

Shariah Advisor's Report - 2014

الحمد لله رب العالمين، و الصلاة و السلام
على خاتم الأنبياء والمرسلين، محمد المصطفى
الأمين، وعلى آله وأصحابه أجمعين، وبعد:

By the Grace of Allah, the year under review was the thirteenth year of Islamic commercial banking for Meezan Bank Limited. During this year, the Bank developed and executed a variety of new as well as established Islamic banking products and transactions after due approval from the Shariah Supervisory Board and/or Shariah Advisor. During the year, the Shariah Supervisory Board (SSB) reviewed various products, concepts, transactions, processes and their Shariah-compliance, referred to them by the Shariah Advisor.

As part of the Shariah-compliance framework a full fledged Product Development & Shariah Compliance (PDSC) department is working under my supervision. The role of this function is facilitating new research & product development activities, refining existing products & procedures, providing Islamic banking training, conducting Shariah audit & compliance reviews of branches and departments, coordinating with the Bank's Shariah Supervisory Board and providing Islamic Financial Advisory services to both local and foreign institutions.

Following were the major developments that took place during the year:

Research & New Product Development

During the year the Bank successfully completed the amalgamation transaction of HSBC Pakistan's operations with Meezan Bank in a Shariah compliant manner. The whole activity of amalgamation, starting from the Amalgamation Agreement till Product Mapping and execution was conducted according to the guidelines of the Shariah Supervisory Board and under my direct supervision.

On the new product development side, since providing Shariah Compliant financing solutions to the service industry was an issue. Alhamdulillah, the Bank developed two solutions based on Running Musharakah to cater the financing requirement of this segment.

The Bank's Salam based financing to Punjab Food Department is a major step towards providing solutions for converting the Government Borrowing into Shariah Compliant financing, which is an encouraging sign.

During the year the Bank remained focus on increasing the ratio of Shirkat ul Aqd based financing which is commendable while Bank launched foreign currency (FCY) based Running Musharakah to increase the scope of Shirkat ul Aqd.

In order to further strengthen the level of Shariah Compliance while executing various transactions, the Bank issued detailed Shariah Compliance Guidelines for Sight and Usance LC, Import and Export Close out in FX Transactions and guidelines for giving NOC to other Banks.

During the year the structuring and documentation of more than 15 syndicated transactions were reviewed under my supervision most prominent of them were Engro Rupiyah Retail Sukuk, Engro Fertilizer Sukuk, LalPir Short term Shirkat ul Aqd Sukuk and project financing transactions for Power sector. The Bank was also successful in providing off-balance sheet solutions to various clients based on the model of Agency and Operating Lease.

Being a leading Islamic Bank, Meezan Bank had the privilege of working closely with State Bank of Pakistan for bringing in Industry reformatations on various industry issues such as Open Market Operations, Lender of Last Resort, Islamic LTTF Financing, Shariah Governance Framework, Structuring and Documentation of M2 Sukuk transaction and recommending ways to make Prime Minister's Youth Financing Scheme Shariah-compliant.

Alongside this as members of the Steering committee for the Promotion of Islamic Banking and Finance created by the Finance Minister, we are actively contributing in the committee with our Vision of establishing Islamic banking as banking of first choice.

Training & Development

During the year 74 Islamic banking training sessions were held which also included Orientation and Product training sessions for HSBC staff, special Product training for Control Group of MBL and purposefully designed training program for Area Managers of Meezan Bank Limited.

During the year Meezan Bank successfully completed the 7th batch of Islamic Banking Certification course Level 1 and also completed 3rd batch of Islamic Banking Certification course Level 2 which is an advanced-level certification program consisting of case studies, assignments, projects etc designed to enhance the Islamic banking expertise of the Bank's employees. Besides this, the Bank also conducted comprehensive six days advance-level Islamic banking courses for Branch Managers, Operation Managers and senior front-end employees at Karachi, Lahore and Multan Regions. Deposit Refreshers and new deposit product-specific training sessions were also held on regular basis throughout the year.

Meezan Bank organized 39 awareness seminars which were attended by more than 8500 participants representing customers, general public and professionals.

Shariah Advisory

Alhamdulillah, on the Islamic financial advisory side Meezan Bank continued its outreach both locally and internationally by sharing its expertise, knowledge, experience and the success story of Meezan Bank with its clientele.

In the international market, the Bank is in the process of certifying Temenos banking software in compliance with recognized Shariah standards such as AAOIFI. The Bank also received the mandate of assisting a global rating agency in assigning Shariah Governance ratings to leading Islamic Financial Institutions in the world.



In the area of Islamic capital markets, the Bank continued to advise all major Islamic mutual funds mainly comprising of those offered by Al-Meezan Investment Management Limited (AMIM) and NBP Fullerton Asset Management Limited (NAFA), regarding establishment & launch of various types of Shariah-compliant Mutual Funds. During the year, the Bank advised AMIM under my supervision on the management of eleven funds. Further the Bank facilitated the launch of two capital preservation funds and two capital preservation plans; whereas two funds and one plan are currently in the pre-launch phase. The Bank also advised NAFA on the management of six funds including the launch of two capital protected funds and one savings plan.

Meezan Bank, being the major player in the establishment of KMI-30 Index (KSE Meezan Islamic Index) which is Pakistan's first ever Shariah Compliant Islamic Index, continued to advise Karachi Stock Exchange (KSE) regarding matters related to the re-composition of KMI-30 Index. The Bank is also assisting KSE in launching a new index named KMI All Shares Index which would include all Shariah compliant stocks.

During the year, the advisory team organized a workshop in collaboration with Chartered Institute of Management Accountants (CIMA) UK on the topic 'Shari'ah Audit Framework for Islamic Financial Institutions'. The workshop had representation from leading Islamic financial institutions of the country.

Meezan Bank achieved a milestone this year by introducing Shariah advisory services for Takaful companies. Meezan Bank will assist companies in strategic business plans, Shariah supervisory framework, Waqf deed and rules, Product development, Capacity building, Manual, Policies, Investments guidelines and Shariah audit services.

The Bank also received the mandate of structuring a Term Finance Certificate as per Shariah guidelines to be issued by Treet Corporation. This perpetual Sukuk has been structured based on Shirkat-ul-Aqd basis with uncapped profit ratio along with the options of conversion and redemption at specific intervals. It is encouraging that this would be the first time that any company has issued a Sukuk based on pure Musharakah.

The Bank also continued to provide advisory services for Islamic consumer sales product to United Sales (Pvt.) Ltd. (USL), a subsidiary of Dawlance group under the umbrella of Diyanat financing.

Review of Assets

The Bank primarily used Murabaha, Ijarah, Diminishing Musharakah, Musawamah, Istisna, Tijarah, Musharakah and Salam for its financing activities during the year.

It is encouraging to note that the Bank has moved towards diversification in the usage of various financing products and has reduced the reliance on Murabaha, as is evident from Bank's financing portfolio. In this context it is extremely encouraging to experience a significant growth of 8% (approx) in Musharakah & Running Musharakah share in total financing portfolio. Share of Istisna increased by 2%, while the share of Diminishing Musharakah, Murabaha and Ijarah remained at 25%, 15% and 6% of the total financing portfolio respectively. The Bank's total financing portfolio reached Rs.183.3 billion (gross) as of

December 31, 2014. All these transactions were executed using Shariah-compliant financing agreements.

Financing Modes	2013 %	2014 %	Growth/(Decline) %
Diminishing Musharakah	29	25	(4)
Murabaha	28	15	(13)
Istisna	20	22	2
Musharakah & Running Musharakah	8	16	8
Ijarah	7	6	(1)
Salam-Bill	4	3.6	(0.4)
Tijarah	2	1	(1)
Salam-Commodity	0	6	6

* Figures are rounded off to the nearest.

Review of Liabilities

On the liability side, the Bank offered different Shariah-compliant deposit products based on the mode of 'Mudarah' & 'Qard'. Total deposits of the Bank increased by 31% and reached a sum of Rs.380 billion as at December 31, 2014. During the year, the Bank also accepted deposits on the mode of Musharakah for short-term liquidity management from inter-bank market and corporate clients.

Throughout the year, the process of allocation of assets and funds to various deposit pools; announcement of overall profit sharing ratios for Mudarah-based deposits; monthly allocation of weightages and distribution of income to deposit accounts was monitored and reviewed in accordance with Shariah rules and principles.

Shariah Audit & Compliance Reviews

The Shariah Audit function plays a vital role in achieving the objective of ensuring Shariah compliance by evaluating the adherence to Shariah guidelines in each and every activity undertaken by the Bank. The Shariah Audit function keeps a continuous check on all activities starting right from the time of opening of a branch and goes hand in hand at each step of product offering till the stage of final profit distribution to the customers.

Shariah Audit of 388 branches and departments was conducted as a part of the Bank's efforts to strengthen the internal Shariah controls mechanism. These audits not only cover the transactions that the branches/departments undertake but also include an evaluation of the Shariah knowledge of staff.

On the financing side, the Bank's PDSC team makes extra effort to understand the customer's business model before approving or renewing any facility. Frequent customer meetings, factory visits and reviews of business processes and transactions are undertaken to ensure that the facility being offered to the customer is delivered through a process that ensures compliance with Islamic Shariah. Shariah Audit of the process of profit distribution to depositors is also conducted periodically to ensure adherence to Shariah guidelines.

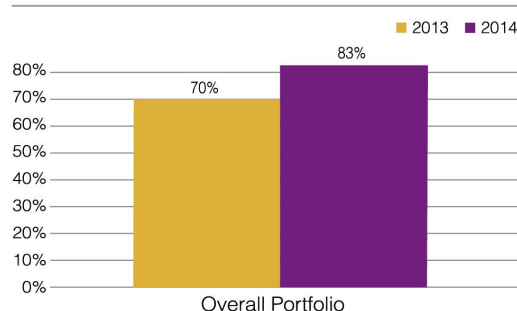
During the year, credit approvals, restructuring of financing facilities, customer-specific transaction process flows, text of LGs and security documents were reviewed to ensure Shariah compliance while offering financing products to the customers.

As part of its ongoing activities, the PDSC department approved more than 1000 product structures and process flows for its clients. Moreover, random physical inspections and concrete measures were taken to verify the purchase evidences and invoices of financing transactions, thus further improving the quality of internal controls. In Istisna and Tijarah transactions, existence of goods were ensured by conducting 100% physical inspections at the time of taking delivery of the goods.

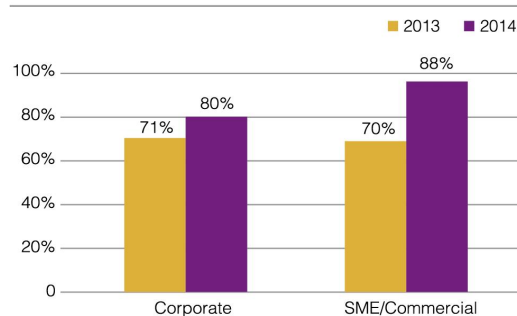
I am pleased to highlight that during the year 2014, direct payments for Murabaha financings to Corporate and SME/commercial customers increased by 13% while overall the percentage of direct payment increased to 83% against 70% in the previous year. It is highly recommended that efforts be continued to increase, or at least maintain, this percentage of direct payment of Murabaha transaction.

Summary of Direct Payment in Murabaha Financing for Meezan Bank

Overall Direct Murabaha Financing Year-wise Trends in %



Customer-wise Segregation Year-wise Trends in %



(The percentages above are rounded off)

An exercise of gauging the basic understanding of the staff about the structures and concepts of Islamic banking & finance was also conducted by way of interviews and on the spot training sessions were conducted to address any shortcomings identified during the course of Shariah Audit & Compliance reviews.

The audit covered overall Shariah-compliance of the Bank's operation and their alignment with the guidelines given by Shariah Advisor and the SSB. In the process, following areas were looked into:

- Suppliers' existence was confirmed by visiting the suppliers' premises on sample basis.
- Cross verification of Murabaha transactions with customers' record was done to ensure that the transactional documents represented actual occurrence of events on ground.
- Genuine purchase evidences were obtained to execute Murabaha transactions to ensure that Murabaha disbursements are not availed to set off previous balances with the supplier.
- Agreements for Murabaha, Ijarah, Diminishing Musharakah, Running Musharakah, Istisna, Tijarah and Bai Salam were reviewed.
- Declarations, description of assets, relevant purchase invoices, sequence and order of the documents and time difference between purchases and declaration in Murabaha were reviewed to obviate the possibility of fictitious transactions.
- Murabaha Monitoring Sheets (MMS) and Delayed Declaration Reports (DDR).
- Purchase deeds, treatment of ownership related cost & recovery of rentals in Ijarah transactions.
- Ownership ratio in Diminishing Musharakah for housing and issuance of timely unit sale receipts.
- Investment made in stock with reference to the stock screening criteria.
- Import finance transactions and related documentation.
- Extensive reviews of client payment, purchase cycle and periodic assessment of client's processes.
- Review of day to day treasury operations and execution of products.
- Other related documents and procedures followed by different functional areas.
- Profit-sharing ratio, profit weightages, pool working, asset & deposit allocation for deposit products.

Charity

During the year, an amount of Rs. 31.06 million was transferred to the Charity Payable Account, this includes Rs. 1.78 million to eliminate the non-compliant income portion identified during Shariah audit, Rs 2.65 million to purify the dividend income earned from the investment made in the Shariah-compliant stocks by the Bank and Rs. 26.62 million transferred to charity payable account, in the normal course of business, on account of non-timely payments by customers in various financial transactions. Moreover, an amount of Rs.73.21 million was disbursed from the Charity Account after approval of the Shariah Advisor. Details of Charity are available in note # 19.4.



Recommendation

Based on the review of various transactions and operations of the Bank, I recommend that:

- The Bank should evaluate the possibility of offering its products, services and network in the international market so as to make other people benefit from Islamic banking.
- Bank IT department should immediately focus on establishing an automated system/mechanism for monthly profit calculations and distribution.
- Due care regarding the mindset and commitment towards the cause of Islamic banking should be taken during the process of hiring of new staff. Moreover, it is recommended to increase the scope of Islamic banking knowledge assessment process already implemented for new Branch and Operations Managers to Area Managers, department heads and new joiners at senior level.
- The Bank should continue its policy of expansion to spread Islamic banking and in this regard continue its focus on employees' training related to Islamic banking products and services offered by the Bank with specific focus on front line staff.
- The Bank should reduce its share of Bai Muajjal transactions and focus more on further increasing its Asset base through direct financing to businesses and individuals through the use of approved Shariah compliant modes.

Conclusion

As per the charter of the Bank, it is mandatory on the management and employees to ensure application of Shariah principles and guidelines issued by the Shariah Supervisory Board and Shariah Advisor and to ensure Shariah-compliance in all activities of the Bank. The prime responsibility for ensuring Shariah-compliance of the Bank's operations thus lies with the management.

Based on the extensive reviews of sample cases for each class of transaction, related documentation, processes, profit distribution mechanism for the depositors and management's representation made in this regard, in our opinion, the affairs, activities and transactions, performed by the Bank during the year comply with the rules & principles of Islamic Shariah in light of the guidelines and directives given by the Shariah Supervisory Board, Shariah Advisor of Meezan Bank and SBP guidelines related to Shariah-compliance. The non-compliant income identified during the review is being transferred to the Charity Account.

May Allah bless us with the best Tawfeeq to accomplish His cherished tasks, make us successful in this world and in the Hereafter, and forgive our mistakes.

Wassalam Alaikum Wa Rahmat Allah Wa Barakatuh.

A handwritten signature in blue ink, appearing to read "Dr. Muhammad Imran Usmani".

Dr. Muhammad Imran Usmani
Member Shariah Supervisory Board & Shariah Advisor
Dated: 7th Rabi-ul-thani-1436 H / January 28, 2015