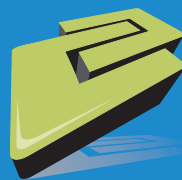


2012

SHARIAH COMPLIANCE GUIDE FOR MODARABAS



NBFI & Modaraba
Association of Pakistan

بِسْمِ اللَّهِ الرَّحْمَنِ الرَّحِيمِ

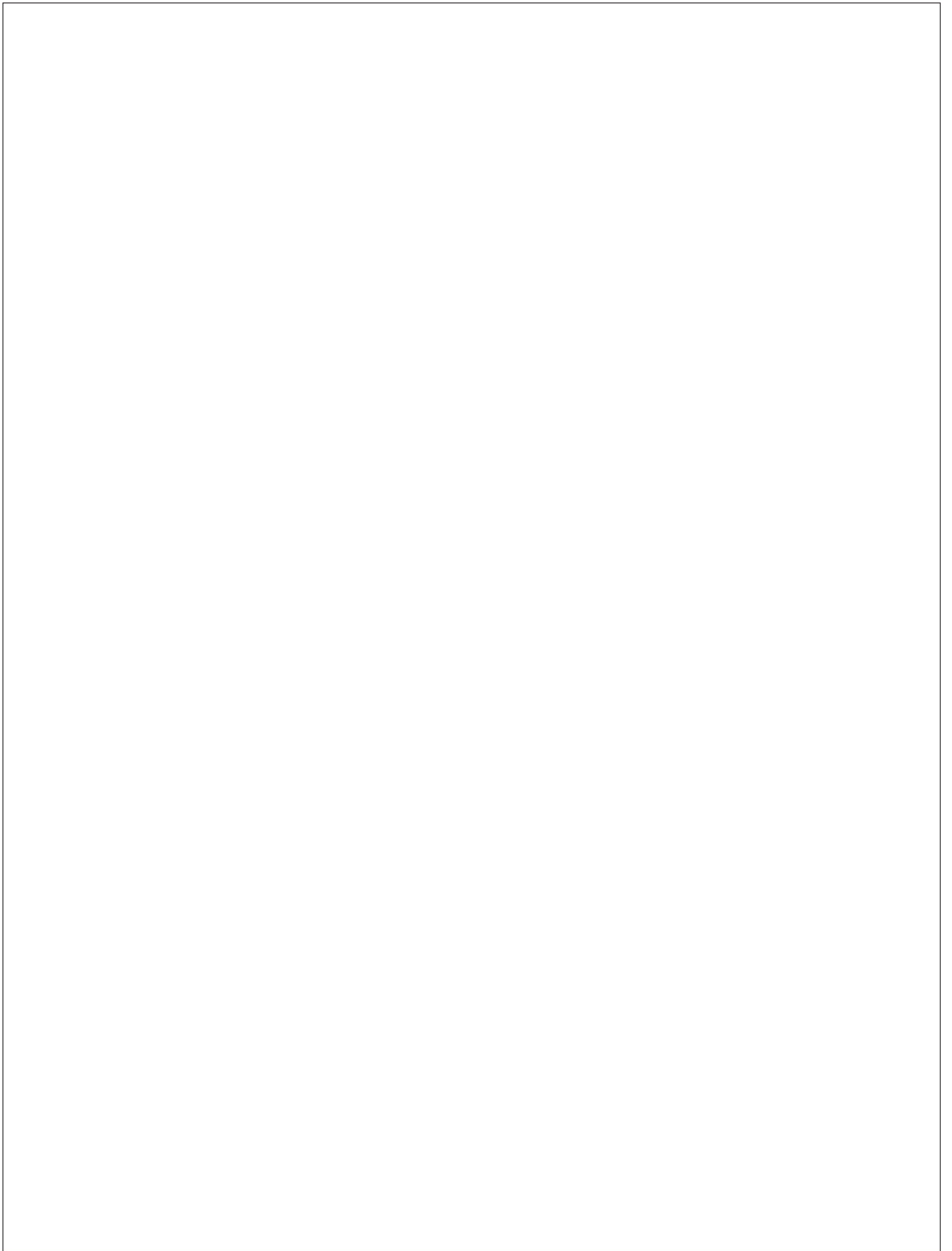
Shariah Compliance Guide for Modarabas



NBFI & Modaraba
Association of Pakistan

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01- INTRODUCTION

Pakistan is the only country that introduced an important Islamic economic activity in modern form - that is Modaraba. The Modaraba is a corporate legal entity which has potential to spread economic impact in the country. This sector is unique in Islamic financial industry.

Modaraba being an Islamic Financial Institution requires compliance of the Modaraba Ordinance, 1980, Modaraba Rules, 1981 Prudential Regulations and Guidelines prescribed by Shariah for Modarabas for its execution. To achieve this objective the Securities and Exchange Commission of Pakistan (SECP) has a Religious Board which approves the business of the Modaraba and provides direction to achieve the Maqasid al Shariah under the control of Registrar Modaraba. Registrar Modaraba is responsible to ensure the compliance of all the regulatory and Shariah requirements by the Modaraba sector.

In a recent move towards quality improvement of Shariah compliance of Modarabas, the Registrar Modaraba SECP has launched the Shariah Compliance Mechanism for Modarabas whereby Modarabas are required to appoint a Shariah Advisor who will look after their Shariah issues and provide them guidance on an on going basis. The mechanism also requires setting up Shariah compliance structure by Modarabas which can ensure compliance at every stage on a continuous basis.

Keeping this need of Modarabas in view, NBFI & Modaraba Association of Pakistan has prepared this Shariah Compliance Guide to help Modarabas in setting up their Shariah compliance mechanism. This Guide explains the requirement of Shariah compliance and provides assistance in developing methodologies for implementation of its various aspects.

The Guide is a consultative document to facilitate and promote a culture of Shariah compliance in the Modaraba sector and will be revised as and when required.

The Association is grateful to Mufti Irshad Ahmad Aijaz and Mr. Muhammad Samiullah for compiling the Guide and to all those who contributed in making it an effective reference document.

Basheer A. Chowdry
Chairman

02- PURPOSE OF THE GUIDE:

This Guide is meant for the use of management and functionaries of Modarabas and its objective is to provide guidelines for the policies, procedures and strategies that help in ensuring Shariah compliance in business operations of the Modarabas.

The Shariah Compliance Guide would serve the purpose of explaining the practical steps required for implementation of Circular No.8 of 2012, issued by Registrar Modaraba. Copy of the Circular is attached as Annexure - I.

This Guide will also explain the functions for Internal Shariah Auditors and Shariah Advisors and their mutual co-ordination so as to ensure a systematic and uniform pattern of Shariah compliance throughout the Sector. This Guide will help stake holders of the Modaraba Sector to understand compliance environment and strength of internal checks and control in the Modaraba regime.

03- SHARIAH COMPLIANCE AND AUDIT OBJECTIVES:

A regular yardstick of Shariah compliance, along with the regulatory or financial compliance, should be applied to all transactions coming in the purview of internal audit to ensure compliance of business operations of Modaraba to Circular 8 of 2012.

The SECP Circular 8 (SCSAM) of 2012 has following objectives:

- ◆ Introduction of mechanism for strengthening the Shariah compliance by the Modarabas, in letter and spirit;
- ◆ Assurance of Shariah compliance in the systems, procedures, policies adopted by the Modarabas, financial products or services offered by Modarabas, agreements entered into by the Modarabas, and the screening process for the investments in shares/securities;
- ◆ Assurance of use of the standard agreements approved by the Religious Board;
- ◆ Mitigation of the reputational and operational risk and enhancing the image and operational framework of Modaraba as Islamic Financial Institution;
- ◆ Introduction of the process for purifications of dividend income, the mechanism for the management of charity, procedure for appointment of Shariah advisor, and to identify the avenues for the investment of surplus funds;
- ◆ Assurance of Shariah objectives of Islamic laws in financial transaction made by Modarabas through introduction of internal Shariah audit system;

To achieve these objectives, this Guide would serve as an operating tool for the Modarabas.

04- SHARIAH COMPLIANCE FUNCTIONS:

As provided in the Shariah Compliance Mechanism, the functions will be carried out at two levels:

a) Appointment of Shariah Advisor:

The appointment of Shariah Advisor is an important step forward to improve Shariah compliance of Modarabas. Within the overall policies, guidelines and documentation prescribed by the SECP Religious Board, the Shariah Advisors shall ensure and provide guidance on operational level and also assist in searching solutions for product structuring and development of practical procedures for execution of transactions according to Shariah discipline.

b) Internal Shariah Audit function:

For strengthening Shariah compliance in the daily transactions internally, it has been provided that the Internal Auditor should be equipped with proper Shariah training to perform Shariah audit on a continuous basis in coordination with Shariah Advisor. The Internal Shariah Auditor would perform Shariah compliance function in terms of practical application of the guidelines of Religious Board and Shariah Advisor and also help the Shariah Advisor to perform his supervisory duties.

05- ROLE OF NBFİ & MODARABA ASSOCIATION OF PAKISTAN:

The co-ordination role of NBFİ & Modaraba Association of Pakistan would be an important factor in assurance of regulatory and Shariah compliance by the Modaraba sector in a uniform and sustained manner. The Association will play the following pivotal roles in this regard, in coordination with its Members and the Registrar Modaraba:

a) Image Building of the NBFİ & Modaraba Sector:

The Association firmly believes that the meticulous implementation of Shariah Compliance Mechanism shall help in image building of the Sector as a responsible component of the Islamic financial regime which, in turn, will gain confidence of all stakeholders, Islamic banks, mutual funds and especially the general public. For this objective to achieve, the Association shall facilitate the compliance structure and encourage its members to be prudent and forthcoming in complying with regulatory and Shariah requirements. Also, any practical difficulties experienced by the Modarabas in implementation of the mechanism will be resolved by the Association in liaison with the Registrar Modaraba and Religious Board.

b) Coordination amongst the Shariah Advisors:

The Association will coordinate, on a continuous basis, with and amongst the Shariah Advisors of Modarabas, to ensure implementation of the Shariah compliance mechanism and to formulate guiding policies and procedures for satisfactory and easy abidance of requirements enunciated in Circular No. 8 of 2012 of the Registrar Modaraba.

c) Periodical review of the Sector:

The Association will review the progress of the Shariah Compliance Mechanism based on the observations and recommendations of Shariah Advisors and the feedback received from its members.

This review would be conducted whenever deemed necessary.

d) Arrangement of training programs:

The Association believes in a continuous skill development process. For this, training and refresher programs for the staff and management of Modarabas would be conducted from time to time. This may also include sharing of mutual experiences on the practicalities of compliance process.

e) Dispute resolution:

The Association will facilitate in resolution of any disagreement between the management and the Shariah Advisor or difference of opinion amongst the panel of Shariah Advisors on any specific issues in line with the decisions and directions issued by the Registrar Modaraba in the similar cases. The Association will provide a copy of the decision to the Registrar Modaraba for all the disputed matters referred to them for resolution. In case the dispute is unresolved, the case shall be submitted to the Registrar Modaraba for final decision of the Religious Board.

06- NATURE OF SHARIAH COMPLIANCE:

a. Concept of Shariah compliance:

The concept of Shariah compliance is similar in nature to the technical concept of compliance which is 'the state of being in accordance with the relevant prudential and regulatory requirements'. Therefore, Shariah compliance is meant for achieving conformity with the guidelines and rulings of Shariah in all matters, aspects and transactions of a business entity.

In the context of Islamic financial guidelines for Modarabas, Shariah compliance would mean state of being in accordance with the relevant Shariah documentation and guidelines issued by Religious Board and also the recommendations, opinions, rulings or Fatwa's of Shariah Advisor for that specific Modaraba.

b. Scope of Shariah compliance:

The following aspects will be included in the scope of Shariah compliance:

- Structure and recording of business transactions of Modarabas;
- Business contracts and agreements of Modarabas;
- Modes of funding and financing or investments;

In addition to these three core functions, the scope will also cover all other sources of revenue earning including but not limited to service charges, placements, acceptances, participation in Sukuks and investments in shares.

Similarly, all syndication, participation or funding arrangements with any financial institutions will qualify for Shariah screening, examination and compliance check.

c. Shariah non-compliance categories:

Non-compliance to Shariah guidelines can be of three categories: (1) Crucial, (2) Significant and (3) Considerable.

The crucial category will include such mistakes, errors and omissions observed in the Shariah audit which are a clear violation of Shariah and, therefore, attract imposition of charity for the income generated through such transaction. Such income would be classified as 'Shariah non-compliant income' that goes to charity and the Modaraba suffers loss of income.

Some mistakes, errors and omissions can affect the status of transaction in terms of violation of recommended process flows or conflicting, imperfect or defective documentation and other similar matters. This will be a significant non-compliance which has the possibility of falling in the category of charity if the relevant deficiencies are not rectified promptly. Such transactions are also prone to be classified as invalid and, therefore, their repetition should be carefully prevented.

A type of non-compliance is also observed when minor deviations from the standard procedures are found. This happens when standard format of approved documents is not used or short cuts are made to avoid the prescribed process-flow. Such deviations are deemed Considerable and the staff should be warned on any such practice because it carries a potential threat of becoming a habitual pattern or developing into serious deviations in future.

07- INVESTMENTS IN SHARES AND SECURITIES:

The investment made by the Modarabas in the shares and securities shall only be made in companies which are Shariah compliant. The shares screening criteria and other details have been explained in Clause III of Part I of Circular No. 8 of 2012. The Shariah Advisor of the Association shall conduct the screening process and publish the list of the compliant securities through the Association once in six months.

It is generally clarified that the listed securities included in the KMI 30 Index of Karachi Stock Exchange, Modaraba certificates, shares of Islamic banks and Takaful companies and units of Islamic mutual Funds will not require any screening. In case, any Modaraba wants to invest in an unlisted company or an entity not previously included in the Association list, it may refer the matter to its Shariah Advisor who will forward the proposal with due rationale to the Association for approval.

08- IMPLEMENTATION OF COMPLIANCE REQUIREMENTS:

The following measures and mechanism would help in ensuring high standards of Shariah compliance:

a) Shariah Compliance of Model Agreements:

- i) An agreement portrays the contractual picture of relationship between Modaraba and its customer and, therefore, its meticulous execution is very critical and important. All Modarabas / Islamic NBFIs should use the model agreements approved by the Religious Board of SECP in March, 2008 (or those prescribed or amended thereafter), copies of which have already been provided to the Modarabas and also placed on the website of the Association. In case of need, these may be obtained from the Association.
- ii) Such agreements shall remain in force and be treated as model agreements by all Modarabas until reviewed or amended by the Religious Board on the recommendations of the Registrar Modaraba. In case of any major or significant amendment effecting the structure of the transaction, a Shariah Advisor may refer the case to the Association with detailed rationale of the proposed changes. The Association may seek opinion of other Shariah Advisors before referring the matter to the Registrar Modaraba.

b) Development of Process Flows and Standard Operating Procedure (SOP):

- i) Every Modaraba needs to develop process flow or standard operating procedures (SOP) for every product or mode of business for assets or liabilities being used by it. These SOPs should be carefully vetted by Shariah Advisor approved by the Management. Based on the practical experience gained by the Modaraba, the SOPs may be reviewed as and when deemed necessary by the Shariah Advisor and the Management.

The Modarabas should develop their operational capability in order to maintain and improve such SOPs in coordination with their Shariah Advisor.

- ii) The product SOPs should explain the transaction flow on a step by step basis and should introduce certain checks to ensure that there is no element of riba, gharar (ambiguity), gambling (speculation) or non-permissible businesses.

A sample SOP is attached as Annexure - II which may be used by Modarabas to develop their own product SOPs.

c) Approval of transactions structure:

- i) The standard transactions structure of all business modes or products to be used by the Modaraba should be documented and approved by the Shariah Advisor and countersigned by the CEO for the use of Modaraba staff and Internal Shariah Auditor as a SOP as explained above. Once it has been achieved, the transactions conducted under standard approved structure would not require additional approval of Shariah Advisor in each and every case. However, any exceptions or deviations observed by the Internal Shariah Auditor and not rectified by the Modaraba management will be referred by the Internal Shariah Auditor to the Shariah Advisor for his opinion or review.
- ii) Any special financial arrangements (for which standard agreements are not available), special purpose structures, syndicated financing and transactions involving multiple modes should be presented to Shariah Advisor and his clearance and guidance received in writing preferably before making any firm commitment with the client or counter-parties. In case further guidance is required, the matter may be referred to the Registrar Modaraba.

d) Review of transaction files upon renewal:

At the renewal of relationships with the existing clients, the transaction should be reviewed by Internal Shariah Auditor, previous executed transactions should be checked and only upon satisfaction of the past transaction, the renewal would be processed. Any compliance discrepancies and deviations found in the earlier cases should be taken care of in the renewed process, fresh documentation completed according to the prescribed SOPs and, where necessary, new checks put in the renewal approval keeping in view any non-compliance risks according to the nature of the transaction. Any deviations should be placed before the Shariah Advisor for his review.

e) Shariah compliance reporting:

- i) Besides seeking guidance of the Shariah Advisor on need basis from time to time, the Internal Shariah Auditor of the Modaraba shall submit a quarterly Shariah compliance report to the Management and the Shariah Advisor. A copy of this report will be included in the agenda of the Audit Committee at the time of reviewing the Modaraba accounts for the respective quarter for the Board approval. Any deviations, un-rectified deficiencies or the Shariah Advisor's comments or observations will be reported to the Audit Committee by the Internal Shariah Auditor for discussion and taking appropriate action, including referral to the Board if deemed necessary. In particular, frequently repeated deficiencies will be reported to the Management by the Internal Shariah Auditor ensure rectification thereof and appropriate actions.

- ii) Such report should comprise of number of transactions executed during the period, sector wise distribution of portfolio, nature of transaction (Murabaha or Ijarah etc.), and the amount of income allocated to charity.

09- SHARIAH ADVISOR'S ROLE:

The role and responsibilities of the Shariah Advisor have been clearly defined in Part II of Circular 8 of 2012 of Registrar Modaraba and should be fully understood and implemented by the Modaraba management and the Shariah Advisors who is responsible for Shariah compliance in the Modaraba. The following clarifications may help in this regard:

a) Access to information:

Shariah Advisor would have right to access any information required for Shariah compliance. No information can be kept confidential from him on the ground of business or client confidentiality.

b) Liaison between Modaraba and Shariah Advisor:

- i) Normally the Internal Shariah Auditor will maintain regular liaison with Shariah Advisor on matters which require his opinion or vetting. The Internal Shariah Auditor shall maintain records of discussions, reviews, opinions and other correspondence with Shariah Advisor. It will be useful if the CEO and the Shariah Advisor also meet at least once in three months to discuss the general level of competence and compliance of the Modaraba and to arrange any training or refresher courses of the concerned staff to improve the compliance culture.
- ii) An opinion or advice from Shariah Advisor should be in the form of a written note, document, a facsimile or email. Verbal discussion or text messages would not be considered a proper medium of communication. In such cases a confirmatory email or a document would be required for record.

c) Shariah Advisor's visit:

- i) Shariah Advisor can physically visit the Modaraba as and when required but he shall visit the Modaraba at least once in a quarter and also meet with the CEO and other members of the management. In case of need, he may be requested to participate in the meeting of the Audit Committee or the Board in case of any serious violations.

- ii) All material discussions with and rulings of the Shariah Advisor should be recorded and kept by Modaraba, with the Internal Shariah Auditor or the Company Secretary.

d) Reviewing Shariah audit reports prepared by Internal Auditor:

- i) Internal Shariah Auditor will send reports of his findings covering compliance aspects of the transactions to Shariah Advisor according to the methodology agreed between the Shariah Advisor and the Modaraba management which should be recorded as part of SOPs. These reports will highlight any deviations from the approved process flows and policy guidelines. Reviewing and commenting on these reports will be very important for Shariah Compliance and must be duly recorded in the respective transaction or client file.
- ii) The Shariah Advisor shall compile a report on the Shariah compliance of the Modaraba as prescribed in Clause X (2) of Circular 8 of 2012 on annual basis according to the Annexure A to the said Circular which shall be published by the Modaraba as a part of its Annual Accounts. The report will be discussed by the Shariah Advisor with the Audit Committee and the Board of Directors for publication with the respective accounts.

Annexure:

- I. Circular No. 08 of 2012 dated 3rd February 2012 of Registrar Modaraba
- II. Sample Standard Operating Process (SOPs)
- III. Sample Shariah Compliance Checklist

Annexure - I



In the name of Allah the most beneficent, the most compassionate

**SECURITIES AND EXCHANGE COMMISSION OF PAKISTAN
POLICY AND REGULATION DEVELOPMENT DEPARTMENT
SPECIALIZED COMPANIES DIVISION
(MODARABA WING)**

No. SCD/M/SCSAM/2012-

Islamabad, 3rd February, 2012
10th Rabi-ul-Awwal, 1433 AH

Circular No. 8 of 2012

Shari'ah Compliance and Shari'ah Audit Mechanism (SCSAM) for Modarabas

Section 10 of the Modaraba Companies and Modaraba (Floatation and Control) Ordinance, 1980 (the Modaraba Ordinance) provides that no Modaraba shall be a business which is opposed to the injunctions of Islam and the Registrar shall not permit the floatation of a Modaraba unless the Religious Board has certified in writing that the modaraba is not a business opposed to the injunctions of Islam.

2. The Registrar, on the basis of the business stated in the prospectus, after obtaining from the Religious Board a certificate to the effect mentioned in section 10 and on being satisfied that it is in the public interest so to do, grant a certificate in the prescribed form authorizing the floatation of modaraba on such conditions as he may deem fit. However, no mechanism is in place to ensure and verify that the business affairs of a Modaraba (after floatation) are being managed in accordance with the principles of *Shari'ah*.

3. The Religious Board in its meetings held on December 9, 2010 and June 13, 2011 deliberated upon this situation and directed to introduce a system to ensure and verify that the business transactions of Modarabas are being carried out in accordance with the injunctions of Islam.

4. In compliance with the directions of Religious Board and in consultation with the NBF & Modaraba Association of Pakistan (the Association) a formal mechanism namely *Shari'ah* Compliance and *Shari'ah* Audit Mechanism (SCSAM) has been prepared and is being implemented to eliminate the risk or possibility of any violation of *Shari'ah* principles by the Modarabas.

5. The SCSAM aimed to achieve the following objectives:

- (i) to ensure that the inflows and outflows of resources of Modarabas are free from the following:
 - a. *Riba* (interest, usury or any other form)
 - b. *Qimar* (Gambling)
 - c. *Gharar* (Speculation)
 - d. Support from Business Prohibited by *Shari'ah* (e.g. *Drugs and Alcohol, Tobacco, Pork Related Items, etc.*)

- (ii) to introduce a mechanism which will strengthen the *Shari'ah* compliance by the Modarabas in letter and spirit and ensure that the systems, procedures and policies adopted by the Modaraba are in line with the *Shari'ah* principles;
- (iii) to mitigate the reputational and operational risk and enhance the image and operational framework of Modaraba as Islamic Financial Institution and to ensure that the financial products or services being offered by Modarabas are in accordance with the *Shari'ah*;
- (iv) to ensure that the agreements entered into by the Modaraba are *Shari'ah* compliant, all the financing agreements are executed on the formats as approved by the Religious Board and all the related conditions are met;
- (v) to prescribe the screening process for the investments in shares and other securities;
- (vi) to provide for the process for purifications of dividend income;
- (vii) to introduce the mechanism for the management of charity;
- (viii) to identify the avenues for the investment of surplus funds;
- (ix) to prescribe procedure for appointment of *Shari'ah* Advisor;
- (x) to introduce internal *Shari'ah* audit of the business transactions of Modarabas to ensure that the goals and objectives of Islamic Law i.e. *Maqasad Al-Shari'ah* are achieved and the financial products, instruments and transactions employed, are based on *Shari'ah* norms and principles; and
- (xi) to prescribe any other ancillary matter that may be required for *Shari'ah* compliance and *Shari'ah* audit.

6. Now, therefore, in order to ensure effective *Shari'ah* compliance and to maintain the trust of the stakeholders on the Islamic Financial System, in terms of the certificate granted for authorization to float a Modaraba read with Section 11 of the Ordinance and rule 3 (2) (e) of Modaraba Companies and Modaraba Rules, 1981, the following *Shari'ah* Compliance and *Shari'ah* Audit Mechanism (SCASM) is hereby issued as an additional condition to the Modaraba Authorization Certificate:

Shari'ah Compliance and *Shari'ah* Audit Mechanism

Part - I - *Shari'ah* Compliance

I. Responsibilities of the modaraba company:- Every modaraba company shall ensure that:

- (i) the business of the Modaraba managed by it, is carried out strictly in accordance with the Prospectus approved by the Religious Board and the model Islamic financing agreements and the investment products approved by the Religious Board from time to time are followed;
- (ii) major changes in any of the existing product structures, financing agreements, terms and conditions have a prior written approval from the Religious Board;
- (iii) all material changes in the existing product structures, agreements, terms and conditions are properly communicated to the concerned stakeholders, clients/customers;
- (iv) monitoring and review system of *Shari'ah* compliance is introduced covering all activities and products of the Modarabas;
- (v) proper training is provided in the area of *Shari'ah* compliance to the relevant staff, responsible for the monitoring and review; and
- (vi) irregularities, if any, recorded and reported by internal *Shari'ah* Auditor are rectified under the guidance of the *Shari'ah* Advisor.

II. Investment in shares and other securities:- The investment by the Modaraba in the shares and securities shall only be made in the companies screened by the *Shari'ah* Advisor of the Association in accordance with screening procedure contained in clause III of this SCSAM and subject to the following conditions:

- (i) the purchase and sale of the same scrip on the same day shall not be made; and
- (ii) the shares shall not be sold before settlement i.e. their title and possession has been transferred to the Modaraba, in accordance with the settlement schedule of the Stock Exchange.

III. Screening Procedure:- (1) The screening test of the selected Investee Company (IC) for the purpose of investment in its shares or other securities shall be conducted by the *Shari'ah* Advisor of the Association who shall observe the following criteria before placement of the scrip in the list of *Shari'ah* compliant securities:

- (i) the business of the IC is Halal and in line with the *Shari'ah*;
- (ii) debt to asset ratio of the IC is less than 40%. Debt in this case is classified as any interest bearing debts. Zero coupon bonds and preference shares shall be considered as part of the debt;

- (iii) the ratio of non-compliant investments to total assets of the IC is less than 33%;
- (iv) the ratio of non-compliant income of the IC to total income is less than 5%. The income includes gross income plus any other income earned by the IC;
- (v) the ratio of illiquid assets to total assets is at least 25%;

Explanation: Illiquid asset means any asset that *Shari'ah* permits to be traded at value other than the par.

- (vi) The market price per share is greater than the net liquid assets per share calculated as: $(\text{Total Assets} - \text{Illiquid Assets} - \text{Total Liabilities}) / \text{No. of outstanding shares}$.

Provided that the investment in the Modaraba certificates of a Modaraba, shares of Islamic Banks and Takuful Companies and the units of Islamic mutual funds shall not be subject to screening process.

(2) The screening for each IC shall be performed on half yearly basis. The list of screened listed companies alongwith charity rate of the respective company shall be placed on the website of the Association and a printed copy duly signed by the authorized person of the Association with a confirmation of its placement on the website, shall be sent to the Registrar Modarabas on half yearly basis.

Explanation: Charity Rate means the ratio of non-compliant income of the IC to total income.

(3) The screening of unlisted companies shall be carried out by the *Shari'ah* Advisor of the Association on the requests made by Modarabas on case-to-case basis.

(4) The existing non-compliant investments in terms of clause III shall be divested within the period of one year from the date of this circular.

IV. Dividend Purification Process:- The dividend income shall be purified by deducting the amount equivalent to charity rate for the respective IC from the total dividend income received by a Modaraba.

V. Non-Shari'ah Compliant income not to form part of Modaraba's income:- (1) The income received by a Modaraba from non-*Shari'ah* compliant sources shall not be accounted for as part of income of a Modaraba, inter-alia the following:

- (i) late payment penalty or surcharge received from any client;
- (ii) the part of dividend income pertains to non-*Shari'ah* compliant business activities of IC as calculated in terms of clause IV; and
- (iii) any other income received by a Modaraba from any transaction which was not carried out in accordance with the principles of *Shari'ah*.

(2) All non-*Shari'ah* compliant income received by a Modaraba shall be deemed as a liability of the Modaraba and shall be transferred by the Modaraba Company to a separate account namely Charity Account.

VI. Management of Charity:- The amount credited in the charity account shall be used in the manner and subject to the conditions stated hereunder:

- (i) all contributions or donation from the charity account shall only be made to the approved charitable organizations registered under Pakistani law as charitable organization (trusts, Hospitals etc). The Income tax exemption certificate issued by the Government of Pakistan to that effect shall be considered as an approval for the purposes. Any exception shall be submitted for approval to the *Shari'ah* Advisor of the Association;
- (ii) the purpose of the donation shall be identified; and
- (iii) the amount available in charity account shall ideally be distributed within three months of its transfer. A summary of operations of the charity account shall be published in the Annual Accounts of the Modaraba.

VII. Investment of surplus funds of Modaraba:- The surplus funds of the Modaraba shall only be placed in the accounts to be opened in the Islamic banks or Islamic branches of conventional banks or Islamic Mutual Funds or products offered by a Modaraba or any other *Shari'ah* compliant investment schemes.

Part – II – *Shari'ah* Advisor

VIII. *Shari'ah* Advisor: (1) Every Modaraba company shall have a *Shari'ah* Advisor of the Modaraba appointed on the terms and conditions as it may deem fit, having the qualification and experience and to perform the functions as specified hereunder. The term of office of the *Shari'ah* Advisor shall be three years, which shall be renewable by the Modaraba Company. The first *Shari'ah* Advisor shall be appointed on or before March 31, 2012. The Modaraba Company shall intimate to the Registrar Modaraba about the appointment of *Shari'ah* Advisor and submit his particulars supported with his relevant documents within 7 days from the date of his appointment.

(2) The casual vacancy caused by the resignation or termination of the *Shari'ah* Advisor shall be filled by the Modaraba Company within 30 days of the resignation or termination as the case may be and the intimation thereof shall be made to the Registrar Modaraba in the manner prescribed above.

IX. Qualification of *Shari'ah* Advisor.- (1) No person shall be appointed as *Shari'ah* Advisor unless he is deemed to be a person of acceptable reputation, character and integrity and has:

a. Educational Qualification:

Shahadat ul Aalmia Degree (Dars e Nizami) from any recognized Board of Madaris with minimum 70% marks and Bachelor's Degree with a minimum of 2nd Class and sufficient understanding of banking and finance.

OR

Post Graduate Degree in Islamic Jurisprudence/Usooluddin, L.L.M. (*Shari'ah*), etc. with a minimum GPA of 3.0 or equivalent from any recognized University with exposure to banking and finance.

b. Experience and Exposure:

Must have at least 4 years experience of giving *Shari'ah* rulings including the period of Takhasus fil Ifta; or at least 5 years post qualification experience in teaching or Research and Development in Islamic Banking and Finance.

- c. good knowledge to understand English and make out the required reports;
- d. exposure in the areas of business or finance specially Islamic Finance;
- e. has not been terminated from any organization in any capacity; and
- f. does not hold any executive or non-executive position in any Modaraba or Modaraba company except as *Shari'ah* Advisor.

(2) The Registrar Modaraba may relax the requirement of educational qualification and experience in exceptional cases where the person is otherwise qualified for giving *Shari'ah* rulings on banking and financial matters.

X. Functions and responsibilities of the *Shari'ah* Advisor:- (1) The *Shari'ah* Advisor shall generally perform the following duties and functions in the Modaraba:

- i. to introduce a mechanism which will strengthen the *Shari'ah* compliance by the Modaraba, in letter and spirit and ensure that the systems, procedures and policies adopted by the Modaraba are in line with the *Shari'ah* principles;
- ii. to advise the Modaraba company so as to ensure that the inflows and outflows of resources of Modaraba are free from the following:
 - a. *Riba* (interest, usury or any other form)
 - b. *Qimar* (Gambling)
 - c. *Gharar* (Speculation)
 - d. Support from Business Prohibited by *Shari'ah* (e.g. *Drugs and Alcohol, Tobacco, Pork Related Items, etc.*)
- iii. to review on regular basis that the business conducted, the transactions carried out and the investments made by the Modaraba are in accordance with the

Prospectus of the Modaraba, Islamic Financial Accounting Standards notified by the Securities and Exchange Commission of Pakistan, the principles of *Shari'ah* and goals and objectives of Islamic Law i.e. *Maqasad Al-Shari'ah* are achieved i.e. the financial products, services, related policies and the instruments are based on *Shari'ah* norms and principles;

- iv. to vet the new products and services before its submission to the Registrar for its final approval from the Religious Board;
- v. to make recommendations to the Modaraba company for potential improvements and the formulation of policies in line with the *Shari'ah* principles and to advise about the process of rectification of irregularities pointed out by him;
- vi. to advise on any matter referred to him by the chief executive or the board of directors of the Modaraba Company;
- vii. to conduct and arrange *Shari'ah* training programs for the board of directors/ officers and the staff of the Modaraba; and
- viii. to determine the non-*Shari'ah* compliant income and ensure its transfer to the charity account.

(2) The *Shari'ah* Advisor shall prepare a report on the Modaraba's affairs, to be called as "the Annual *Shari'ah* Advisor's Report" which shall cover the overall *Shari'ah* compliance position of the Modaraba for the whole year and be prepared on the format attached as Annexure-A. The same shall be annexed by the Modaraba Company just after the statutory auditor's report of the annual audited accounts of the Modaraba, to be disseminated to the certificate holders.

(3) Notwithstanding the above, the first report of the *Shari'ah* Advisor shall be prepared and annexed with the half yearly accounts ending on December 31, 2012 and thereafter on annual basis starting from the annual accounts of the Modaraba ending on June 30, 2013.

XI. Powers of *Shari'ah* Advisor (1) Every *Shari'ah* Advisor shall have a right of access at all times to the books, papers, accounts, vouchers, record, information, agreements and reports of the Modaraba, whether kept at the registered office of the Modaraba company or elsewhere and shall be entitled to require from the directors and other officers of the Modaraba company, such information and explanation as he may require for the performance of his duties and the board of directors and all the employees of the Modaraba Company as well as the Modaraba shall be bound to provide the requisite access to the record and information to the *Shari'ah* Advisor.

(2) The *Shari'ah* Advisor shall have direct and regular communications with all levels of management.

(3) The fatwa and ruling of the *Shari'ah* Advisor in all business transactions, not being inconsistent with the ruling of the Religious Board, shall be binding on the Modaraba companies.

XII. Reporting of *Shari'ah* Advisor:- (1) The *Shari'ah* Advisor shall report to the Board of Directors of the Modaraba.

XIII. Dispute Resolution:- In case of any dispute or difference of opinion arises between Modaraba Company and the internal *Shari'ah* auditor on the matters relating to *Shari'ah* interpretation, the same shall be referred to the *Shari'ah* Advisor for the decision. In case of difference of opinion between the *Shari'ah* Advisor of the Modaraba and the Registrar Modaraba on any matter came to his knowledge, the matter shall be referred by the Registrar Modaraba to the Religious Board, whose decision shall be final.

XIV. Performance review of the *Shari'ah* Advisor:- (1) The performance of *Shari'ah* Advisor shall be reviewed by the Registrar Modaraba from time-to-time.

(2) The Registrar Modaraba, after being satisfied that the *Shari'ah* Advisor is not performing his duties as required under this mechanism may direct the Modaraba Company to terminate the services of the *Shari'ah* Advisor before expiry of three years.

Part - III - Internal *Shari'ah* Audit

XV. Internal *Shari'ah* Audit: (1) Every modaraba shall strengthen its existing Internal Audit Department established in terms of regulation No. 1 of Part -IV of the Prudential Regulations for Modarabas, either by appointing a trained internal *Shari'ah* auditor having relevant qualification and experience of the *Shari'ah* audit or train at least one of its existing employees in the internal audit department for the purpose of internal *Shari'ah* audit, on or before March 31, 2012 so that internal *Shari'ah* audit functions becomes fully operational with effect from first day of April 2012.

(2) The training of the internal *Shari'ah* auditor shall be arranged from a well known *Shari'ah* training institute.

XVI. Duties of Internal *Shari'ah* Auditor:- (1) The internal *Shari'ah* auditor shall follow the same reporting norms, as are applicable on the internal auditor under the PRs and the Code of Corporate Governance implemented by the Stock Exchanges.

(2) The minimum required duties of the internal *Shari'ah* auditor shall be to verify on day to basis that the:

- (i) business transactions of the Modaraba are *Shari'ah* compliant;

- (ii) agreements entered into by the Modaraba are *Shari'ah* compliant and financing agreements executed on the formats as approved by the Religious Board, without any major change, and all the related conditions are met;
 - (iii) investments of the Modaraba in the shares and other securities are as per list of the companies screened by the *Shari'ah* Advisor of the Association;
 - (iv) process for purifications of dividend income has been carried out by the modaraba company;
 - (v) non-*Shari'ah* compliant income has been transferred in Charity Account and distributed in accordance with the manner prescribed in this circular;
 - (vi) surplus funds have been invested in the avenues prescribed in this circular; and
 - (vii) to share his findings with the Chief Executive and *Shari'ah* Advisor in respect of all the above items including irregularities, inadequacy in risk management, governance and internal controls which are necessary to avoid non-*Shari'ah* compliant business transactions in the Modaraba.
- (3) The Internal *Shari'ah* auditor shall submit his report on quarterly basis to the board of directors with a copy of the Report to the *Shari'ah* Advisor of the Modaraba.
- (4) The Internal *Shari'ah* auditor shall maintain a liaison with the *Shari'ah* Advisor and seek his guidance and help in case of any difficulty in ensuring *Shari'ah* compliance of any particular transaction.

XVII. Compliance on the internal *Shari'ah* Auditor's Report:- The board of directors of the Modaraba company, in consultation with the *Shari'ah* Advisor, shall take necessary steps on the observations/recommendation of the internal *Shari'ah* Auditor and prepare an action plan with a timetable for compliance. The audit committee of the Modaraba shall monitor the compliance/implementation of the action plan.

7. Since the *Shari'ah* review system is imperative in ensuring such compliance and an effective *Shari'ah* framework will harmonize the *Shari'ah* interpretations, strengthen the regulatory and supervisory oversight of the Modaraba sector and nurture a pool of competent *Shari'ah* auditors, the implementation of SCSAM will help the management of modaraba companies to achieve the objectives of Halal business as enshrined in the *Shari'ah* and emerge as a responsible member of the Islamic financial regime.

8. The provisions contained in the SCSAM are the minimum requirements for *Shari'ah* compliance to be followed by the modaraba companies and Modarabas in the course of their operations. The Modaraba and the Modaraba Companies may include additional requirements and control in their procedures for the sake of more effective *Shari'ah* compliance and prudence.

9. All the modaraba companies are directed to ensure the implementation of the SCSAM in letter and spirit and initiate necessary action for its compliance with immediate effect.

(Jawed Hussain)
Registrar
Modaraba Companies and Modaraba

Distribution:

1. Chief Executives of all Modaraba Companies.
2. NBF and Modaraba Association of Pakistan.
3. Institute of Chartered Accountants of Pakistan.
4. Institute of Cost and Management Accountants of Pakistan.
5. P.S. to all Commissioners, SECP.
6. Executive Director (PRDD-SCD).
7. Executive Director (SD-SCD).
8. Office Copy.

Note: For any query or further assistance the following team members may be contacted:

Name	Designation	Email Addresses
Imran Hussain Minhas	Joint Registrar	imran.hussain@secp.gov.pk
Shahid Mahmood	Joint Registrar	shahid.mahmood@secp.gov.pk
Hafiz M. Wajid Wahidi	Assistant Registrar	wajid.wahidi@secp.gov.pk

Annexure- A

Specimen of Annual *Shari'ah* Advisor's Report

I have conducted the *Shari'ah* review of _____ Modaraba managed by _____ Modaraba Management Company for the financial year ended _____ in accordance with the requirements of the ***Shari'ah* Compliance and *Shari'ah* Audit Mechanism for Modarabas** and report that except the observations as reported hereunder, in my opinion:

- i. the Modaraba has introduced a mechanism which has strengthened the *Shari'ah* compliance, in letter and spirit and the systems, procedures and policies adopted by the Modaraba are in line with the *Shari'ah* principles;
- ii. following were the major developments that took place during the year:
 - a) Research and new product development (Brief on the research and new product development, if applicable)
 - b) Training and Development (detail of training conducted by the *Shari'ah* Advisor of the Modaraba management and staff, if any).
- iii. the agreement(s) entered into by the Modaraba are *Shari'ah* compliant and the financing agreement(s) have been executed on the formats as approved by the Religious Board and all the related conditions have been met;
- iv. to the best of my information and according to the explanations given to me, the business transactions undertaken by the Modaraba and all other matters incidental thereto are in conformity with the *Shari'ah* requirements as well as the requirements of the Prospectus, Islamic Financial Accounting Standards as applicable in Pakistan and the *Shari'ah* Compliance and *Shari'ah* Audit Regulations for Modarabas
- v. profit sharing ratios, profits and charging of losses (if any) relating to any deposit raising product conform to the basis and principles of *Shari'ah*.
- vi. the earnings that have been realized from the sources or by means prohibited by *Shari'ah* have been credited to charity accounts.

Observation(s)

Recommendation(s)

Conclusion

Signature
Stamp of the *Shari'ah* Advisor

Dated:

Standard Operating Process

The sample process flow would help Modarabas in developing Standard Operating Process (SOPs) to ensure Shariah compliance through compiling necessary information about the transaction, its structure and documentation.

It is suggested that every Modaraba should formulate its SOPs separately for all modes of business undertaken by it (like Ijarah, Murabaha, Musharakah, Diminishing Musharakah /Murabaha etc) and get it approved by its Shariah Advisor as a standard reference document. Its contents and rationale should be fully explained to the operating and audit staff members to help promote a culture of compliance amongst them. The Internal Shariah Auditor shall complete the Shariah Compliance Check List in case of every transaction which will remain on record and referred to by the competent authority for authorizing disbursement and also for any subsequent audit.

If the check-list confirms that there is no deviation, violation or exception from the SOP, then the transaction need not be referred to the Shariah Advisor before disbursement. It may, however, be examined by the Shariah Advisor subsequently as the part of his test check exercise. Every exception or deviation from the SOPs which is not rectified before disbursement MUST be referred to the Shariah Advisor for his opinion, guidance and clearance. A proper record of the matters referred to the Shariah Advisor and his rulings must be presented by the Internal Shariah Auditor to the Audit Committee every quarter. All violations requiring transfer of accrued income to Charity Account or any systemic deficiencies in the compliance process must be reported to the Board.

Following procedure should be followed in every transaction of financing carried out by any Modaraba.

I) Initial discussions and draft offer letter:

While doing due diligence of customer and compiling required credit and other information, the marketing officer should also agree with the client a specific mode of financing like Ijarah, Murabaha, Modaraba, Musharakah, Diminishing Musharakah or any other applicable mode. The basic principles of the agreed mode, its documentation and operational disciplines must be explained to the client for his understanding and compliance. The terms must be discussed with the Client and his queries thoroughly replied to.

II) Specific requirements for various modes:

1. Murabaha:

In case of Murabaha following information should be obtained and recorded:

Promise Stage:

- 1.1 The description of goods i.e. all possible details of goods which helps in identification or inspection of goods;
- 1.2 Type of goods / assets to be financed under Murabaha whether it is storable or perishable, seasonal, fast moving or normal turnover goods
- 1.3 Terms of the agreement i.e. disclosure of price and profit to be charged
- 1.4 Application from the Client and execution of the agreement

Agency Stage:

- 1.5 Procurement process of the asset i.e. how would it be ordered and delivered;
- 1.6 Method of price payment i.e. credit from supplier or cash based procurement, is the payment direct to supplier or it is through agent (customer);
- 1.7 Execution of agency agreement (if applicable).

Acquisition Stage:

- 1.8 When will the risk transfer from vendor (supplier) to Modaraba (buyer from supplier) and when would the risk be transferred to customer;
- 1.9 Physical inspection of goods is possible or not. If not what are the reasons? If yes to what extent inspection is possible in terms of percentage of total volume of transactions? What will be time frame for inspection?
- 1.10 In cases where client acts as agent of Modaraba and procures assets/goods on behalf of its principle (Modaraba), the signing of declaration (offer and acceptance of sale between client and Modaraba) is possible before utilization of assets/goods by agent (client)
- 1.11 Is agency agreement intact and signed by agent before he makes purchasing?
- 1.12 Is there any additional conditions agreed with client which are not covered by standard approved agreements?

Execution Stage:

- 1.13 Has the documentation been completed on the appropriate dates at different stages of the transaction?
- 1.14 Has the documentation for security been completed?

Post Execution Stage:

- 1.15 Monitoring as per terms of agreement.
- 1.16 Recovery of installments (principle + profit) and recording of entries.
- 1.17 Penalty in case of delayed payments & accounting entries.
- 1.18 Rebate in case of early payments & accounting entries.
- 1.19 In case of default its classification & accounting treatment.

2. Ijarah

In case of Ijarah following information should be obtained and recorded:

Application Stage:

- 2.1 Complete description of assets i.e. all possible details of asset which helps in identification of asset;
- 2.2 Has the rental schedule been discussed clearly with the Client which has details of rentals i.e. monthly, quarterly, semiannual or annual payment; Are the payments in advance or in arrears? Has the Client been made fully aware of the significance of due date?
- 2.3 Has a proper explanation of ownership and usage related expenses, including insurance and maintenance, been discussed and allocation agreed by the Client and documented?

Acquisition Stage:

- 2.4 Procurement process of the assets i.e. how it is to be ordered and delivered;
- 2.5 How GRN (good receiving note) or delivery confirmation from lessee is to be obtained?

Execution Stage:

- 2.6 Has a proper mention of date of start of Ijarah and due dates for rentals been made?
- 2.7 Transfer of the Assets with the usufruct rights.

Post Execution Stage:

- 2.8 Monitoring as per terms of the agreement.
- 2.9 Recovery of rental and recording of entries
- 2.10 Penalty in case of delayed payments & Accounting entries
- 2.11 Rebate in case of early payments & Accounting entries
- 2.12 In case of default its Classification & Accounting Treatment
- 2.13 Is there any arrangement of sale of Ijarah asset at the end of period of Ijarah? If yes, then it should be explained i.e. is it through separate sale or gift?
- 2.14 Is there any additional conditions agreed with client which are not covered by standard approved agreements? Has that been approved by the Shariah Advisor, in case of any Shariah issue.

3. Musharakah:

In case of Musharakah or DM, some information in addition to the information required for Ijarah, would be required which is as following:

- 3.1 Details of Musharakah asset(s) with complete description should be available.
- 3.2 Asset Information should be confirmed either in possession of client or to be purchased from market
- 3.3 Where required, Client or third party may be appointed as agent under Agency agreement to purchase assets and declaration to transfer title of ownership after acquisition by agent in favour of Modaraba
- 3.4 Share of each Partner (Musharik) in terms of percentage or amount should be defined clearly;
- 3.5 Rental calculation formula and revision frequency should be mutually agreed with out any ambiguity and documented.
- 3.6 Separate agreements/contracts, if required, at different times should be drawn in such a manner and in such sequence so that each agreement/contract is independent of the other in order to ensure that each agreement is a separate transaction
- 3.7 Documentation order for DM is mention below:
 - a) Creation of joint ownership between the co-owners through Musharakah Agreement.
 - b) Execution of Diminishing Musharakah Agreement
 - c) Renting out by one co-owner of his share to other partner through Ijarah / Rental Payment Agreement

- d) Undertaking to purchase the units at a mutually agreed price until the entire ownership of the asset is transferred.
- 3.8 A separate arrangement for sale of units from Modaraba to customer should be made. i.e. Musharaka agreement should not contain such sale arrangement;
- 3.9 Proper and clear mention of risks of Partners should be documented in order to avoid any subsequent ambiguity.

III) Approval of transaction:

The Approval Stages and Approval Limits being implemented by the Modaraba for business transactions, as approved by the Board of Directors, will apply and be verified. In addition, the following may be focused upon:

- a. While taking approval of disbursement from management, the check list for Shariah Compliance should be filled out by the Internal Shariah Auditor along with the check list for credit and regulatory requirements and duly referred to and signed by the disbursing authority.
- b. In case of recurring procedure, one time approval of process flow from Shariah adviser is sufficient. All the other disbursements would be made according to that approved process flow;
- c. In case of any unique or unusual nature of transaction structure, fresh approval of process flow from Shariah adviser would be required;
- d. In case of deviation from normal process flow, written approval of Shariah Advisor would be required;

IV) Review or renewal of limits:

- a. Renewal of finance limits would require review of process flow from Shariah Advisor. Any update in process after audit objection or as process strengthening should be incorporated in renewal cases;
- b. In case serious deviation is observed in Shariah audit, the renewal of limits would require rewriting of the whole process;
- c. It would be a better practice if internal Shariah Auditor's input is sought for considering the renewal cases.

V) Cases of defaults and rescheduling:

- a. In case of default from a customer or request for rescheduling, the financial dues (accounts receivable) should remain unchanged. However, a charity can be received from client;
- b. The charity amounts so collected would be deposited in a charity account and given to approved entities;
- c. In case of Ijarah and DM, an increase in future rental is possible by mutual consent of Modaraba and client or by Modaraba alone if prior consent for such increase has been obtained from client in agreement of Ijarah. However, previous rental dues would remain unchanged as no increase is possible in dues once it become debt (receivable).
- d. The Modaraba can, at its discretion, discount the dues of Murabaha (unpaid installments) or dues of Ijarah (unpaid due rentals) in case of early settlement by the client (rebate on early payment) provided no prior agreement is there between client and Modaraba on such discount.
- e. The future rental in Ijarah or units' redemption price in DM may be increased to cover the losses caused by delay or default of client. This increase may be done by mutual consent of Modaraba and client or by Modaraba alone if the agreements include permission for such increase from client. However, this permissibility of increase should not be used for passing on the ownership losses to client.

SAMPLE SHARIAH COMPLIANCE CHECK LIST

NOTE: The existing check-lists for risk management, regulatory requirements and internal monitoring mechanism already being used by a Modaraba will be completed as usual for every transaction. This additional check list is meant to ensure simultaneous compliance of Shariah requirements and will form an integral part of the overall approval and monitoring procedures of the Modaraba. Separate check-lists for every type of mode like Ijarah, Murabaha and Musharakah are to be developed according to the needs of the mode.

Customer: _____ Account/File Ref: _____
 Mode of Transaction: _____ Financing Amount _____
 Date of Agreement: _____ Date of Commencement: _____

1	Pre-Transaction	Check	Comment
a	Appropriate mode of financing has been chosen and all regulatory, credit risk and approval requirements completed as per Modaraba's policy?		
b	All documents are in accordance with the model agreements approved by the Religious Board?	Yes/No	If No, give/ attach details of Exceptions.
c	All columns in documents properly filled/signed?		
d	Dates on documents including the Offer Letter comply with SOP of the Mode?		
e	Schedule of rentals/Installments are properly attached with the documents?		
f	Ensure no Buy-back arrangement in case of Murabaha.		
g	In case of sale and lease back, proper process timing followed, ownership of the asset verified and its independent value obtained?		

h	Is there any aspect of transaction, goods or documentation being non-compliant of Shariah in the opinion of the Internal Shariah Auditor?		If Yes, give/attach details
i	In case of non-compliance as mentioned in (H) above, please confirm (i) Whether non-compliance rectified by Modaraba? If Yes, When? If Not, attach: 1. Copy of referral to Shariah Advisor 2. Opinion of Shariah Advisor and 3. Decision of the Management		
j	Any other observations relating to Shariah Compliance.		

2	Post-Transaction	Check	Comment
a	Transaction execution is as per Process flow?		
b	Sequence of execution of documents is in accordance with the prescribed time line?		
c	Facility documents have been audited and cleared?		
d	Any deviations/non-compliance recorded pre-transaction has been duly rectified or cleared by the Shariah Advisor?		
e	All regulatory or risk management requirements are fully complied with?		
f	Any matters or aspects to be followed up?		If Yes, give details below
g	Any periodical audit reviews required?		

3. Additional Space for listing any deviations/comments or requirements (particularly with reference to items 1(b), 1(h) and 2(f) above.

Date: _____

SIGNATURE OF INTERNAL SHARIAH AUDITOR

4. Any noting/opinion (if required) of the Shariah Advisor in case it is not separately attached:

Date: _____

SIGNATURE OF SHARIAH ADVISOR

5. APPROVAL/INSTRUCTIONS OF DISBURSING AUTHORITY/AUTHORISED EXECUTIVES:

Date: _____

SIGNATURE & DESIGNATION



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