves as a blue print for a bank to meet its funding

needs in a timely manner and at a reasonable cost. A CFP is a projection of future cash flows and funding sources of a bank under market scenarios including aggressive asset growth or rapid liability erosion. To be effective it is important that a CFP should represent management's best estimate of balance sheet changes that may result from a liquidity or credit event. A CFP can provide a useful framework for managing liquidity risk both short term and in the long term. Further it helps ensure that a financial Bank can prudently and efficiently manage routine and extraordinary fluctuations in liquidity.

Article 14: Cash Flow Projections

- (1) At the basic level banks may utilize flow measures to determine their cash position. A cash flow projection estimates a bank's inflows and outflows and thus net deficit or surplus (GAP) over a time horizon. The contingency funding plan discussed previously is one example of a cash flow projection. Not to be confused with the re-pricing gap report that measures interest rate risk, a behavioral gap report takes into account bank's funding requirement arising out of distinct sources on different time frames. A maturity ladder is a useful device to compare cash inflows and outflows both on a day-to-day basis and over a series of specified time periods. The number of time frames in such maturity ladder is of significant importance and up to some extent depends upon nature of bank's liability or sources of funds. Banks, which rely on short term funding, will concentrate primarily on managing liquidity on very short term. Whereas, other banks might actively manage their net funding requirement over a slightly longer period. In the short term, bank's flow of funds could be estimated more accurately and also such estimates are of more importance as these provide an indication of actions to be taken immediately. Further, such an analysis for distant periods will maximize the opportunity for the bank to manage the GAP well in advance before it crystallizes. Consequently, banks should use short timeframes to measure near term exposures and longer time frames thereafter. It is suggested that banks calculate daily GAP for next one or two weeks, monthly Gap for next six month or a year and quarterly thereafter. While making an estimate of cash flows, following aspect needs attention:
 1. The funding requirement arising out of off- Balance sheet commitments also need to be accounted for.
 2. Many cash flows associated with various products are influenced by interest rates or customer behavior. Banks need to take into account behavioral aspects instead of contractual maturity. In this respect past experiences could give important guidance to make any assumption.
 3. Some cash flows may be seasonal or cyclical.
 4. Management should also consider increases or decreases in liquidity that typically occur during various phases of an economic cycle.
- (2) While the banks should have liquidity sufficient enough to meet fluctuations in loans and deposits, as a safety measure banks should maintain a margin of excess liquidity. To ensure that this level of liquidity is maintained, management should estimate liquidity needs in a variety of scenarios.

Article 15: Liquidity Ratios and Limits

- (1) Banks may use a variety of ratios to quantify liquidity. These ratios can also be used to create limits for liquidity management. However, such ratios would be meaningless unless used regularly and interpreted taking into account qualitative factors. Ratios should always be used in conjunction with more qualitative information about borrowing capacity, such as the likelihood of increased requests for early withdrawals, decreases in credit lines, decreases in transaction size, or shortening of term funds available to the bank. To the extent that any asset-liability management decisions are based on financial ratios, a bank's asset-liability managers

should understand how a ratio is constructed, the range of alternative information that can be placed in the numerator or denominator, and the scope of conclusions that can be drawn from ratios. Because ratio components as calculated by banks are sometimes inconsistent, ratio-based comparisons of Banks or even comparisons of periods at a single Bank can be misleading.

1. **Cash Flow Ratios and Limits:** One of the most serious sources of liquidity risk comes from a bank's failure to "roll over" a maturing liability. Cash flow ratios and limits attempt to measure and control the volume of liabilities maturing during a specified period of time.
 2. **Liability Concentration Ratios and Limits:** Liability concentration ratios and limits help to prevent a bank from relying on too few providers or funding sources. Limits are usually expressed as either a percentage of liquid assets or an absolute amount. Sometimes they are more indirectly expressed as a percentage of deposits, purchased funds, or total liabilities.
 3. **Other Balance Sheet Ratios:** Total loans/total deposits, total loans/total equity capital, borrowed funds/total assets etc. are examples of common ratios used by financial Banks to monitor current and potential funding levels.
- (2) In addition to the statutory limits of liquid assets requirement and cash reserve requirement, the board and senior management should establish limits on the nature and amount of liquidity risk they are willing to assume. The limits should be periodically reviewed and adjusted when conditions or risk tolerances change. When limiting risk exposure, senior management should consider the nature of the bank's strategies and activities, its past performance, the level of earnings, capital available to absorb potential losses, and the board's tolerance for risk. Balance sheet complexity will determine how much and what types of limits a bank should establish over daily and long-term horizons. While limits will not prevent a liquidity crisis, limit exceptions can be early indicators of excessive risk or inadequate liquidity risk management.

Article 16: Internal Controls

- (1) In order to have effective implementation of policies and procedures, banks should institute review process that should ensure the compliance of various procedures and limits prescribed by senior management. Persons independent of the funding areas should perform such reviews regularly. The bigger and more complex the bank, the more thorough should be the review. Reviewers should verify the level of liquidity risk and management's compliance with limits and operating procedures. Any exception to that should be reported immediately to senior management / board and necessary actions should be taken.

Article 17: Monitoring and Reporting Risk Exposures

- (1) Senior management and the board, or a committee thereof, should receive reports on the level and trend of the bank's liquidity risk at least quarterly. A recent trend in liquidity monitoring is incremental reporting, which monitors liquidity through a series of basic liquidity reports during stable funding periods but ratchets up both the frequency and detail included in the reports produced during periods of liquidity stress. From these reports, senior management and the board should learn how much liquidity risk the bank is assuming, whether management is complying with risk limits, and whether management's strategies are consistent with the board's expressed risk tolerance. The sophistication or detail of the reports should be commensurate with the complexity of the Bank.

Article 18: Custodian of the Liquidity Risk Management Guideline

- (1) This Guideline shall be under the safe custody of the Islamic Banking Division ("IBD") of DAB. Any changes to this Guideline 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 Guideline shall be made available to all stakeholders and SSB members for reference and implementation.

- (2) Banks may further refine the Guideline to suit their particular structure and policies. Such amendments shall be approved by the Bank's Risk Management Committee at the Board level. The Bank's Risk Management Division will have custody over the Bank's Guiding Principles of Risk Management Guideline.

Enforcement Action Regulation

Book (9)

Chapter 1: General Provisions

Article 1: Basis

This regulation is issued pursuant to Article 177 of Banking Law of Afghanistan in relation to the powers of DAB to regulate and supervise banks in the Islamic Republic of Afghanistan and any amendments thereto.

Article 2: Objective

- (1) The purpose of the regulation is to give guidance to banks on how to conduct operations in a sound and prudent manner by providing examples of particular actions deemed unsound and imprudent. The regulation further inventories the options that DAB has to respond to such actions.
- (2) To set forth a transparent process that DAB will follow to intervene in a timely manner in applying enforcement measures against financially weak or poorly managed banks or banks operating in violation of the Banking Law or regulations issued by DAB under that law
- (3) To set forth standards used and sample practices that will trigger enforcement against institutions whose solvency is threatened, whose operations are conducted in an unsound or imprudent manner or who are operating in violation of the Banking Law or regulations issued by DAB under that law.

Article 3: Scope

This regulation is applicable on all Islamic banks, Islamic subsidiary of bank, Islamic banking window of conventional bank and Islamic branch of foreign bank licensed by Da Afghanistan Bank, unless the context otherwise require.

Article 4: Definitions

In this subpart the following terms shall have the meanings assigned:

- (1) Adequately capitalized institution - a financial institution who capital ratios are in compliance with DAB requirements, but is not wellcapitalized.
- (2) Critically undercapitalized institution - a financial institution whose regulatory capital to risk-weighted assets ratio is less than 6%, or whose core capital to risk-weighted asset ratio is less than 3%.
- (3) Significantly undercapitalized institution - a financial institution whose regulatory capital to risk-weighted assets ratio is less than 8% or whose core capital to risk-weighted asset ratio is less than 4%, but is not critically undercapitalized.
- (4) solvency or liquidity of a bank is threatened - with regard to capital insolvency, being classified as an undercapitalized institution as defined under this regulation; and with regard to liquidity

insolvency, having difficulty meeting the legitimate claims of depositors or other creditors, defined as a quick ratio of 10% or less and broad liquidity ratio of 7% or less, as defined in Regulation Five.

- (5) under capitalized institution - a financial institution whose capital in either category is less than the required level, but is not critically or significantly undercapitalized.
- (6) unsound or imprudent manner - any action or inaction that is contrary to generally accepted standards of prudent operation and if continued would present an abnormal risk of loss or damage to an institution.
- (7) well capitalized institution - a financial institution whose regulatory capital to risk-weighted assets ratio is greater than 14% and whose core capital to risk-weighted asset ratio is greater than 7%

Article 5: Unsound or Imprudent Practices

- (1) Actions Deemed Unsound or Imprudent: The Banking Law details a number of preliminary actions that DAB should undertake if it determines that a bank is about to conduct or is conducting its operations in an "unsound or imprudent manner." Section 8.1.2 above sets forth a general definition for this concept and the following examples are intended to give guidance in the form of particular actions deemed unsound or imprudent:
 - 1. Engaging in hazardous lending and lax collection practices which include, but are not limited to, extending credit which is inadequately secured; extending credit without first obtaining complete and current financial information; extending credit in the form of overdrafts without adequate controls; and extending credit with inadequate diversification of risk.
 - 2. Operating without adequate liquidity, in light of the bank's asset and liability mix.
 - 3. Operating without adequate internal controls including failing to maintain controls on official checks and unissued certificates of deposit, failing to segregate duties of bank personnel, and failing to reconcile differences in correspondent bank accounts.
 - 4. Engaging in speculative or hazardous investment policies.
 - 5. Paying excessive dividends in relation to the bank's capital position, earnings capacity and asset quality.
- (2) Inaction Deemed Unsound or Imprudent: The following examples are intended to give guidance in the form of particular inaction deemed unsound or imprudent:
 - 1. Failure to provide adequate supervision and direction over the administrators of the bank to prevent unsafe or unsound practices, and violation(s) of laws, rules and regulations.
 - 2. Failure to make provision for an adequate allowance for credit losses.
 - 3. Failure to post the general ledger promptly.
 - 4. Failure to keep accurate books and records.
 - 5. Failure to account properly for transactions.
 - 6. Failure to enforce programs for repayment of loans.
 - 7. Failure to obtain or maintain on premises evidence of priority of liens on loans secured by real estate.

- (3) Conditions Deemed Unsound or Imprudent: The following examples are intended to give guidance in the form of particular conditions deemed unsound or imprudent:
1. Inadequate amount of capital for the amount, kind and quality of the assets held.
 2. Maintenance of unduly low or negative net interest margins.
 3. Excessive overhead expenses.
 4. Excessive volume of credits subject to adverse classification or past due.
 5. Excessive net loan losses.
 6. Excessive volume of fixed and other non-earning assets.
 7. Excessive large liability dependence.

Article 6: Inventory of Actions at the Disposal of DAB

- (1) Written Warning: The first step in enforcement actions is to issue a written warning to the bank pursuant to Article 46.1 of the Banking Law. The warning, which may be issued on the basis of inspection findings, puts the bank's management on notice that the bank is operating in an unsound or imprudent manner or is violating a law or a regulation.
- (2) Written Supervisory Order (WSO): If the written warning does not elicit corrective action, DAB can serve the bank a WSO pursuant to Article 46.2 of the Banking Law. A WSO is a request to the bank's management board to present a plan with specific written commitments to take corrective action in response to problems or concerns identified by DAB. If the bank fails to present a plan, if DAB deems the plan to be unacceptable, or if the bank does not take the corrective action as promised in the plan, then preventive action has not worked and DAB needs to pursue more severe, more formal enforcement action.
- (3) Plan to Take Corrective Action (PTCA): If more formal measures are required, DAB can request that a bank present PTCA, as detailed in Article 47 of the Banking Law. These are formal written supervisory agreements developed by DAB and the bank's Management Board and the Board of Supervisors and accepted by DAB. As the law provides, DAB may use a PTCA to require a bank to cease any statutory or regulatory violation or unsafe practice. The agreements may also require affirmative corrective action to address any existing violations, management or operational deficiencies, or other unsound practices.
- (4) Order to Take Prompt Corrective Action (PCA): If the supervisory agreement is not fulfilled, and corrective action is urgently required, DAB may issue an order to take prompt corrective action (cease and desist order) as detailed in Article 48 of the Banking Law. These orders may require the bank to stop or undertake a variety of actions, including suspending borrowing or deposit taking, removing an administrator, freezing existing deposits or increasing capital. DAB may also impose a fine on the bank, not to exceed one percent of the sum of common stock and share premium on common stock of the bank.

(5) Summary of Capital Categories, CAMELS Ratings, Corrective Measures

CA	Well	Adequate	Under	Sign. Under	Critic. Under
3	Warning	Warning	WSo	NIA	NIA
4	NIA	NIA	WSo PTCA	PTCA PCA	NIA
5	NIA	NIA	PTCA PCA	PTCA PCA	PTCA PCA

1. In general, a CAMELS rating of 3, 4, 5 leads to a presumption that an enforcement action is warranted.
2. NIA = Specific combination of capitalization and CAMELS is unlikely

Article 7: Plan to Take Corrective Action

(1) Contents of a Plan to Take Corrective Action:

1. A PTCA must contain the following elements:
 - a. an analysis of causes of the worsening of the financial standing or unprofitable activity of the financial institution, in particular addressing the violations and deficiencies noted in the most recent report of examination undertaken by DAB;
 - b. specific corrective measures to be taken, including specific goals to be achieved and realistic projections as to the time period within which such achievement is expected;
 - c. realistic projections of improvements in the financial institution's financial condition that are expected to be achieved on carrying out of the indicated measures;
 - d. a quarterly budget of income and expenditures, with procedures for reconciling variances between actual and projected income and expenses; and
 - e. time frames (no less than quarterly) under which the financial institution must submit periodic reports to DAB on its progress in meeting the requirements of the plan.
2. Depending upon the causes of the capital deficiency or asset quality problems, the plan also must include measures to achieve the following goals, insofar as they are applicable to the financial institution's capital situation:
 - a. forming reserves for possible losses on loans and other assets at necessary amounts;
 - b. diversifying assets;
 - c. closing unprofitable branches;
 - d. developing a plan to improve the quality of credit granting, monitoring the progress of repayments of credits, and addressing adversely classified assets;
 - e. improving the collection of past due credits; and
 - f. disposing of unprofitable investments.
3. With regard to issues other than capital and asset quality, the plan also must include measures to achieve the following goals:
 - a. applying measures with regard to creation and subsequent intensive development of the internal audit function;
 - b. revising the institution's accounting/management information system to make it possible for the institution's management to obtain immediate information regarding the institution's asset

portfolio (including, in particular, for loan, the borrower's name, outstanding balance, whether the loan is current or past due, and the amount of any accrued interest); and

- c. Reviewing the financial institution's management structure, with a view toward streamlining and enhancing its efficiency, and to make necessary changes based on this review.
- (2) A financial institution under a PTCA shall submit reports, no less frequently than quarterly, to DAB, regarding its progress of implementing the plan. DAB may require more frequent reports if it determines this to be necessary based on the financial condition of the institution.
- (3) In the event that an undercapitalized financial institution becomes significantly undercapitalized, DAB may require the institution to amend its plan.

Article 8: Restriction on Activities of Undercapitalized Institutions

- (1) An undercapitalized financial institution may not:
 - 1. pay dividends or distribute profits in any other form;
 - 2. increase its risk-weighted assets (including on balance sheet and off balance sheet items that are risk weighted) more than 5% per fiscal year;
 - 3. establish new branches or engage in new lines of business without the approval of DAB, based on a determination that such action would be consistent with, and would further the goals of, the plan to take corrective action; or
 - 4. Buy back any shareholders' stock.
- (2) A significantly undercapitalized or critically undercapitalized financial institution is prohibited from doing any of the items in subparagraph a), and, in addition, may not:
 - 1. attract new deposits;
 - 2. pay interest rates on deposits in excess of market rates;
 - 3. invest in securities of other legal persons;
 - 4. Increase risk-weighted assets (including on balance sheet and off balance sheet items that are risk weighted) more than 1.25% per quarter.
 - 5. increase the salary or other form of compensation, or pay any bonus to any member of the financial institution's board of directors or persons with power of management;
 - 6. Engage in transactions with related persons of the institution, as defined in DAB Regulation Four issued pursuant to the Banking Law.
- (3) The restrictions of this subparagraph also apply to undercapitalized institutions that fail to submit a plan to take corrective action within the time period required by this Notification, or fail to implement a plan approved by DAB. DAB may also impose any of the restrictions in this paragraph on an undercapitalized institution if it determines such restrictions to be necessary in order to successfully implement the plan to take corrective action approved by DAB.
- (4) The restrictions in subparagraphs a) and b) shall become applicable at the time that the financial institution's capital position becomes known to the board of directors or management of the institution.

Article 9: Termination of a Plan to Take Corrective Action

- (1) On the termination of the time period specified in a plan to take corrective action (which cannot be more than one year), DAB shall make a conclusion as to the further activity of the financial institution.
- (2) The plan to take corrective action can be terminated early in the case of successful implementation of the measures specified in the plan. A plan to take corrective action cannot be terminated unless the financial institution has been restored to the required capital adequacy ratios and addressed any other deficiencies recognized in the plan to take corrective action. This must be confirmed by the reported materials and a full-scope examination of the institution.
- (3) In the event of failure to implement the plan, DAB has the right to take any enforcement or other measures specified in the Banking Law that it deems appropriate, including an order to take prompt corrective action, placement into conservatorship, revocation of banking license and forced liquidation

Article 10: Circumstances Warranting Extraordinary Measures

- (1) Article 48 of the Banking Law enumerates a variety of powers that DAB has at its disposal in order to take prompt corrective action, some of which are considered extraordinary measures. These are measures that should only be considered by DAB in the most extreme cases of financial or operational distress. Article 48.4, requires that DAB issue specific guidelines regarding the use of select extraordinary measures, specifically where:
 1. DAB may order the bank not to repay any money on deposit or advance (moratorium on liabilities).
 2. DAB may order the bank not to pay or transfer any amount to any person, or order the bank not to create an obligation, contingent or otherwise, to do so (moratorium on transfers and obligations).
- (2) These extraordinary measures can be undertaken if the appointment of a conservator under Article 54 of the Banking Law is considered imminent by DAB or if there are indications that the bank has engaged in criminal activities that may jeopardize the financial standing of the bank.

Chapter 1: General Provisions

Article 1: Basis

This regulation is issued pursuant to Article 177 of Banking Law of Afghanistan in relation to the powers of DAB to regulate and supervise banks in the Islamic Republic of Afghanistan and any amendments thereto.

Article 2: Objectives

The purpose of this Regulation is to:

- (4) To make clear to banks precisely how the capital adequacy of their institution will be assessed for regulatory purposes to comply with the Islamic Financial Service Board's Capital Adequacy Standard.
- (5) To provide banking products and services in safe and sound manner that supports the bank's compliance
- (6) To collect reliable information on the total capital and assets of the bank, used for calculating economic normative regulating banking activities.

Article 3: Scope

This regulation is applicable on all Islamic banks, Islamic subsidiary of bank bank licensed by Da Afghanistan Bank, unless the context otherwise requires

Article 4: Definitions

The terms used in this Regulation shall have the following meanings

- (1) Capital Adequacy Framework (CAF): is a framework issued by DAB for Islamic Banks to specify the risk measurement methodologies of calculating a minimum capital requirement against credit risk, market risk and operational risk.

Chapter 2: Capital Adequacy

Article 5: Type of Pillars

- (1) CAF consists of three pillars as follows:
 1. Minimum capital requirements
 2. Supervisory review process
 3. Market discipline.

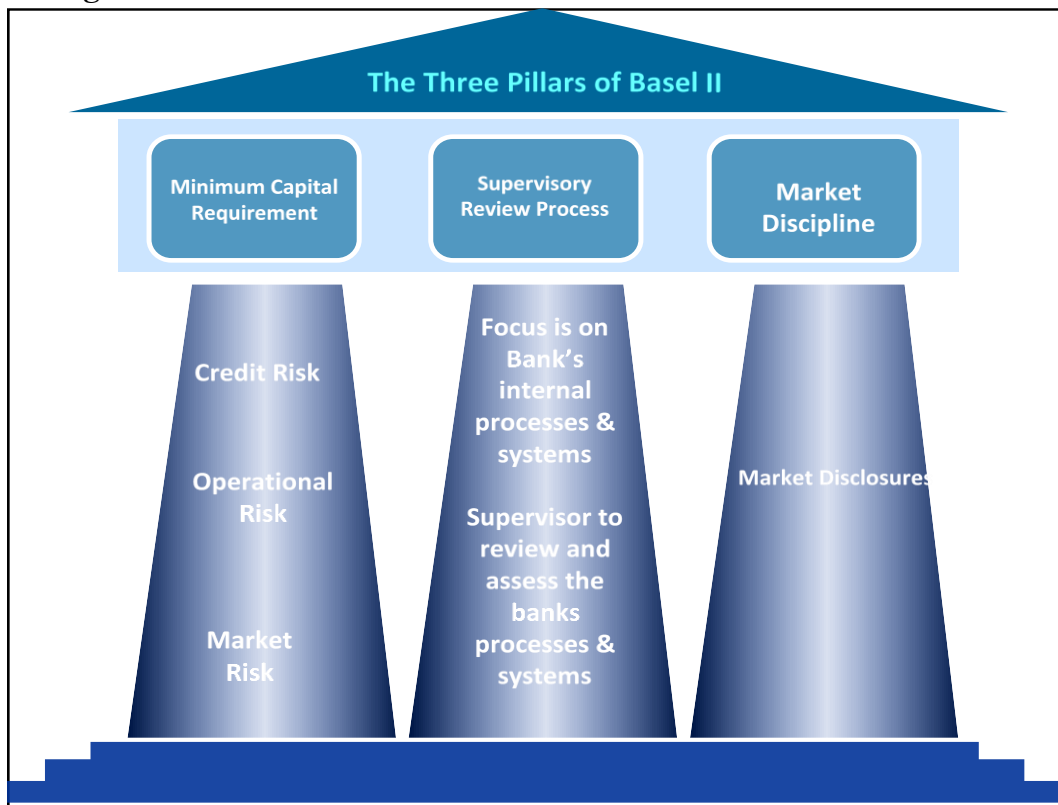
Article 6: Minimum Capital Requirements

- (1) Minimum capital requirement covers regulatory requirements for credit, market and operational risk. The capital adequacy is measured by using the following formula: -

$$\frac{\text{Total Capital}}{\text{Credit Risk} + \text{Market Risk} + \text{Operational Risk}} = \text{The bank's capital ratio (minimum 8\%)}$$

- (2) Under CAF (Basel II), the denominator of the minimum capital total capital ratio will consist of three parts: the sum of all risk-weighted assets for credit risk, plus 12.5 times the sum of the capital charges for market and operational risk.

Figure 1: Three Pillar of CAF



Article 7: Supervisory Review Process

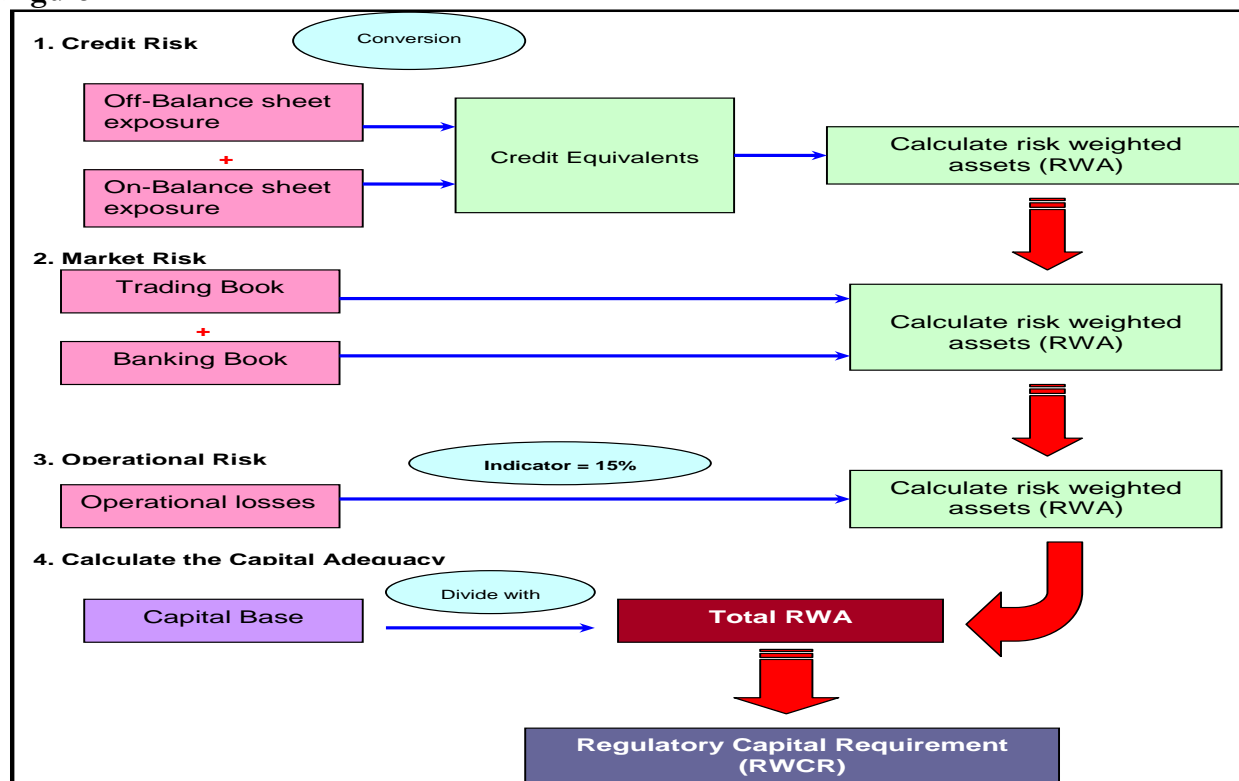
- (1) The supervisory review process defines the process for supervisory (DAB) review of an institution's risk management framework and its capital adequacy.
- (2) It sets out specific oversight responsibilities for the board and senior management, thus reinforcing principles of internal control and other corporate governance practices established by DAB.
- (3) According to the Basel Committee, "The [New Accord] stresses the importance of bank management developing an internal capital assessment process and setting targets for capital that are commensurate with the bank's particular risk profile and control environment.
- (4) DAB would be responsible for evaluating how well the Banks are assessing their capital adequacy needs relative to their risks. This internal process would then be subject to DAB review and intervention, where appropriate.

Article 8: Market Discipline

- (1) Market discipline aims to bolster market discipline through enhanced disclosure by banks. It sets out disclosure requirements and recommendations in several areas, including the way a bank calculates its capital adequacy and its risk assessment methods. Enhanced comparability and transparency are the intended results.
- (2) At the same time, the Basel Committee has sought to ensure that the Basel II disclosure framework aligns with national accounting standards and, in fact, does not conflict with broader accounting disclosure standards, of which banks must comply.

Article 9: Calculation of Minimum Capital Requirements

Figure 2

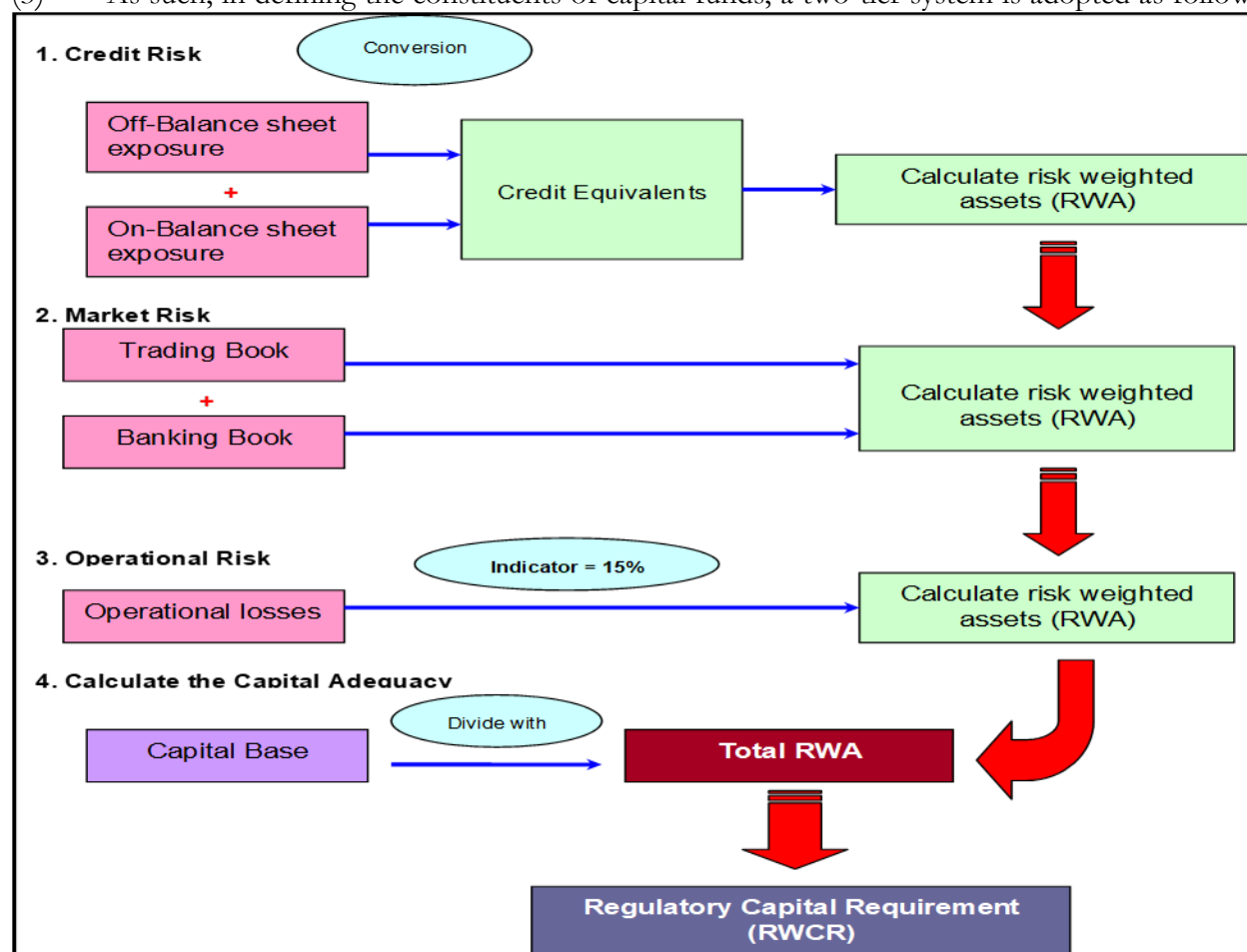


Article 10: Capital Base

(1) Figure 2 above presents the calculation of the total minimum capital requirements for credit, market and operational risk. The capital ratio is calculated using the definition of regulatory capital and risk-weighted assets. The total capital ratio must be no lower than 8%.

(2) For supervisory purposes, should be defined in two tiers in a way which will have the effect of requiring at least 50% of a bank's capital base to consist of a core element comprised of equity capital and published reserves from post-tax retained earnings (Tier 1). The other elements of capital (supplementary capital) will be admitted into the Tier 2, which is limited to 100% of Tier 1.

(3) As such, in defining the constituents of capital funds, a two-tier system is adopted as follows:



Article 11: Capital Base

- (1) Figure 2 above presents the calculation of the total minimum capital requirements for credit, market and operational risk. The capital ratio is calculated using the definition of regulatory capital and risk-weighted assets. The total capital ratio must be no lower than 8%.
- (2) For supervisory purposes, should be defined in two tiers in a way which will have the effect of requiring at least 50% of a bank's capital base to consist of a core element comprised of equity capital and published reserves from post-tax retained earnings (Tier 1). The other elements of capital (supplementary capital) will be admitted into the Tier 2, which is limited to 100% of Tier 1.
- (3) As such, in defining the constituents of capital funds, a two-tier system is adopted as follows:

Capital Elements	Current Period
Tier 1 Capital	
Paid Up Ordinary Share Capital	
Paid Up Non Cumulative Perpetual Preference Shares	
Share Premium	
Retained Profit/(Loss)	
Surplus after Tax Arising from The Sale of Fixed and Long Term Investments	
Current unadjusted net profits on a half-yearly basis	
Innovative Tier 1 Capital	
Tier 1 Minority Interest	
Other Reserves	
less:	
Goodwill	
Deferred Tax Assets/(Liabilities)	
Others (please specify)	
Total Tier 1 Capital (Core Capital)	-
Tier 2 Capital	
Property Revaluation Reserve	
Ordinary Shares Capitalised from Property Revaluation Reserve	
Cummulative Perpetual Preference Shares	
Minority Interest in Cumulative Perpetual Preference Shares of Non Wholly Owned Subsidiaries	
Approved Hybrid Debt Capital Securities Issued	
General Allowance for Bad and Doubtful Debts and Financing	
Maximum Allowable Subordinated Debt/Sukuk Capital	
Total Tier 2 Capital	-
Total Eligible Tier 2 Capital	
less:	
Investment in Subsidiaries	
Investment in Insurance Companies	
Holdings of Other Banking Institution's Capital Instruments	
Investment in Property funded by Shareholders' Fund*	
Other Deductions	
Capital Base	-

Article 12: Risk-Weighted Assets

- (1) Total risk-weighted assets are determined by multiplying the capital requirements for market risk and operational risk by 12.5 and adding the resulting figures to the sum of risk-weighted assets for credit risk.
- (2) For on-balance sheet and off-balance sheet in credit risk, they are assigned to the relevant Risk Weight Assets (RWA) bucket and multiplied by the appropriate risk-weight; 0%, 20%, 50%, 100% and 150%.
- (3) Unlike the credit risk (RWA) calculation, the market and operational risk calculation results directly in a capital requirement. It can be converted to RWA calculations by multiplying with 12.5, (inverse of 8%).

Article 13: The Standardized Approach for Credit Risk

- (1) The capital requirements under the Standardised Approach for Credit Risk is determined based on an approach that link predefined sets of exposures or classes of assets to predefined risk weights.
- (2) In principal a risk weights for the exposures of Islamic banks shall be determined based on recognized rating of an external credit assessment institution (ECAI), preferential risk weight for the regulatory retail and residential real estate portfolios, or specific rating prescribed by DAB for specifically identified exposures. In addition, this Framework also recognizes wider range of credit risk mitigation techniques.

Article 14: The Standardised Approach for Market Risk

- (1) Market risk is defined as the risk of losses in on- and off-balance sheet positions arising from movements in market prices. The standardised approach for market risk shall address the following:
 1. Benchmark rate risk and equity risk pertaining to financial instruments in the trading book;
 2. Foreign exchange risk and commodities risk in the trading and banking books;
 3. Inventory risk arising from Islamic banks' business activities; and
 4. Treatment of options.

Article 15: The Basic Indicator Approach for Operational Risk

- (1) The measurement of the capital for operational risk is based on the Islamic Financial Services Board (IFSB) in Basic Indicator Approach.
 1. Under Basic Indicator Approach the Operational Risk capital charge shall hold capital for operational risk equal to the average over the previous three years of a fixed percentage (denoted alpha) of positive annual gross income.
 2. Gross Income Figures for any year in which annual gross income is negative or zero should be excluded from both the numerator and denominator when calculating the average.
 3. The Bank need to keep 15% of its Gross Revenue in receives to cover all it financing out.
 4. In the basic indicator approach the measure is a Bank's average annual gross income over the previous three years. The average is multiplied by a factor 0.15 is set by Basel Committee to produce the capital requirement.
- (2) The three standardized approaches for capital computation will be formulated and the detailed frameworks will be circulated in the specific guidelines of capital adequacy requirements.

Article 16: Enforcement Date

These Regulations shall be enforced after approval by high council of DAB and the previous regulations shall be null and void.