



**Shari'a Quality Rating**

AA (SQR)

*This rating means that DIBL conforms to very high level of standards of Shari'a requirements in all aspects of Shari'a quality analysis.*

**Strengths**

- A highly efficient and effective Shari'ah Supervisory Structure.
- The SSC is headed by a well known Shari'a Scholar, Professor Mufti Munib-ur-Rehman who has forty years of Fatawas experience.
- DIBL has approved procedures and manual for Shari'ah compliance, audit and control.
- The Shari'a Supervisory Committee (SSC) enjoys close working relationship with the shareholders, Board of Directors and the executives of the bank.
- DIBL has committed itself in providing training in Islamic banking to all its employees through intensive internal and external courses.
- A significant portion of bank's assets consist of Mudarabah, Ijarah and Musharakah based transactions.

**Suggestions**

- The depositors may be offered assistance in calculating and distributing Zakah.
- A policy could be adopted to enhance further the share of more desirable participatory modes of financing.
- Activities aimed at benefiting the society at large could be emphasized further as a bank policy.

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## **Introduction**

Pakistan's sixth Islamic commercial bank, Dawood Islamic Bank Limited (DIBL), officially commenced operations on Friday, April 24, 2007. The Bank is the result of an initiative of the First Dawood Group who joined with the Islamic Corporation for the Development of the Private Sector (ICD) Jeddah, which is a wholly owned subsidiary of Islamic Development Bank –Jeddah, Unicorn Investment Bank - Bahrain, which is a full fledged Shari'ah compliant Investment Bank Al Sufat Investment Company - Kuwait, Gargash Enterprises (LLC) - Dubai, Mr. Azam Essof Kolia - a Singapore based entrepreneur and Shaikh Abdullah Mohammad Al-Romaizan, an entrepreneur from the Kingdom of Saudi Arabia.

The bank was established with an initial paid-up capital of Rs. 3 billion (US\$ 50 million), (which has now reached to PKR 5 Billion) with a vision of establishing a network of branches all over the country to provide financial solutions to all segments of an increasingly Shari'ah conscious business and consumer society.

DIBL asserts that it is focused on corporate customers. DIBL believes that there is a growing segment of importers and exporters who are reluctant to utilize conventional banks financing due to the absence of Shari'a compliance solutions to their needs. To meet such kinds of banking customers' needs, is one of the major objectives of DIBL.

The bank had 21 branches as at the end of year 2008 (up from 7 at the year of start) with a dispersed geographical presence that includes 11 branches in Karachi, 2 in Lahore, Multan and Khushab and 1 in Islamabad, Faisalabad, Sialkot and Rahimyar Khan.

By the end of first quarter of 2009 the bank had 391 employees (up from 220 as at end of year 2008). Total assets amounted to 10.5 billion PKR (up from 7.8 billion PKR one year ago) while Shareholders' equity amounted to 5.09 billion PKR (up from 4.1 billion one year ago.) Total deposits equalled 4.97 billion PKR (up from 3.41 billion one year ago) while total financings equalled 5.29 billion PKR (up from 4.46 billion one year ago.)

The Board of Directors consists of the following members:

Mr. Rafique Dawood	Chairman
Mr. Ayaz Dawood	Director
Mr. Aamir Hussain Khan	Director
Mr. Mohammad Tariq	Director
Mr. Azam Essof Kolia	Director
Mr. Jamil A. Qureshi	Director
Mr. Adel Yousef Al-Sqabi	Director
Mr. Shehab M. Gargash	Director

### **Shari'ah Compliance – State Bank Regulations**

The Islamic Banking Department of the State Bank of Pakistan (SBP), the central bank of Pakistan, was established in 2003 to develop Islamic banking as a “parallel and compatible banking system in the country.”<sup>1</sup> It has since issued a series of regulations governing all aspects of Islamic banking in Pakistan. The government's objective is to increase the market share of Islamic banking assets from the current

<sup>1</sup> Islamic Banking Department website <http://www.sbp.org.pk/departments/ibd.htm>

5% to 12% by 2012 through increasing outreach in urban consumer and corporate markets and extending the market to cover new segments of Islamic Micro Finance, Agriculture Finance and SME finance<sup>2</sup>.

A basic feature of SBP regulation is the requirement for prior approval by the SBP for appointment of a Shari'ah Advisor by all Islamic Banking institutions. He shall be appointed according to the Fit and Proper Criteria for Shari'ah Advisors issued by the SBP Shari'ah Board and his decisions shall be binding on the Islamic Banking institution (IBIs). IBIs are free to appoint a Shari'ah committee/board at their own discretion but this is not part of SBP regulation<sup>3</sup>.

The fit and proper criteria prescribe criteria for education; experience and exposure; track record; solvency and financial integrity; honesty, integrity and reputation. The Shari'ah advisor of one IBI cannot hold the same position in other IBI.

The SBP instructions for Shari'ah compliance specify Shari'ah compliant modes of banking and finance that may be adopted by IBIs. These are divided into participatory modes, trading modes/ debt based modes and other modes. IBI's may develop new products with prior approval from their Shari'a Advisor. Before introducing new products to the market the IBI shall submit to the Shari'a Advisor salient features of these products for his approval and after getting Shari'ah advisor approval, the approved products are submitted to the director of Islamic Banking Department of SBP along with proper approval obtained by IBIs from their Shari'a Advisor.

The SBP has developed essentials and instructions for major Islamic modes of financing such as Murabaha, Ijarah, Salam, Istisna'a, Mudarabah and Musharakah. IBI's are required to comply with these essentials and instructions as the minimum. For modes not included with these the IBI may use AAOIFI Shari'a standards with consultation with their Shari'a Advisor.

It is a requirement that all IBIs maintain a charity fund and proper accounts and records regarding all transactions relating to this fund. Amounts available shall be substantially utilized by the IBI within the same accounting year in which it is accrued or in the subsequent year Under the supervision of Shari'ah advisor.

The SBP declares that IBIs should introduce a system of internal Shari'a audit so as to ensure that the goals and objectives of Shari'a compliance are achieved<sup>4</sup>. At least one internal Shari'ah audit shall be conducted during the year for a stand-alone branch<sup>5</sup>. In case of difference of opinion between the Shari'ah advisor and SBP inspection staff or departments regarding Islamic banking practices, the issue shall be referred to the SBP Shari'a board for final decision.

IBIs are required to submit a weekly statement of position to the SBP and shall submit other statements regarding their Islamic banking operations as prescribed from time to time.

### **DIBL Shari'a Supervisory Structure**

The Shari'ah supervisory structure at DIBL works through an Internal Shari'ah Supervisory Committee (SSC) consisting of three members. This SSC is headed by a well known Shari'ah Scholar, Professor

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<sup>2</sup> SBP Strategic Plan for Islamic Banking Industry in Pakistan

<sup>3,5</sup> SBP Branch Opening Guidelines

<sup>4</sup> SBP Guidelines for Shari'a compliance in Islamic Banking Institutions

Mufti Munib-ur-Rehman who has forty years of “Fatawaas”(Shari’ah pronouncements) experience. For external purposes he is the Shari’ah Advisor of DIBL, to compliance with SBP regulations in this respect. Two other members of the SSC are also qualified Shari’ah scholars from recognized religious institutions and have moderate experience of “Fatawaas”(Shari’ah pronouncements). The functions of the SSC are a combination of Shari’ah supervisory over the development and operations of DIBL’s products and services and review and monitoring of Shari’ah internal control mechanism. The Board of Directors first appointed the head of Shari’ah Supervisory Committee (the head of SSC) Professor Mufti Munib-ur-Rehman and upon his recommendation the two other members of the SSC were appointed. The scope of SSC’s functions has been given full coverage in the Shari’ah Compliance Manual which has been duly approved by the Board of Directors. Thus the head of SSC has direct reporting line to the Board of Directors.

The branch network is divided into two main centers: Karachi and Lahore. About 80% of the assets side financing is done through Karachi where the members of the SSC sit on almost all working days and check almost each and every transaction of DIBL. The SSC supervises the financing transactions from pre-execution of financing contracts to post financing performance of the customers. For the initial two years of DIBL’s operations, a Financing Risks Division (FRD) manager was appointed at Lahore centre after getting extensive training on Shari’a compliant products and services. The FRD manager was delegated by management to oversee Shari’a compliance issues at Lahore with the approval of Shari’ah Advisor and he has very close liaison with the head of SSC as regard the Shari’ah compliance of products and services is concerned. Though FRD manager takes all measures to make sure the Shari’ah compliance, still almost every major financing transaction at Lahore is referred to Karachi centre before execution to attain approval from all aspects including Shari’a. Thus each financing transaction is also reviewed by the members of SSC on regular basis. The SSC also monitors the profit calculation and its distribution among the depositors on monthly basis. The SSC also conducts surprise Shari’a review of the financing transactions based on well planned internal Shari’a audit.

Thus the above said structure of SSC is the same as that used by most other Islamic banks and in the model assumed by AAOIFI governance standard for Islamic financial institutions.

The two members of SSC (other than the head of SSC) also act as internal Shari’a controllers, although this is typically outside of their role as part of the SSC. Thus, in the initial period of operations DIBL has had a separate Internal Shari’a Control department (i.e. not part of the organization structure). In this capacity these two members report directly to the head of SSC along with sending copies of their reports to the CEO. The head of SSC meets with the members of the Board of Directors at each board meeting.

The head of SSC attends DIBL on a daily basis for 50% of normal working hours while the other two members attend DIBL on full time basis. While the members of SSC are specialized in Shari’ah matters, DIBL required a professional who is experienced in both application of Shari’a rulings and commercial banking operations to not only develop the Shari’ah compliant banking products and services and to get their approval from the SSC but to serve as a an intermediary between the SSC and other staff to smoothly apply the Fatawaas/Shari’ah pronouncements issued by SSC for different products and services starting from their pre-execution stage till their post execution applications. Mr. Mujeeb Beig is currently handling this role. Mr. Mujeeb has experience in both Shari’ah rulings applications and commercial banking as he is not only banker but is also a qualified post graduate diploma holder with silver medal from one of the most recognized Islamic Finance educational institutions, Centre for Islamic Economics, headed by Sheikh Taqi Usmani. This institute is a division of one of the most recognized religious educational institutions of Pakistan Dar-ul-Uloom Karachi. He also delivers presentations and lectures on Islamic banking and finance concepts regularly at different national and international forums and at different educational institutions as well.

Thus the Shari'a structure at DIBL consists of three components, each with its own functions. In the following sections we will examine in more detail the documentation and functions of each component and provide an appraisal of the adequacy of documentation and efficiency of performance related to the effectiveness of Shari'ah compliance at DIBL.

## **I. Internal Shari'a Supervisory Committee(SSC)**

### Meetings of SSC and their Agenda

The SSC met 14 times in 2007 and 28 times in 2008. The duration of meetings ranged between 30 minutes to two hours to allow necessary time to complete the agenda. The meetings discussed issues relating the operations of DIBL based on the Shari'ah approval given by SSC, the products structures and the legal documentation of the products as per Shari'ah principles and to issue Fatawaas/Shari'a pronouncements for these products and legal documentation if they are found Shari'ah compliant. If necessary, modifications are suggested. Further, these meetings also focused on the discussions and approval of new contracts, modification in existing product structures as per customers requirements and considering specific transactions/contracts with specific clients. The final decisions are taken by the head of SSC, Mufti Munib-ur-Rehman, after having done thorough discussions with the other two members of SSC.

The meetings of SSC, held subsequent to the initial meetings (which was held for considering the approval of DIBL's products and services) along with their legal documentation, often focused on fresh issues which were highlighted during the operations of DIBL and because the internal Shari'a committee members attend DIBL on a daily basis, thus the frequency of such meetings in 2007 was at least one in a month and in 2008 the frequency was at least two in a month. The meeting minutes are taken by one of the SSC member Mufti Syed Sabir Husaain who is the designated person for this task. In some cases the minutes were found brief describing only the result of the meetings. In other cases, minutes were detailed describing the sequence of discussions which led to the decisions. Mufti Syed Sabir Hussain explained that this difference is according to the methodology set by SSC according to the level of meeting's importance.

Following are some examples of meetings agenda:

- Discussing all products and services along with their legal documents – this was the agenda of the first SSC meeting where it revisited all products and services which had already been reviewed by the Shari'ah advisor to ensure strict Shari'ah compliance, while executing transactions based on such products and services.
- Investment in different a particular Sukuk and syndicated financing
- Implementation of Islamic Financial Accounting Standard -2 on Ijarah
- Charity fund utilization policy
- Permission to provide advisory services for An Islamic mutual fund.
- Dress code for female staff
- Approving transaction structure and contract based on restricted Musharakah
- Training of staff
- Review of polices, procedures, manuals of different Divisions/departments of DIBL
- Shari'a Inspection review of Lahore and other Branches
- Profit computation and distribution among Rabb-ul-Maal
- House financing to a beauty parlor – the issue was whether to sell a house to a parlor who will pay back from proceeds of his partly non-Shari'a compliant business.

## Terms and Procedures

The head of SSC 's role is governed by the terms of reference of the Shari'ah Advisor given by SBP and by the Shari'a compliance manual of DIBL.

### **Shari'a Compliance Manual**

This manual has three sections relating to the functions of SSC related to the Shari'ah supervisory for the approval and applications on DIBL's products services and departmental policies and procedures, Internal Shari'ah control mechanism over DIBL's operations and reporting to Board of Directors. These sections are hereby explained as follows:

#### i) Appointment of head of SSC

This section states that the head of SSC shall be appointed by the Board of Directors based on criteria prescribed by the State Bank of Pakistan. Terms and conditions must be agreed between DIBL and the head of SSC prior to appointment. Termination power shall be with the BOD and that termination and resignation must be notified to the SBP within 14 days. The rulings of the head of SSC shall be binding on DIBL.

#### ii) Duties and Responsibilities of head of SSC

This section states that the head of SSC shall ensure that all products, services, policies of each and every department and their applications and other operational arrangements of DIBL are Shari'ah compliant. If any income is declared non-Shari'a compliant by the head of SSC then such income shall be credited to the charity account. The head of SSC is to have access to all records, documents and information and management is responsible to provide any relevant information to the head of SSC. The head of SSC shall review operations of DIBL on periodic basis in coordination with the other members of the SSC and the head of product development and research. The head of SSC may provide advice to legal counsel, auditor or consultants if requested. The head of SSC shall arrange Shari'a training programs in coordination with management for the bank's employees or will authorize the other members of SSC or head of product development and research to conduct training.

#### iii) Report of head of SSC

This section prescribes that on annual basis one report shall be prepared by the head of SSC and to be published in DIBL's annual report to the shareholders. The report shall include the head of SSC's declaration of conduct of examination; opinion on Shari'a compliance of DIBL affairs; whether allocation of funds, weightages and profit sharing ratios, were Shari'a compliant; and whether non-Shari'a compliant income has been credited to charity account.

#### Conflict Resolution in Shari'a Rulings.

This section stipulates that the SBP Shari'a Board shall have the final decision over any difference of opinion arising between head of SSC and SBP inspection staff or other departments. In case of differences between head of SSC and DIBL management, the matter shall be referred to the BOD who will decide regarding whether the matter be referred to SBP Shari'ah Board or Shari'ah advisor rulings be accepted in spite conflicted with the management view point on certain matters

## Terms of Reference of head of SSC

This document contains 20 terms which specify the applied tasks of the head SSC which principally reinforce the provisions of the Shari'a compliance manual.

### History and major components of annual reports

The head of the SSC has produced two yearly reports for 2007 and 2008 addressed to the shareholders and published in the bank's annual report. The reports consists of three parts. The first part is a declaration of the liability-side products approved by the head of SSC during the course of the year. The second part is a declaration of the asset-side products approved during the course of the year. The third part consists of seven observations which were observed and reported by the head of the SSC in his report for the year ended 31 December 2008 .

In summary, the head of SSC stated that where he felt doubt that execution of Murabaha contracts possession of DIBL over the goods could not be ascertained/confirmed (e.g. Murabaha on raw milk) he stopped DIBL's management to execute such Murabaha transactions. He explained that the members of SSC tried their level best to examine DIB's financial transactions to the maximum extent, starting before their execution till their conclusion and also observed their post execution affects. This continuous Shari'ah supervisory control allowed the bank to identify and rectify negligence, errors and omissions before making the financial transactions voidable. He also explained that he endeavored his best to ascertain that Murabaha, Ijara and Diminishing Musharakah transactions have been conducted in the proper Shari'a compliance sequence and that charity/donations imposed on clients resulting from late payments have been duly received and deposited to a charity account.

Regarding utilization of charity contribution, the head of SSC stated that DIBL is awaiting BOD approval to utilize charity as a policy in order to commence distribution of charity amounts. Some clients requested a waiver to charity applied to them due to unavoidable circumstance. The head of SSC exempted them from the payment of charity through DIBL but explained that it is not possible to exempt them from their obligation to God to whom they professed an undertaking to make charity and that the clients should make charity in the ways of God when they become able to do so. Finally, the head of SSC stated that DIBL has prepared a compliance record system to aid in ascertaining proper sequencing of transactions.

### Shari'a audit plan

The head of SSC produced one plan each year for the year 2007 and 2008 respectively. Both plans cover almost all areas of operations. Here we consider the Shari'a audit plan for 2008.

The plan for 2008 is a comprehensive statement by the head of SSC which includes areas which the head of SSC and other members of SSC intended to cover in 2008.

It covered charity, Islamic export refinancing schemes, syndicate arrangements and financings, Sukuk purchases, profit sharing ratios, profit payment to fund providers, Murabaha business and operational expenses and training. The plan stressed that the two members at Karachi centre and the FRD manager at Lahore centre shall inspect all legal documents and their applications starting from pre-execution stage to their conclusion. It also explained that deficiencies found at the pre-execution stage of financings would be referred to the Corporate Banking Division and Financing Risk Division before the financing transaction is executed. The post-execution stage inspection shall review all documents and the performance towards contractual obligations of the clients to verify existence of proper ownership taking by DIBL over assets in the process of earning profits.

The head of SSC further explained that because of adopting techniques to carry out continuous Shari'ah audit by the SSC to verify almost all transactions, both in Karachi and Lahore, starting from pre-execution stage to the conclusion of the financial transactions, the need for formal internal Shari'a audit will be minimized. This means that SSC may conduct at least one visit per year to each outstation branch of DIBL including Lahore. This was done in 2008. The plan went on to establish that, prior to any corporate financing, the head of R & D is to visit the client and explain the mode of finance to be extended.

## **II. Role of members of SSC (other than head of SSC)**

The head of SSC's role is complemented with two Shari'a scholars who are the members of SSC, namely Mufti Syed Sabir Hussain and Mufti Syed Zahid Siraj. The profile of both is annexed to this report. Their role for the past two years included the following two major functions.

- The first function was to attend meetings with the head of SSC in the capacity of "full fledged Shari'a scholars."
- The second function was to review all financial transactions of DIBL at Karachi centre and conducting at least one Shari'a review of the financial transactions at Lahore centre and other outstation branches.

### Reports

During the first two years of operations, the relatively small volume of transactions permitted the two members of SSC review all executed transactions at Karachi centre on the asset side for consumer banking, corporate banking and investment banking and treasury functions. All legal transactional documents were checked immediately after signing the contract and all the financial transactions were reviewed after their execution till their conclusion. This was done under the continuous supervision of the head of SSC. This allowed immediate rectification of errors, omissions, mistakes, and negligence. For this purpose in each case of rectification required, prior to the execution of financial transactions, they sent their advises to the head of R&D who performed accordingly and delivered the corrected financial transactions documents to the members of SSC and explained to them how the concerned department took the measures to get the financial transactions documents corrected.

Regarding Lahore centre, one Shari'a internal audit report was produced in 2008 after one of the SSC member's visit. The Shari'a compliance manual (as will be described below) does require at least one outstation visit by at least any one of the SSC member. The reason for this, as explained to us, is that the Lahore centre represents only 20% of the financial transactions and that its internal Shari'ah audited based on the Shari'ah transactions check list guided by the head of SSC is conducted on continuous basis by FRD manager at Lahore centre. The above said Internal Shari'ah Audit report did covered only Murabaha transactions only, being 65% of the total transactions volume. The member of the SSC who visited Lahore explained in his report the reason that "we focused on Murabaha transactions only during the visit as generally we feel that this mode of finance has more operational risks than Ijarah and Diminishing Musharakah, but will focus later on InshaAllah other modes as well." There were no reports in writing for outstation branches located in Multan, Khushab, Islamabad, Faisalabad, Sialkot and Rahimyar Kna, because these branches do not extend assets side financing and just perform the functions for the liability side(deposits). Instead, any member of SSC may visit from time to time to answer queries and confirm proper documentation for the liability side products as well. Such visits were conducted to some branches one time each. The said report was addressed to the CEO with a copy to the head of SSC and the concerned departments. It included a list of mistakes discovered in a number of audited transactions along with the member of SSC request for further clarification and recommendations on how to fix/avoid these mistakes in future. The last section of the report included general recommendations on how to improve



Shari'a compliance of Murabaha transactions. The report mentioned that the Lahore centre promised to send five files of completed transactions related to Murabaha, Ijara, Diminishing Musharakah, on a random basis in order to be inspected by the members SSC. This was not done in 2008. At a later stage, the concerned departments at Lahore centre responded to this report and provided their comments to the SSC. This information was properly passed on to the head of the SSC who used it in formulating his overall opinion at the end of the year in the shape of his annual report to the shareholders of DIBL.

### Terms of Reference

The Two members' of SSC (other than the head of SSC) role is governed by the Shari'a Compliance Manual of DIBL and the terms of reference for them. On the review function, they use sections 3 and 4 of the Shari'a compliance manual of DIBL and a review checklist for each type of financing transactions.

### **Shari'a Compliance Manual of DIBL (Section 2)**

#### Section 2 – Scope and Guidelines for Internal Shari'a Audit in DIBL

This section aims to outline an effective system of internal Shari'a audit “so as to ensure that the goals and objectives of Shari'a compliance are achieved.” The audit is to be conducted by “the head of SSC or other two members of SSC and the Head of Product Development and Research will assist them.”

The manual says that the Shari'a audit will be conducted before execution, during the execution and after the execution of financial transactions till their final conclusion. The Shari'a auditor is given the right to conduct surprise visits to any of the branches.

The section explains that internal Shari'a audit may either form part of the regular internal audit or may be conducted separately. There shall be no scope limitation or restriction of access to information to the members of SSC in the capacity of Shari'a auditor(s) who will perform this duty unless proper Internal Shari'ah audit staff is appointed in the Internal Shari'ah Audit Division of DIBL.

The reports of internal Shari'a audit shall contain observations and assessment of systems and controls in place and recommendations for potential improvements and corrective actions. These comments shall be placed before the concerned group head(s) and the Chief Executive Officer. Any disputes or differences between the head of SSC and management shall be referred to the CEO to attempt to solve them. If queries are not resolved within the given time then these shall be placed before a committee of senior DIBL executives. If there is a stalemate then the head of SSC has the right to report the issue in his annual report to the shareholders. The head of SSC may also, formally or informally, meet with the BOD to discuss or resolve any issues.

### **Terms of Reference for the members of SSC (other than head of SSC)**

This document complements the Shari'a compliance manual. This following is a summary of this document:

- The two members of SSC (other than head of SSC) will coordinate with head of SSC in all matters.
- They will inform the Head of Research and Product Development for incorporating Shari'a modifications time by time in products and services and their legal transaction documents as and when prepared.
- They will arrange meetings of the Head of SSC with the group heads of different departments.

- They will present reports to the head of SSC regarding products and services structures and their legal documentation time by time as and when prepared.
- They will take minutes of all SSC meetings with the senior officials of DIBL; will manage meetings of the head of SSC; and will represent head of SSC in any meeting not attended by the head of SSC for any reason.
- They will seek head of SSC's approval of promotional material.
- They will undertake research or assignment if directed by the head of SSC.
- They will share his Shari'a opinions with the head of SSC in giving replies to different issues.
- They will be compensated by DIBL as per the policy.

### Shari'a Compliance and Review Procedures

#### **Shari'a Compliance Manual of DIBL (Sections 3 and 4)**

##### Section 3 – Shari'a Guidelines for Investment in Shares

This section includes five guidelines. The first guideline states that DIBL may, in the normal course of its banking operations, invest in shares or extend funding to stock/equity brokers. Only those companies with acceptable core business activities will be chosen and these will be further evaluated based on ratio filters as advised by the head of SSC. These filters are not specified in this document but an informal copy is available with the members of SSC and were reported in some of the minutes of SSC meetings.

The second guideline states that in the event a portion of an investee company's income comes from non-Shari'a compliant sources, DIBL's dividends will be purified and channeled to charity.

The third guideline states that DIBL will abide by regulatory limits to exposure.

The fourth guideline states that "DIBL shall submit a summary of each asset and liability side product to Islamic Banking Department, State of Pakistan."

The fifth guideline states that the head of SSC enjoys full discretion in deciding whether to exercise Shari'a audit on all transactions or some on a sample basis and that he will decide whether he wants to appoint one of SSC member or Head of Research and Development department or to conduct the Shari'a audit by himself.

##### Section 4 – Shari'a Guidelines for Profit Distribution for Liability Side Products

This section prescribes that DIBL shall focus on proper recording of earning assets and the associated income and that profit and loss sharing ratios must be fixed at the beginning of each month. The method of allocation of expenses and policy for charging provisions against non-performing assets or income generated from PLS must be clearly stated. The distribution policy shall be subject to Shari'a audit by the head of SSC. The profit distribution figures must be displayed in branches and DIBL website. Figures for special deposits or treasury deposits may be withheld and solely disclosed to the relevant party.

#### **Product Review Checklist**

Product review checklists are available for asset side products which consist of Murabaha financing, Mudarabah facility, Diminishing Musharakah and Ijarah. These checklists are applied on all transactions at the Karachi and Lahore centre and they were put in place soon after the start of financial transactions by

DIBL. They have so far only been applied on Murabaha transactions at the Lahore centre during one of SSC member’s visit in 2008.

The Murabaha financing checklist is reproduced here:

INTENSITY

100%    75%    50%    25%    10%

							<i>Shariah Review</i>
Review Date:		Reference No.					
Name of the Company		Sino-Pak Electro Chemical Industries (Pvt) Limited					
Type	<i>Murabaha Financing</i>	Funding No	Draw down No	D/Date			
e							
Type	<i>Murabaha Financing</i>	Finance No	288	Draw down No	01	D/Date	
Maturity Date		No of Days		Profit Rate		14-06-2008	
Cost		Profit		Total			

SUMMARY (Checklist)

- 01 Murabaha Facility Agreement      ▪ Dated: 04-06-2008
- 02 A- Description of Goods
- 03 B- Purchased Order Form
- 04 C- Declaration
- 05 GRN/ Delivery Challan /Bill
- 06 Sales Tax invoice /  
Commercial Invoice
- 07 Customer’s Offer to Purchase
- 08 Bank’s Acceptance
- 09 Receipt

The right hand column of the checklist would include any one of the SSC member’s comments on the availability and compliance of the mentioned criteria on the left. The Intensity table refers to the seriousness level of the violation. Each level of seriousness has a special color attached to it. Depending on the findings one of these colors would be added in the right column of the checklist to indicate the level of seriousness.

**III. Assessment of head of SSC functions in light of AAOIFI Governance Standard No.2 - Shari’a Review**

This standard was established to “assist Shari’a Supervisory Boards of IFIs in performing Shari’a reviews to ensure compliance with Islamic Shari’a Rules and Principles.” According to the standard, the review must be carried out in three stages. The first stage (Planning and Designing) is the joint responsibility of SSB and management. The second and third stages are the responsibility of the SSB. Relevant portions from these stages are reproduced below.

- *Stage 1: Planning and Designing Shari’a Review Procedures*

Findings:

1. The Shari’a compliance manual of DIBL gives the head of SSC the freedom to plan as he feels necessary. The head of SSC has produced an annual Shari’a review and audit plan at the start of each year. This plan is formulated and approved by the head of SSC with a copy sent to the CEO and the

head of R&D. The two annual Shari'ah review and audit plans stated the areas which the head of SSC intends to cover throughout the year. The most important area is the continuous monitoring and review of day to day transactions of DIBL.

There must be a distinction between planning for the Lahore centre and Karachi centre, when the transactional volume is increased at Lahore centre as well. The Karachi centre enjoys the privilege of the availability of the head of SSC and the other members of SSC who perform the supervision of Shari'ah applications review and auditing process continuously on all transactions, leaving little room for deficiency in overlooking non-Shari'a compliant functions/transactions/income. However, the annual plan could be further enhanced by prescribing at least four visits during the year to the Lahore centre and by explaining how many reports the head of SSC expects to receive during the year. It must also explain how the head of SSC plans to cover the other branches and how many times he expects from other members of SSC to conduct their visits.

2. The head of SSC has approved a Shari'a review checklist for each type of financing activity as was described above. This is an important positive aspect of Shari'a review design. As the bank's business expands there will appear more avenues to expand review design.

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- *Stage 2: Executing review procedures and preparation and review of working papers.*

“At this stage all the planned review procedures are executed. The SSB review procedures shall normally include:

- Obtaining an understanding of the management's awareness, commitment and compliance control procedures for adherence to Shari'a
- Reviewing of contracts, agreements, etc.
- ascertaining whether transactions entered into during the year were for products authorized by SSB
- reviewing other information and reports such as circulars, minutes, operating and financial reports, policies and procedures, etc.
- consultation/coordination with advisors such as external auditors; and
- discussing Findings with an IFI's management

The execution of the above review procedures shall be documented in work papers which shall be complete, neat and cross referenced to review procedures.”

#### Findings:

1. The head of SSC understands the attitude and awareness of management about Shari'ah because he attends regularly at the bank and maintains a close view on its operations. This contributes in giving him the correct perspective to identify the areas that need to be addressed at the start of each year. He communicates his findings to the management through the head of R & D, who promptly follows up with the senior management and replies to head of SSC.

2. The head of SSC does not report directly or interact with the Board audit committee. It is preferred to include this function in the terms of reference of the head of SSC. Similarly, it is preferred to identify

cases where the head of SSC might need to meet the external auditors and include these in the terms of reference.

3. The findings of the head of SSC are usually documented in his annual report to the shareholders and in the documents produced by the other two members of SSC. At the moment, the number of transactions at the bank does not require further complication of documenting the review procedures. But as the bank expands it is better to start documentation with cross referencing to the Shari'a Review Manual and the Shari'a Review Checklist as this will keep track of the whole process for future reference.

The purpose of cross referencing is to ensure that terms of reference of the head of SSC are not overlooked. This happens very often in this industry. In many cases, only a few items of terms of reference are implemented. One way to alleviate this problem is to produce a comparison between work done by the head of SSC and the terms of reference of the head of SSC. This comparison shall be detailed and comprehensive.

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- *Stage 3: Documenting conclusions and report*

“The SSB shall document their conclusions and prepare their report to the shareholders based on the work done and discussions held...”

Findings:

1. The head of SSC produces an annual report sent to the shareholders as was described earlier. This report is informative and gives details behind the head of SSC's findings, which is an important feature of reporting.

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**IV. Analysis: Internal Shari'a Governance and Activities and reports in light of AAOIFI Governance Standard No.3 – Internal Shari'a Review**

The purpose of Standard No.3, which consists of five pages, is to provide guidance on the internal Shari'a review in IFI's. The standard requires that internal Shari'a reviewers are to have no executive authority or responsibility for the activities they review. The performance of internal Shari'a review is described in four sections which will be of concern to this rating report as follows:

- *Section I: General – this section explains the necessity of planning the review. This includes: obtaining background information about the activities to be reviewed such as location, products/services, branches and divisions; establishing review objectives; obtaining Fatwas and resource; communicating the plan to all concerned individuals; obtaining plan approval from SSB; and other areas.*

Findings:

1. The Shari'a compliance planning at DIBL is a function of the head of SSC not the other two members of SSC. They are required to implement the plan as produced by the head of SSC. An assessment of the head of SSC's planning was given earlier.
2. The two members of the SSC (other than head of SSC) are given the right by the Shari'a compliance manual to have access to any information they may require, helped by the head of R & D, who acts as an effective link between SSC and other departments, we detected no adverse issues in their ability to obtain information. This is helped by the convention at the bank that all transactions shall be reviewed first before execution and will be monitored after execution. This positive aspect is constrained by the fact that there is inadequate planning for reviewing the Lahore centre. However that was tried to be covered by internal Shari'ah audit, besides continuous assistance in monitoring the transactions by the FRD manager posted at Lahore centre having proper Shari'ah training and experience.
3. The charity policy as approved by the head of SSC gives "two main reasons for building up charity...:
  - a) If any income is declared non-Shari'a compliant by the head of SSC, the same is transferred from income account to Charity Funds Account;
  - b) If the client does not pay its dues/financial obligations on due dates, he pays charity as per his promise for the days during which default continues."

The charity policy goes on to include the relevant section from the State Bank of Pakistan regulation. The existence of charity policy that is approved by head of SSC is an important element of planning the review.

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*- Section 2: Examining and Evaluating internal Shari'a review information – this section explains Shari'a auditor's responsibility in collecting, analyzing and interpreting preliminary information and documenting the review process in appropriate working papers.*

Findings:

1. The members of the SSC document the review process in the review checklist described earlier in this report. Their comments are communicated to the concerned department through the head of R & D and then communicated back to the coordinators with the answers. The same is applied for the Lahore office during the sole visit during the year. No evaluation was conducted for other branches because they do not extend financing.
2. It is also observed that the coordinators have not reviewed other than Murabaha transactions at Lahore centre. The explanation provided (that Murabaha is the more risky mode) is not satisfactory and is not based on profound basis. This aspect should be addressed by the head of SSC.

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*- Section 3: Reporting – explains that reporting must be based on appropriate discussions with management and that at least quarterly Shari'a control reports are to be sent to the Audit*

Committee with a copy to SSB and management; and requires the report to be objective, clear, constructive and timely and to present the purpose, scope and results of internal Shari'a review, and it shall contain an expression of the reviewer's opinion and the reviewee's views about the Shari'a review. It shall further include recommendations for improvement and corrective action and acknowledge satisfactory performance where appropriate.

Findings:

1. This section emphasizes the need to report to the audit committee on a quarterly basis. This is currently unavailable at DIBL and has to be initiated by the coordinators.

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- *Section 4: Follow Up* – explains that “Shari'a reviewer shall follow to ascertain that appropriate action has been taken on Shari'a review findings and on any other Shari'a Findings of SSB, external auditors and regulatory bodies.”

Findings:

1. The Shari'a coordinators follow up at Karachi centre through their continuous presence. There has also been adequate correspondence and follow up following their visit to the Lahore centre. All correspondence is kept on record by the Shari'a coordinators. The coordinators correspond with other branches by phone or they may conduct a visit but there is no uniform basis for these visits so far.

### Accounting Regulations

The bank uses Financial Accounting Standards in general and IFAS I for Murabaha and IFAS II for Ijarah as per State Bank of Pakistan regulations.

### Training and Human Resources

There is one comprehensive course offered internally over a period of three days presented by Mr. Mujeeb Beig, head of R & D. This course is offered based on need by the employees. Every new employee of the bank is required to attend this course by Mr. Mujeeb. The members of SSC delivered their presentations as well in this course. The head of SSC could not participate regularly in the training due to his other activities as he has to look after the affairs of a big recognized religious institution in the morning (during the timing of training)

DIBL informed us that it had sent 33 employees to external training in 2007 and 41 employees in 2008. We find the level of employees' knowledge in Shari'a as conducive to Islamic banking. We conclude this based on the Shari'a coordinators' remarks on the products checklists which included no major discrepancies and based on our dialogue with the head of R & D who was satisfied with the level of knowledge within the bank.

The internal training course is conducted in three days and includes 16 sections. The following table gives the outline of these sections, summarized from the detailed outline provided to us by DIBL:

Section	Contents
1	Different types of Riba, the consequences of applying Riba on the economy and the wisdom in prohibition of Riba
2-4	Equity based modes of financing + case studies
5-7	Non-equity based instruments + case studies
8-9	Ijarah as a semi debt contract + case studies
10-12	Some sub contracts such as debt trading and kafalah, trading in financial instruments and Islamic instruments for conventional money and Capital markets
13	The Islamic Contract at a Glance
14	Securitization and Salam based securities
15	Services, foreign exchange, LC, LG, cash transfer
16	Risk management methods, modes of Collection of Funds, modes of disbursement of funds, modes of placement of idle funds

### Zakah

The Zakah payment and calculation is directly supervised by the State Bank of Pakistan under the Zakat and Ushr Ordinance of the year 1980. Each year on the first day of the month of Ramadhan the SBPK automatically deducts the Zakah amount if the bank meets the prescribed criteria. All funds go to Bait-ul-Maal fund run by the SBPK.

The Zakah calculation and distribution service is not available to the bank's clients. Only payment on behalf of shareholders is made each year as described.

### Social Action

The financing policy of DIBL states that "The core objective of the bank is to make a positive contribution to the fulfillment of socio-economic obligations of the society in all spheres, including trade, industry and agriculture sector.."

The mission of DIBL states that DIBL provides financial products by following several key objectives including "Investing time, talents and resources in the social progress of the Ummah and establishing banking services in areas – urban and rural – which are so far not covered without for seeking the profitability of the institutions."

We were informed by management that the State Bank of Pakistan has recently mandated all banks to open rural centers to serve underserved communities. Consequently, DIBL has completed the establishment of one branch at Iqbalabad and is setting up another branch at Jauharabad. These branches are expected to provide necessary banking services to underdeveloped areas and to poor people in these areas. While these branches serve such communities, though we could not distinguish between DIBL and other banks in Pakistan because this step is a regulatory requirement, but our query was responded that DIBL is planning to establish such rural branches over and above SBP regulatory requirements to pass maximum benefits of Islamic Banking at low costly products and services to the maximum level of population. Thus, favorable pricing to the poor or sustaining losses to support these communities would be of high regard to this rating.



### **Modes of Financing**

In the latest quarterly report (March 2009) total financings compose approximately 50% of total assets. Modaraba composes approximately 4% of total assets while Diminishing Musharakah captures nearly 21% of total assets. Total Mudarabah and Musharakah capture about 25% of total assets. Ijarah composes approximately 6.6% while Murabaha captures around 18% of total assets. The other assets comprise of investments in Sukuk largely based on Ijarah mode.

DIBL's financing policy does not prescribe a certain percentage for Mudarabah and Musharakah modes. Management informed us that the minimum in the balance sheet shall be 20% for both Mudarabah and Musharakah. It is a better practice to include this in the financing policy in order to ensure this policy shall be properly implemented in the future. This would further emphasize management's regard for the aims of Shari'a which promote profit and loss sharing schemes.

### **Identity and Corporate Image**

DIBL's The bank's Islamic identity is manifest in its name and the two minarets making up its logo. Its vision statement is "to be the best provider of customer centric Shari'a compliance services and products in Pakistan and to help its customers to succeed financially and to promote economic and social progress in Pakistan through innovative Shari'a compliant products..." The mission statement is "to serve as a trusted provider of Islamic financial products and services, by focusing on the following key objectives... Support and maintain a sustainable growth for clients, shareholders, employees, Ummah and the country and meeting its financial goals and measuring its success against the best performing Islamic and conventional peers in Pakistan."

### **Other Considerations**

DIBL's main branch has a room dedicated for prayer. Employees may also perform prayer at their office. We were informed that other branches do also have prayers room as well. There are currently no separate ladies branches but management informed us that it is in progress of creating these branches. There is no gender separation at work but females are required to wear a head scarf.

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