



ISLAMIC FINANCIAL SERVICES BOARD

**CAPITAL ADEQUACY STANDARD FOR INSTITUTIONS
(OTHER THAN INSURANCE INSTITUTIONS) OFFERING
ONLY ISLAMIC FINANCIAL SERVICES**

December 2005

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ACRONYMS

1996 Market Risk Amendment	Amendment to the Capital Accord to incorporate Market Risks, January 1996
PL	Promise to Lease
PP	Promise to Purchase
Basel I	International Convergence of Capital Measurement and Capital Standards, July 1988
Basel II	International Convergence of Capital Measurement and Capital Standards: A Revised Framework, June 2004
CRE	Commercial Real Estate
CRM	Credit Risk Mitigation
ECA	Export Credit Agencies
ECAI	External Credit Assessment Institution
HJ	<i>Hamish Jiddiyah</i> , a security deposit held as collateral upon entering into PP or PL
IAH	Investment Account Holders (holders of PSIA)
IIFS	Institutions (other than Insurance Institutions) offering only Islamic Financial Services
IMB	<i>Ijārah Muntahia Bittamleek</i> (or known as <i>Ijārah wa Iqtinā</i>)
IRR	Investment Risk Reserve
MDB	Multilateral Development Bank
MPO	<i>Murābahah</i> for the Purchase Orderer
PER	Profit Equalisation Reserve
PSIA	Profit Sharing Investment Accounts (or <i>Mudārabah</i> Investment Account)
RRE	Residential Real Estate
RW	Risk Weight
RWA	Risk-weighted Assets
SSB	<i>Sharī'ah</i> Supervisory Board

Bismillahirrahmanirrahim.

Allahumma salli wasallim 'ala Sayyidina Muhammad wa'ala ālihi wasahbihi

A. INTRODUCTION

Purpose

1. This Section provides a general introduction to the Islamic Financial Services Board's Capital Adequacy Standard (hereinafter collectively referred to as the Standard) for institutions (other than insurance institutions) offering only Islamic financial services (IIFS). The term "IIFS" as used in this Standard refers to such financial institutions that mobilise funds as deposits and investment accounts in accordance with *Sharī'ah* rules and principles, and invest them in accordance with *Sharī'ah* compliant investment and financing instruments.
2. The objectives of the Standard are to:
 - address the specific structure and contents of the *Sharī'ah* compliant products and services offered by the IIFS that are not specifically addressed by the currently adopted and proposed international capital adequacy standards, and *Sharī'ah*-compliant mitigation; and
 - standardise the approach in identifying and measuring risks in *Sharī'ah* compliant products and services and in assigning risk weights (RW) thereto, thereby, creating a level playing field amongst the IIFS, in adopting and developing risk identification and measurement practices that meet internationally acceptable prudential standards.

Basis and Limitations of the Standard's Measurement Methodology

3. The proposals contained herein are primarily based on the Basel Committee on Banking Supervision's documents on the (a) International Convergence of Capital Measurement and Capital Standards: A Revised Framework, June 2004 (Basel II) and (b) Amendment to the Capital Accord to Incorporate Market Risks, January 1996 (1996 Market Risk Amendment), with the necessary modifications and adaptations to cater for the specificities and characteristics of the *Sharī'ah* compliant products and services offered by the IIFS.

4. The Standard covers **minimum capital adequacy requirements** based predominantly on the standardised approach in respect of credit risk and the basic indicator approach for operational risks of the IIFS, with respect to Pillar 1 of Basel II, and the various applicable measurement methods for market risk set out in the 1996 Market Risk Amendment. The IFSB is aware of the fact that some IIFS are progressively improving their risk management practices to the extent that they will be in a position to meet the requirement for applying the internal models approach for measuring their risk exposures. While this Standard stops short of explaining approaches other than the standardised approach, supervisory authorities are welcome to use other approaches for regulatory capital purposes if they have the ability to address the infrastructure issues adequately. The IFSB will monitor these developments and plans to consult the industry in the future and eventually to make any necessary revisions.

5. The Standard does not address the requirements covered by Pillar 2 (Supervisory Review Process) and Pillar 3 (Market Discipline) of Basel II as these two issues will be covered by separate standards.

Scope of Application

6. The Standard is intended to be applied to non-insurance institutions offering only Islamic financial services. Supervisory authorities may, at their discretion, extend the calculation of the minimum capital adequacy requirements to Islamic "window" operations that are self-contained or other institutions offering Islamic financial services that fall within their jurisdictions. In addition, the risk weighting methodology set out in this Standard may be applied to *Sharī'ah* compliant financing assets held by Islamic "window" operations that are not self-contained or by other institutions holding such assets.

7. The Standard will be applicable to any IIFS that falls within the scope as stated herein, on a fully consolidated basis at the holding company level within a group or sub-group of IIFS, or as appropriate, on an individual basis subject to approval of the supervisory authorities. The Standard is not intended to be applied at the consolidated level to a group or sub-group that consists of entities other than IIFS as defined in the Standard.

Specificities of Islamic Financial Instruments

8. Islamic financial instruments are asset-based (*Murābahah*, *Salam* and *Istisnā`* which are based on the sale or purchase of an asset, and *Ijārah* which is based on the selling the benefits of such an asset), profit-sharing (*Mushārahah* and *Muḍārahah*), or *sukūk* (securities) and investment portfolios and funds which may be based on the above assets. In the case of the asset-based instruments, the IIFS's gross return is the spread between the cost of the asset to the IIFS and the amount that can be recovered from selling or leasing it. Such instruments may therefore involve exposure to market (price) risk in respect of the asset as well as credit risk in respect of the amount due from the counterparty. In the case of the profit-sharing instruments, *Mushārahah* and *Muḍārahah*, the exposure is of the nature of an equity position not held for trading similar to an 'equity position in the banking book' as described in Basel II, and is likewise dealt with under credit risk, except in the case of investments (normally short-term) in assets for trading purposes, which are dealt with under market risk.

9. For these reasons, the CAS is structured in a matrix format so that the minimum capital adequacy requirements in respect of both the credit risk and the market risk exposures arising from a given type of financial instrument are dealt with under the heading of that instrument, as indicated below.

Structure of the CAS

10. The Standard is divided into seven sections, **C1 to C7**, where the minimum capital adequacy requirements for both credit and market risks are set out for each of the *Sharī'ah* compliant financing and investment instruments:

- C1: *Murābahah* and *Murābahah* for the Purchase Orderer;
- C2: *Salam* and *Parallel Salam*;
- C3: *Istisnā`* and *Parallel Istisnā`*;
- C4: *Ijārah* and *Ijārah Muntahia Bittamleek*;
- C5: *Mushārahah* and *Diminishing Mushārahah*;
- C6: *Muḍārahah*; and
- C7: *Sukūk* held as investment (in the "banking book").

In addition, the provisions for operational risk are set out in **Section B3**, and the treatment of Profit Sharing Investment Account (PSIA) is set out in **Section B4**.

11. The Standard has been endorsed by the *Sharī'ah* Advisory Committee of the Islamic Development Bank and co-opted *Sharī'ah* scholars representing central banks and monetary agencies, which were members of the IFSB in December 2005. The *Sharī'ah* rules and principles as set out in the Standard do not represent an exhaustive list of diverse practices amongst the various IIFS and compliance with the principles stated herein shall not be construed as a formal endorsement by the IFSB that the products and services offered by the IIFS are in accordance with the *Sharī'ah* principles. The IIFS are expected to fulfil the requirements set by their supervisory authorities and *Sharī'ah boards* in determining and ensuring that their activities are in compliance with the *Sharī'ah* rules and principles.

Implementation Date

12. The Standard is recommended for implementation with effect from 2007.

B. PRINCIPLES FOR MINIMUM CAPITAL ADEQUACY REQUIREMENTS

13. This Section covers the calculation of the overall minimum capital requirements for credit, market and operational risks for IIFS. Please refer to **Appendix A** for the Capital Adequacy Ratio (CAR) formula.

14. In the stated CAR formula, the calculation of minimum capital adequacy requirements is based on the definition of (eligible) regulatory capital and risk-weighted assets (RWA) and this calculation should be read in conjunction with **Sections B3** on Operational Risk, and **Sections C1 to C7** of the Standard for *Sharī'ah* compliant instruments. The adjustment to the capital adequacy denominator is explained in **Section B4**.

15. Some IIFS may use different product names or contract titles as part of their market differentiation or a commercial expression. While it is not the intention of the IFSB to require IIFS to change the way they manage the business and risks, **IIFS are required to use the substance of the *Sharī'ah* rules and principles governing the contracts of these instruments to form the basis for an appropriate treatment in deriving their minimum capital adequacy requirements.**

16. **The minimum capital adequacy requirements for IIFS shall be a CAR of not lower than 8% for total capital. Tier 2 capital is limited to 100% of Tier 1 capital.**

17. In calculating the CAR, the regulatory capital as the numerator shall be calculated in relation to the total risk-weighted assets as the denominator. The total of RWA is determined by multiplying the capital requirements for market risk and operational risk by 12.5 (which is the reciprocal of the minimum CAR of 8%) to convert into risk-weighted equivalent assets, and adding that resulting figures to the sum of RWA computed for credit risk.

18. The *Sharī'ah* rules and principles whereby IAH provide funds to the IIFS on the basis of profit-sharing and loss-bearing *Muḍārabah* contracts, or on the basis of agency for an agreed upon fee, instead of debt-based deposits, i.e. lending money to the IIFS, would mean that the IAH would share in the profits of a successful operation, but could also lose all or part of their investments. The liability of the IAH is exclusively limited to the provided capital and the potential loss of the IIFS is restricted solely to the value of its work. However, if negligence, mismanagement, fraud or breach of contract conditions can be proven, the IIFS will be financially liable for the capital of the IAH. **Therefore, credit and market risks of the investment made by the IAH shall normally be borne by themselves, while the operational risk is borne solely by the IIFS.** In jurisdictions where an IIFS has practiced the type of income smoothing for IAH, the supervisory authority has discretion to require the IIFS to include a specified percentage of assets financed by PSIA in the denominator of the CAR (represented by α in the Supervisory Discretion Formula as set out in **Appendix A**). This would apply to RWA financed by both unrestricted and restricted PSIA, unless the practice of income smoothing for IAH by the IIFS had been confined to the unrestricted PSIA.

B.1 CREDIT RISK

19. Credit risk exposures in Islamic financing arise in connection with accounts receivable in *Murābahah* contracts, counterparty risk in *Salam* contracts, accounts receivable and counterparty risk in *Istisnā`* contracts and lease payments receivable in *Ijārah* contracts, and sukuk held to maturity in the banking book. In the standard, credit risk is measured according to the Standardised Approach of Basel II, as will be discussed below, except for certain exposures arising from investments by means of *Mushārahah* or *Muḍārabah* contracts in assets in the banking book.¹ The latter are to be treated as giving rise to credit risk (in the form of capital impairment risk), and risk-weighted using the methods proposed in Basel II either for “equity exposures in the banking book” or, at the supervisor’s discretion, the supervisory slotting criteria for specialised financing.

20. The assignment of RW shall take into consideration the followings:
- The credit risk rating of a debtor, counterparty or other obligor, or a security, based on **external credit assessments**. The IIFS are to refer to their supervisory authorities for eligible external credit assessment institutions (ECAI) that are to be used in assigning credit ratings for the purpose of calculating credit risk weights;
 - **credit risk mitigation techniques** adopted by the IIFS;
 - types of the **underlying assets** that are sold and collateralised or leased by the IIFS; and
 - amount of **specific provisions** made for the overdue portion of accounts receivable or lease payments receivable.

21. The IIFS shall disclose the names of the ECAI that it has used for the purpose of assigning RW to its assets. If there are two assessments by ECAI chosen by an IIFS which map into different risk weights, the higher risk weight will be applied. If there are three or more assessments with different risk weights, the assessments corresponding to the two lowest risk weights should be referred to and the higher of those two risk weights will be applied.

¹ Banks already authorised by the supervisory authority to use IRB for credit risk in their conventional banking business may, at the supervisor’s discretion, be allowed to do so for their Islamic banking business.

(i) **Individual Claims based on External Credit Assessments**

22. Below are the proposed credit RW for the following counterparties:

Risk Weights						
Rating/Risk Score²	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated
ECA Country Risk Score³	1	2	3	4 to 6	7	
Counterparty	Risk Weight (RW)					
Sovereigns and Central Banks ^(a)	0% ^(b)	20%	50%	100%	150%	100%
Non-Central Government Public Sector Entities (PSEs) ^(c)	Subject to supervisory authorities' discretion to treat as either IIFS, banks and securities firms (Option 1 or Option 2a) or as Sovereigns					
Multilateral Development Banks (MDBs) ^(d)	20%	50%	50%	100%	150%	50%
IIFS, banks and securities firms						
Option 1*	20%	50%	100%	100%	150%	100%
Option 2a **	20%	50%	50%	100%	150%	50%
Option 2b**/ ^(e)	20%	20%	20%	50%	150%	20%
Rating/Risk Score	AAA to AA-	A+ to A-	BBB+ to BB-	Below BB-	Unrated	
Corporates ^(f)	20%	50%	100%	150%	100%	

* Credit assessment based on ECAI of sovereigns

** Credit assessment based on an ECAI of the IIFS, banks and securities firms

^(e) Applicable for original maturity ≤ 3 months which is not rolled over

- (a) Supervisory authorities have the discretion to reduce the RW for exposures to the sovereigns and central banks that are denominated and funded in domestic currency.
- (b) Inclusive of official entities that will receive a 0% RW as determined by supervisory authorities.
- (c) PSEs, such as regional government and local authorities, may be risk-weighted as sovereigns if they have the power of raising revenue and a specific institutional arrangement to reduce their default risk. An administrative body owned by the government or a local authority may be treated in the same manner as IIFS even though it has sovereign immunity but has no power of raising revenue or a specific institutional arrangement.
- (d) Certain MDBs are eligible for a 0% RW as determined by the supervisory authorities.
- (e) Under Option 2b, the RW are one category less favourable than that assigned to claims on the sovereigns subject to a floor of 20% when the exposure is denominated and funded in domestic currency.
- (f) An unrated corporate shall not be given a preferential RW compared to its sovereign. Supervisory authorities have discretion to require a RW higher than 100% or to allow all corporates to be risk-weighted at 100%.

23. For any *Shari'ah* contract with an original maturity of up to three months that is not rolled over, the short-term RW as set out in the following table shall be applied.

Short-term Risk Weights⁴				
Rating/Risk Score	A-1 / P-1	A-2 / P-2	A-3 / P-3 or unrated	Others⁵
Risk Weight	20%	50%	100%	150%

² The notations follow the methodology used by Standard & Poor's. The use of Standard & Poor's credit ratings is an example only; those of some other external credit assessment institutions could equally well be used.

³ For the purpose of risk weighting claims on sovereigns, supervisors may recognise the country risk scores assigned by Export Credit Agencies (ECAs).

⁴ The short-term assessments are considered to be issue-specific and they can be used to derive RW for claims arising from the rated facility. This short-term assessment can only be used for short-term claims against IIFS, banks and corporates.

⁵ This category includes all non-prime and B or C ratings.

24. The supervisory authorities have discretion to allow IIFS that operate within their jurisdiction to apply an internal-rating based (IRB) approach if such institutions meet minimum requirements set by the supervisory authorities. The specific details of the requirements are not covered in the Standard.

(ii) Off-balance Sheet Exposures

25. Off-balance-sheet items under the standardised approach will be converted into credit exposure equivalents through the use of credit conversion factors (CCF).

26. Commitments with an original maturity up to one year and commitments with an original maturity over one year will receive a CCF of 20% and 50%, respectively. However, any commitments that are unconditionally cancellable at any time by the IIFS without prior notice, or that effectively provide for automatic cancellation due to deterioration in a borrower's creditworthiness, will receive a 0% CCF.

27. An import or export financing, which is based on *Murābahah* where the underlying goods/shipment are collateralised and insured, shall attract a 20% credit conversion factor to the IIFS that issues or confirms the letter of credit. This treatment of collateral assumes there are no obstacles to the exercise of rights over it by the issuer or confirmer (see paragraph 33(d)).

(iii) Exposures in Investments Made Under Profit Sharing Modes

28. An IIFS may hold investments made under profit-sharing and loss-bearing mode (*Muḍārabah*) and profit and loss sharing mode (*Mushārahah*) that are made not for trading or liquidity purposes but for the purpose of earning investment returns from medium to long-term financing. Such investments are:

- not held with the intent of trading or short-term resale benefiting from the actual or expected price movements;
- not marked-to-market on a daily basis;
- not actively monitored with reference to market sources; and
- exposed to credit risk in the form of capital impairment risk.

29. In the Standard, the RW for such investments shall be calculated according to one of the following two methods for equity exposure held in the banking book:

a) Simple risk-weight method

A 400% RW is to be applied to all equity exposures in private and commercial enterprise. However, funds invested on a *Muḍārabah* basis may be subject to withdrawal by the investor at short notice (maximum 5 working days), and in that case may be considered as being as liquid as shares that are publicly traded. The applicable RW in such a case is 300%.

b) Slotting method

In appropriate cases, the supervisor may permit an IIFS to employ an alternative approach, namely the supervisory slotting criteria approach. Under this method, an IIFS is required to map its internal risk grades into four supervisory categories for specialised financing as set out in **Appendices B and C**, and each of these categories will be associated with a specific risk weight.

Diminishing *Mushārahah*

30. This form of *Mushārahah* is a means whereby an IIFS can provide term financing to a client on a profit sharing basis. The IIFS enters into this type of *Mushārahah* with the objective of transferring the ownership to the partner/customer, where the IIFS acts as a joint-owner of the asset, whereby the partner gives a binding promise in a separate document to purchase the IIFS's share making a payment on one or more specified future dates in accordance with separate contract(s) of sale that are entered into at that time. The IIFS's selling price shall be based on the fair value of the partnership share being transferred on the date of each purchase or at the price agreed upon at the time of entering into the contract, which may expose the IIFS to the risk of selling its share of ownership below the acquisition price.

31. As a joint-owner, the IIFS is also entitled to its share of income generated from the assets of the *Mushārah*, such as *Ijārah* lease rentals in which the rental entitlements of the IIFS is adjusted periodically according to the IIFS's share of ownership in the asset.

32. The IIFS's position in a Diminishing *Mushārah* thus entails two kinds of exposure. The amounts due from the partner to purchase the agreed shares of the asset on the agreed dates are subject to credit risk in respect of the partner's ability and willingness to pay, with the partner's shares of the asset providing credit risk mitigation as collateral. The IIFS is also subject to the risk that the value for which the client buys the share of the IIFS may be less than the amount invested because the value of the *Mushārah* assets has decreased. This is a form of equity exposure not held for trading purposes, and as such will be treated using the Basel II approach for "equity exposures in the banking book".

(iv) Credit Risk Mitigation

33. The exposure in respect of a debtor, counterparty or other obligor can be further adjusted or reduced by taking into account the credit risk mitigation (CRM) techniques employed by the IIFS. The CRM techniques that are commonly employed by the IIFS are as follows:

(a) *Hamish Jiddiyyah* (security deposit held as collateral)

Hamish jiddiyyah (HJ), a refundable security deposit taken by the IIFS prior to establishing a contract, carries a limited recourse to the extent of damages incurred by the IIFS when the purchase orderer fails to honour a binding promise to purchase (PP) or promise to lease (PL). The IIFS has recourse to the clients in the PP/PL if the HJ is insufficient to cover for the damages.

In the case of a non-binding PP/PL, the HJ shall be refunded in full to the clients, and hence is not considered as an eligible CRM.

(b) *'Urbūn* (earnest money held after a contract is established as collateral to guarantee contract performance)

The *'urbūn* taken from a purchaser or lessee when a contract is established accrues to the benefit of the IIFS if the purchaser or lessee breaches the contract within the agreed upon term.

(c) Guarantee from a Third Party (recourse or non-recourse guarantee)

The guarantor may or may not have recourse to the debtor (i.e. purchaser or lessee) and the guarantee can be for a fixed period and for a limited amount, without any consideration being received by the guarantor. However, a claim should first be made against the debtor, and then against the guarantor, unless an option is provided to make the claim against either the debtor or the guarantor.

The guarantee can also be given in a 'blanket' form that covers an unknown amount or a future receivable. However, this type of guarantee (sometimes known as a "market/business guarantee" or "guarantee of contractual obligation") is revocable at any time prior to the existence of the future receivables and does not qualify as an eligible CRM.

(d) Pledge of assets as collateral

The pledged asset must be a *Sharī'ah* compliant asset of monetary value that can be lawfully owned, and is saleable, specifiable, deliverable and free of encumbrance. The pledge must be legally enforceable. The asset pledged may either be the underlying asset or any other asset owned by the customer. The pledge of an asset owned by a third party is subject to the owner's consent to the pledge.

The pledgor can authorise the IIFS, as the pledgee, to sell the asset and to offset the amount due against the sales proceeds without recourse to the courts. Alternatively, the IIFS can demand the sale of the pledged asset in order to recover the amount due. Any surplus from the sale proceeds is to be returned to the pledgor and any

shortfall shall be treated as an unsecured exposure that ranks *pari passu* with other unsecured creditors when the debtor is declared insolvent.

In case the IIFS that take collateral of an asset pledged more than once, the collateral of the IIFS shall be ranked either *pari passu* to the collaterals of other earlier pledgees with their consent, or junior to the earlier pledgees, in which case the IIFS's claim shall be limited to the residual value of the pledged asset after payment is made to earlier pledgees. The IIFS shall take the residual value after deducting a haircut⁶ under the Simple Approach, the Standard Supervisory Haircuts or the Internal Haircut Approach to offset its credit exposure but should first ascertain the recoverability value of the asset after taking into consideration the IIFS's position as a pledgee as to whether it ranks *pari passu* with the other pledgee(s) or ranks junior to a pledgee that is registered earlier than the IIFS.

(e) Leased assets

Assets leased under Ijarah or IMB contracts fulfil a function similar to that of collateral, in that they may be repossessed by the lessor in the event of default by the lessee.

34. The collateralisation under the concept of "*rahn*" or "*kafālah*" shall be properly documented in a security agreement or, in the body of a contract to the extent permissible by *Sharī'ah*, and must be binding on all parties and legally enforceable in the relevant jurisdictions.

35. Capital relief for the use of a guarantee shall be given when the following conditions are satisfied:

- the guarantee represents the IIFS' direct claim on the guarantor;
- the guarantee is irrevocable and does not allow the guarantor to unilaterally cancel the guarantee after creation of the receivables;
- the guarantee is unconditional and provides no protection clause that prevents the guarantor from being obliged to pay out in a timely manner in the event that the original counterparty fails to make payments due;
- the IIFS has the right to pursue, in a timely manner, the guarantor for monies outstanding, rather than having to pursue the original counterparty to recover its exposure;
- the guarantee shall be an explicitly documented obligation assumed by the guarantor; and
- the guarantee shall cover all types of expected payments made under the contract in the event that the original counterparty defaults.

Types of Collateral

36. The following types of collateral are eligible for relief in respect of the above CRM techniques:

-
- (a) *Hamish jiddiyyah* (security deposit) only for agreements to purchase or lease preceded by a binding promise.
-
- (b) *'Urbūn*
-
- (c) Profit sharing investment account or cash on deposit⁷ with the IIFS which is incurring the exposure
-

⁶ The term 'haircut' in this context refers to a discount on the full value of an asset as collateral after taking into consideration some inherent risks that affect the volatility of the market price or value of the asset. It is commonly expressed in terms of a percentage by which an asset's value as collateral is reduced.

⁷ Must be supported by an agreement or documentation that gives IIFS the right of set-off against the amount of receivables due.

-
- (d) *Sukūk* rated by an external rating agency which are issued by:
- (i) Sovereigns and PSEs (treated as sovereigns) with a minimum rating of BB-; or
 - (ii) Issuers other than the above, with a minimum rating of BBB- or A-3 / P-3.
-
- (e) *Sukūk* that are unrated by an ECAI but fulfil each of the following criteria:
- (i) issued by an IIFS or a conventional bank or a sovereign;
 - (ii) listed on a recognised exchange;
 - (iii) all other rated issues by the IIFS or conventional bank of the same seniority of at least BBB - or A-3/P-3 by a recognised ECAI, as determined by the supervisory authorities;
 - (iv) the IIFS which incurs the exposure or is holding the collateral has no information to suggest that the issue would justify a rating below BBB- or A-3/P-3; and
 - (v) the supervisory authorities are sufficiently confident about the market liquidity of the securities.
-
- (f) Equities and units in collective investment schemes
-
- (g) Guarantees issued by third parties that fall within the following categories:
- (i) Sovereigns and central banks;
 - (ii) PSEs;
 - (iii) MDBs;
 - (iv) International organisations/official entities with 0% RW
 - (v) IIFS or conventional banks; and
 - (vi) Corporate entities (including insurance and securities firms) either by the parent, subsidiary and affiliates, of a minimum rating of A-.
-
- (h) Assets pledged as collateral as stated in paragraph 33(d) above or fulfilling the function of collateral as stated in paragraph 33(e) above
-

37. Any portion of the exposure which is not collateralised shall be assigned the RW of the counterparty.

38. Capital relief against the collateral can be granted based on either one of the following:

- (a) Simple Approach
- The IIFS can substitute the RW of the collateral for the RW of the counterparty for the collateralised portion of the exposure subject to the collateral being pledged for at least the duration of the contract. The RW of that collateralised portion shall not be lower than 20%. A 0% risk weight can be applied where the exposure and the collateral are denominated in the same currency, and either:
- the collateral is cash on deposit; or
 - the collateral is in the form of sovereign/PSE securities eligible for a 0% risk weight, and its market value has been discounted by 20%.
- (b) Standard Supervisory Haircuts
- Both the amount of exposure to a counterparty and the value of collateral received are adjusted by using standard supervisory haircuts as set out below:

Types of Collateral*	Residual Maturity (yrs)	Haircuts (%)	
		Sovereigns ⁸	Others
Cash	All	0	0
Sukūk	≤ 1	0.5	1
Long-term: AAA to AA- and	> 1 to ≤ 5	2	4
Short-term: A-1	> 5	4	8
Sukūk	≤ 1	1	2
Long-term: A+ to BBB- and	> 1 to ≤ 5	3	6
Short-term: A-2 to A-3	> 5	6	12
Sukūk	All	15	15
Long-term: BB+ to BB-			
Sukūk (unrated)	All	25	25
Equities (included in main index)	All	15	15
Equities (not included in main index but listed)	All	25	25
Units in collective investment schemes	All	Depending on the underlying assets as above	Depending on the underlying assets as above
Physical assets pledged in accordance with paragraph 30 (d)	All	≥30	≥30

* Collateral denominated in different currency will also be subject to additional 8% haircut to cater for foreign exchange risk

(c) Internal Haircuts

Subject to obtaining the approval from its supervisory authority, an IIFS may use its own estimate of haircuts to measure market price and foreign exchange volatilities. Such approval will normally require the fulfilling of certain qualitative and quantitative criteria set by the supervisory authority, inter-alia:

- integration of risk measures into daily risk management;
- validation of any significant change in the risk management process;
- verification of consistency, timeliness and reliability of data; and
- accuracy and appropriateness of volatility assumptions.

(v) Credit Risk Mitigation for *Muḍārabah* Classified as Equity Exposures

39. A placement of funds made under a *Muḍārabah* contract may be subject to a Sharī'ah compliant guarantee from a third party. Such a guarantee relates only to the *Muḍārabah* capital, not to the return. In such cases, the capital should be treated as subject to credit risk with a risk-weighting equal to that of the guarantor provided that the RW of that guarantor is lower than the RW of the *Muḍārib* as a counterparty. Otherwise, the RW of the *Muḍārib* shall apply.

40. In *Muḍārabah* investment in project finance, collateralisation of the progress payments made by the ultimate customers can be used to mitigate the exposures of unsatisfactory performance by the *Muḍārib*.

41. An IIFS may also place liquid funds with a central bank or another IIFS on a short-term *Muḍārabah* basis in order to obtain a return on those funds. Such placements serve as an interbank market with maturities ranging from an overnight market up to three months, but the funds may be withdrawn on demand before the maturity date in which case the return is calculated proportionately on the basis of duration and amount. Although from a juristic point of view the amounts so placed do not constitute debts, since (in the absence of misconduct or negligence) *Muḍārabah* capital does not constitute a liability for the institution that acts as *Muḍārib*, in practice the operation of this interbank market requires that the *Muḍārib* should effectively treat them as liabilities. Hence an IIFS placing funds on this basis may treat them

⁸ Includes PSEs and MDBs

as cash equivalents and, for risk weighting purposes, apply the risk weight applicable to the *Muḍārib* as counterparty.

(vi) Preferential Risk Weights based on Underlying Assets

42. The RW of a debtor, counterparty or other obligor shall be reduced and given preferential treatment if the underlying assets that are sold under *Murābahah* or leased under *Ijārah* fall within the categories as set out below. The supervisory authorities have discretion to apply an appropriate RW that can be higher than as set out below for their circumstances.

	<i>Murābahah</i>	<i>Ijārah</i>
Retail	<p>The RW shall be 75% if the <i>Murābahah</i> receivables are due from an individual person or persons or a small business provided that:</p> <ul style="list-style-type: none"> ▪ the subject matter which is sold on the basis of <i>Murābahah</i> is pledged to the IIFS; and ▪ the aggregate accounts receivable, consisting of accounts receivable in <i>Murābahah</i> and <i>Istisnā`</i>, and lease payments receivable in <i>Ijārah</i>, due from a single counterparty or person shall not exceed USD250,000 or lower as determined by the supervisory authorities. <p>A <i>Murābahah</i> contract which is collateralised by an asset other than the subject matter, shall not qualify for this preferential treatment unless the value of such collateral after adjustment for haircuts is higher than the <i>Murābahah</i> contract selling price throughout the tenure of the <i>Murābahah</i> contract.</p> <p>For any sale on a <i>Murābahah</i> basis that is secured by real estate, the accounts receivable arising from the sale can be excluded from this category and qualify for a lower RW as stated below.</p>	<p>The RW shall be 75% if the lease payments receivable in <i>Ijārah</i> are due from an individual person or persons or a small business provided that the aggregate receivables, consisting of accounts receivable in <i>Murābahah</i> and <i>Istisnā`</i>, and lease payments receivable in <i>Ijārah</i>, due from a single counterparty or person shall not exceed USD250,000 or lower as determined by the supervisory authorities.</p> <p>For any <i>Ijārah</i> contract that involves real estate, the payments receivable arising from the lease may be excluded from this category and may qualify for a lower RW as stated below.</p>
Residential real estate (RRE)	<p>The RW will be 35% subject to meeting the prudential criteria imposed by the supervisory authorities, which amongst others include:</p> <ul style="list-style-type: none"> ▪ the subject matter of the RRE must be pledged to the IIFS; ▪ the total accounts receivable in the <i>Murābahah</i> contract do not exceed 50% of the market value of the collateralised RRE subject to professional valuation of the RRE made within one year preceding the <i>Murābahah</i> contract date, the 50% figure 	<p>The RW will be 35% subject to meeting the prudential criteria imposed by the supervisory authorities, which amongst others include the following:</p> <ul style="list-style-type: none"> ▪ the total lease rentals over the life of the leasing contract do not exceed 50% of the market value of leased RRE provided that the professional valuation of the RRE is made within one year preceding the <i>Ijārah</i> contract date, the 50% figure being subject to the supervisor's discretion; and

	<i>Murābahah</i>	<i>Ijārah</i>
	<p>being subject to the supervisor's discretion; and</p> <ul style="list-style-type: none"> there exists a legal infrastructure whereby the IIFS can enforce the repossession and liquidation of the RRE. <p>The supervisory authorities have discretion to apply a higher RW up to 100% if any of the above criteria is not met.</p>	<ul style="list-style-type: none"> there exists a legal infrastructure whereby the IIFS can enforce the repossession and liquidation of the RRE. <p>The supervisory authorities have discretion to apply a higher RW up to 100% if any of the above criteria is not met.</p>
Commercial real estate (CRE)	<p>The RW shall be 100%, but in exceptional circumstances for well-developed and long-established markets, <i>Murābahah</i> for, and collateralised by, office and/or multi-purpose premises and/or multi-tenanted premises may have the potential to receive a preferential RW of 50%, this being subject to the supervisor's discretion.</p> <p>For the tranche of the <i>Murābahah</i> facility that does not exceed 50% of the market value of the collateralised CRE, provided the IIFS is able to show that its total losses from CRE financing (<i>Murābahah</i> or <i>Ijārah</i>) do not exceed 0.5% of the total amount due in respect of such financing in any given year.</p>	<p>The RW shall be 100%, but in exceptional circumstances for well-developed and long-established markets, <i>Ijārah</i> for office and/or multi-purpose premises and/or multi-tenanted premises may have the potential to receive a preferential RW of 50% this being subject to the supervisor's discretion.</p> <p>For the tranche of the <i>Ijārah</i> facility that does not exceed 50% of the market value of the leased CRE, provided the IIFS is able to show that its total losses from CRE financing (<i>Murābahah</i> or <i>Ijārah</i>) do not exceed 0.5% of the total amount due in respect of such financing in any given year.</p>

(vii) Past Due Receivables

43. In the event that accounts receivable or lease payments receivable become past due, the exposure shall be risk-weighted in accordance with the following table. The exposures should be risk weighted net of specific provisions.

Type	RW	% of Specific Provisions for Past Due Receivables
Unsecured exposure (other than unsecured portion of receivable partly secured by RRE) that is past due more than 90 days, net of specific provisions	150%	Less than 20% of the outstanding receivables.
	100%	At least 20% of the outstanding receivables.
	100%	At least 50% of the outstanding receivables but Supervisory authorities have discretion to reduce RW to 50%.
Exposure fully secured by other than eligible collateral (as set out in paragraph 36)	100%	At least 15% of the outstanding receivables. Supervisory authorities are to set strict operational criteria to ensure quality of collateral.
Exposure secured by RRE	100%	For receivables that are past due for more than 90 days, net of specific provisions.
	50%	The RW can be reduced to 50% RW if specific provisions are at least 20% of the outstanding receivables.

B.2 MARKET RISK

44. Market risk is defined as the risk of losses in on- and off-balance sheet positions arising from movements in market prices. The risks in IIFS that are subject to the market risk capital requirement are:

- equity position risk in the trading book⁹, and market risk on trading positions in *Sukūk*;
- foreign exchange risk; and
- commodities and inventory risk.

(i) Equity Position Risk (including *Sukūk* held for trading)

45. The capital charge for securities in IIFSs' trading book comprises two charges that are separately calculated for the following types of risk:

(a) Specific Risk

The capital charge for specific risk is 8% on all long equity positions and must be calculated on a market by market basis (for each national market). The capital charge can be reduced to 4% for a portfolio that is both liquid and well diversified, subject to criteria determined by the supervisory authorities.

(b) General Market Risk

The capital charge for general market risk is 8% on all long equity positions. These positions must be calculated on a market by market basis (for each national market).

(c) In the case of *Sukūk* in the trading book, the provision for **specific risk** charge will depend on the RW of the issue and the term to maturity of the *Sukūk*, as follows:

Government*	0%
Investment Grade ¹⁰	0.25% (residual term to final maturity 6 months or less)
	1.00% (residual term to final maturity 6 and 24 months)
	1.60% (residual term to final maturity exceeding 24 months)
Others	8%

* *Supervisory authority has the discretion to apply a different specific risk weight to sukūk issued by certain foreign government.*

The provision for **general market risk**¹¹ will depend on the residual term to maturity or to the next repricing date, using a simplified form of the Maturity Method on the net positions in each time-band in accordance with the table below:

Residual term to maturity	RW
1 month or less	0.00%
1-3 months	0.20%
3-6 months	0.40%
6-12 months	0.70%
1-2 years	1.25%
2-3 years	1.75%
3-4 years	2.25%
4-5 years	2.75%
5-7 years	3.25%
7-10 years	3.75%
10-15 years	4.50%

⁹ An equity position treated under "equity exposures in the banking book" is dealt with under the Credit Risk as set out in **Section B1**.

¹⁰ e.g. rated Baa or higher by Moodys and BBB or higher by Standard & Poor's

¹¹ At the supervisor's discretion, the IIFS may alternatively use the duration method as set out in the 1996 Market Risk Amendment, paragraphs 14-15.

15-20 years	5.25%
> 20 years	6.00%

46. In the case of equity investments made by means of a *Mushārah* or a *Muḍārah* contract where the underlying assets are commodities, the market risk provisions for commodities, as described below, will be applicable.

(ii) Foreign Exchange Risk

47. The capital charge to cover the risk of holding or taking long positions in foreign currencies, and gold and silver,¹² is calculated in two steps by:

- (a) Measuring the exposure in a single currency position; and
- (b) Measuring the risks inherent in an IIFS's portfolio mix of long and short positions in different currencies.

Measuring the Exposure in a Single Currency and Open Position in the unilateral binding promise to buy or sell Gold and Silver

48. The net open position in each currency exposure is calculated by adding the following:

- (a) Net spot position (total assets less total liabilities including accrued profit in the currency in question);
- (b) Net position of a binding unilateral promise¹³ by the IIFS to buy and/or sell currencies on a specified future date (that are not included in the spot position);
- (c) Guarantees and similar off-balance sheet instruments that are likely to be called and irrecoverable; and
- (d) Any other items representing a profit or loss in foreign currencies, e.g. specific provision held in the currency in question but the underlying asset is held in a different currency.

49. The net open position with a unilateral binding promise to buy or sell gold or silver should first be expressed in terms of the standard unit of measurement (i.e. ounces or grams) and then be converted at current spot rate into the reporting or base currency.

50. Structural positions, which are of a non-trading nature and are merely positions taken in order to hedge partially or totally against the adverse effect of the exchange rate on the IIFS's capital ratio, may be excluded from the calculation above, subject to the supervisory authority's satisfaction that such positions are merely to protect the IIFS's capital ratio.

51. There is no capital charge for positions related to items that are deducted from the IIFS's capital, such as investments in non-consolidated subsidiaries or long-term participations denominated in foreign currencies which are reported at historical cost.

Measuring the Foreign Exchange Risk in a Portfolio

52. The IIFS are allowed to use either a Shorthand Method or Internal Models Approach in calculating the risks inherent in the IIFS's mix of long and short positions in different currencies. However, the Shorthand Method as stated below is recommended for the IIFS.

- (a) Convert the nominal amount of the net position (net long or net short positions) in each foreign currency and in gold/silver into the reporting currency using spot rates.
- (b) Aggregate the sum of converted net short positions or the sum of converted net long positions.
- (c) The greater sum of net short positions or net long positions calculated in (b) is added to the net position of gold/silver, to derive at the overall net position.

¹² Gold, silver and currency fall under foreign exchange risk in accordance with the *Sharī'ah* rules and principles that require the exchange of currencies be made in equality of amount and on spot basis. Note that the Basel 1996 Market Risk Amendment (section A3) treats gold as under foreign exchange risk and silver as under commodity risk.

¹³ A binding bilateral promise in an exchange of currencies is equivalent to a forward contract which is prohibited by *Sharī'ah* jurists in most (but not all) countries as the delivery of one or both countervalues is deferred.

53. The capital charge is 8% on the overall net position as calculated in 52(c) above.

54. The use of an Internal Models Approach by an IIFS is subject to the supervisory authority's explicit approval and fulfilment of qualitative standards, specifications of market risk factors being captured into the IIFS's risk management system, quantitative standards, comprehensive stress testing program and validation of the models by external auditors and/or supervisory authorities. Those requirements are not included in this section.

(iii) Commodities and Inventory Risk

55. This section sets out the minimum capital requirements to cover the risks of holding or taking long positions in commodities, including precious metals but excluding gold and silver (which falls under foreign exchange risk as set out in paragraphs 47 to 54), as well as the inventory risk which results from IIFS holding assets with a view to re-selling or leasing them. A commodity is defined as a physical product which is and can be traded on a secondary market, e.g. agricultural products, minerals (including oil) and precious metals. Inventory risk is defined as arising from holding items in inventory either for resale under a *Murābahah* contract, or with a view to leasing under an *Ijārah* contract. In the case of inventory risk, the simplified approach described in paragraph 61 below should be applied.

56. Commodities risk can be measured using either the maturity ladder approach or the simplified approach for the purpose of calculating the capital charge for commodities risk. Under both approaches, each commodity position is expressed in terms of the standard unit of quantitative measurement of weight or volume (barrels, kilos, grams, etc.). The net position in each commodity will then be converted at current spot rates into the reporting currency.

57. Positions in different groups of commodities¹⁴ cannot be offset unless:

- (a) The sub-categories of commodities are deliverable against each other;
- (b) The commodities represent close substitutes for each other; and
- (c) A minimum correlation of 0.9 between the price movements of the commodities can be clearly established over a minimum period of 1 year to the satisfaction of the supervisory authority.

58. Netting of positions for different commodities is subject to the supervisory authorities' approval. Under the maturity ladder approach, the net positions are entered into seven time-bands as set out below:

Time-band	
1)	0 – 1 month
2)	1 – 3 months
3)	3 – 6 months
4)	6 – 12 months
5)	1 – 2 years
6)	2 – 3 years
7)	Over 3 years

59. A separate maturity ladder is used for each type of commodities, while the physical stocks are allocated to the first time-band. The calculation of capital charge is made in the following three steps:

- (a) The sum of short and long positions that are matched will be multiplied by the spot price for the commodity and then by the appropriate spread rate of 1.5% for each time band.

¹⁴ Commodities can be grouped into clans, families, sub-groups and individual commodities, e.g. a clan might be Energy Commodities, within which Hydro-carbons is a family with Crude Oil being a sub-group and West Texas Intermediate, Arabian Light and Brent being individual commodities.

- (b) The residual or unmatched net positions from nearer time bands may be carried forward to offset exposures in a more distant time-band, subject to a surcharge of 0.6% of the net position carried forward in respect of each time-band that the net position is carried forward.
- (c) Any net position at the end of the carrying forward and offsetting will attract a capital charge of 15%.

60. The summation of the above three capital charges represents the total capital charge for commodities risk based on the maturity ladder approach.

61. Under the simplified approach as applied to commodities, the net position, long or short, in each commodity requires a capital charge of 15% to cater for directional risk plus an additional capital charge of 3% of the gross positions, i.e. long plus short positions, to cater for basis risk. The capital charge of 15% applies to assets held by IIFS in inventory with a view to resale or lease.

62. For *Istisnā* work-in-process (WIP), WIP inventory belonging to the IIFS shall attract a capital charge of 8% (equivalent to a 100% RW). In the case of the balance of unbilled WIP inventory under *Istisnā* without parallel *Istisnā*, in addition to the RW for credit risk a capital charge of 1.6% is applied (equivalent to a 20% RW) to cater for market risk exposure.

63. The funding of a commodities position that exposes the IIFS to foreign exchange exposure is also subject to capital charge as measured under the foreign exchange risk (please refer to paragraphs 47 to 54).

B.3 OPERATIONAL RISK

64. Operational risk is defined as the risk of losses resulting from inadequate or failed internal processes, people and systems or from external events, which includes but is not limited to, legal risk and *Sharī'ah* compliance risk. This definition excludes strategic and reputational risks.

65. The proposed measurement of capital to cater for operational risk in IIFS may be based on either the Basic Indicator Approach or the Standardised Approach as set out in Basel II. Under the Basic Indicator Approach, a fixed percentage of 15% of annual average gross income, averaged over the previous three years, is set aside. Under the Standardised Approach, this percentage varies according to the line of business (LOB) from 12% to 18%, being 18% for corporate finance, trading and sales, and payment and settlement, to 15% for commercial banking and agency services, and 12% for retail banking, asset management and retail brokerage. **As the LOBs into which IIFS are organised are different from the above, it is proposed that, at the present stage, the Basic Indicator Approach be used by IIFS, which requires the setting aside of a fixed percentage of average annual gross income over the previous three years.** Subject to the supervisory authority defining the applicable business lines, the supervisory authority may allow IIFS in its jurisdiction to apply the Standardised Approach in which the percentage (12%, 15% or 18%) of gross income is to be set aside according to the business lines.

66. *Sharī'ah* compliance risk is a type of operational risk facing the IIFS which can lead to non-recognition of income and resultant losses.

67. Set out below are examples of *Sharī'ah* requirements that are to be complied with by the IIFS in respect of the financing contracts. The list is not conclusive and may vary according to the views of the various *Sharī'ah* Supervisory Board (SSB):

- (a) *Murābahah* and *Ijārah* contracts
 - The asset is in existence at the time of sale or lease or, in case of *Ijārah*, the lease contract should be preceded by acquisition of the usufruct of that asset except if the asset was agreed upon based on a general specification.
 - The asset is legally owned by the IIFS when it is offered for sale.
 - The asset is intended to be used by the buyer/lessee for activities or businesses permissible by *Sharī'ah*; if the asset is leased back to its owner in the first lease period, it should not lead to contract of *'inah*, by varying the rent or the duration.
 - There is no late payment, penalty fee or increase in price in exchange for extending or rescheduling the date of payment of accounts receivable or lease receivable, irrespective of whether the debtor is solvent or insolvent.
- (b) *Salam* and *Istisnā`* contracts
 - A sale and purchase contract cannot be inter-dependent and inter-conditional on each other, such as *Salam* and Parallel *Salam*; *Istisnā`* and Parallel *Istisnā`*.
 - It is not allowed to stipulate a penalty clause in respect of delay in delivery of a commodity that is purchased under *Salam* contract, however it is allowed under *Istisnā`* or Parallel *Istisnā`*.
 - The subject-matter of an *Istisnā`* contract may not physically exist upon entering into the contract.
- (c) *Mushārahah* and *Mudārahah* contracts
 - The capital of the IIFS is to be invested in *Sharī'ah* compliant investments or business activities.
 - A partner in *Mushārahah* cannot guarantee the capital of another partner or a *Mudārib* guarantees the capital of the *Mudārahah*.
 - The purchase price of other partner's share in a *Mushārahah* with a binding promise to purchase can only be set as per the market value or as per the agreement at the date of buying. It is not permissible, however, to stipulate that the share be acquired at its face value.

(i) Capital Charge

68. The extent of losses arising from non-compliance with *Sharī'ah* rules and principles cannot be ascertained owing to lack of data. Therefore, the IIFS is not required to set aside any additional amount over and above the 15% of average annual gross income over the preceding three years for operational risk. Supervisory authorities have discretion to impose a higher capital charge as they deem fit to cater for the *Sharī'ah* compliance risk of a particular IIFS.

69. Gross income is defined as:

- (a) Net income from financing activities which is gross of any provisions and operating expenses and of depreciation of Ijarah assets;
- (b) Net income from investment activities; and
- (c) Fee income (e.g. commission and agency fee)

Less:

Investment account holders' share of income

The gross income includes income attributable to restricted and unrestricted Profit Sharing Investment Accounts' funds, but excludes extraordinary or exceptional income. Net income from investment activities includes the IIFS's share of profit from Mushārah and Muḍārahah financing activities.

B.4 PROFIT SHARING INVESTMENT ACCOUNTS

70. This section deals with the capital adequacy requirement for assets financed by Profit Sharing Investment Accounts (PSIA), a pool of investment funds placed with an IIFS on the basis of *Muḍārabah*. Where investment accounts are managed under *Wakālah* contract, the relationship between IIFS and the investors is a simple agency relationship with the IIFS earning a flat fee rather than a share of profit. Hence, paragraphs 72, 74 and 75 would apply.

71. The PSIA (commonly referred to as “investment accounts” or “special investment accounts”) can be further categorised into:

- (a) Unrestricted PSIA; and
- (b) Restricted PSIA.

72. The IIFS has full discretionary power in making investment decisions for unrestricted PSIA, but in the case of the restricted PSIA the placement of funds by IIFS is subject to investment criteria specified by the IIFS in the *Muḍārabah* contract or agreed between the investment account holders (IAH) and the IIFS at the time of contracting.

73. The IIFS assumes the role of economic agent or *Muḍārib* in placing such funds in income-producing assets or economic activities, and as such is entitled to a share (the *Muḍārib* share) in the profits (but not losses) earned on funds managed by it on behalf of the IAH, according to a pre-agreed ratio specified in the *Muḍārabah* contract.

(i) Adjustment to the Capital Ratio Denominator

74. The capital amount of PSIA is not guaranteed by the IIFS and any losses arising from investments or assets financed by PSIA are to be borne by the IAH except under certain circumstances as described in paragraph 75. In principle, therefore, the commercial risk on assets financed by PSIA do not represent risks for the IIFS’s own (shareholders’) capital and thus would not entail a regulatory capital requirement for the IIFS. This implies that assets funded by either unrestricted or restricted PSIA would be excluded from the calculation of the denominator of the capital ratio. In practice, however, the IIFS may forgo its rights to some or all of its *Muḍārib* share of profits in order to offer its IAH a more competitive rate of return on their funds, or may be treated as constructively obliged to do so by the supervisory authority as a measure of investor protection and in order to mitigate potential systemic risk resulting from massive withdrawals of funds by dissatisfied IAH. This applies particularly to unrestricted PSIA. The implications of this for capital adequacy purposes are addressed under “displaced commercial risk” in paragraph 76 and supervisory discretion in paragraphs 77 to 79.

(ii) Impact on Capital

75. The IIFS is liable for losses arising from its negligence, misconduct or breach of its investment mandate, and the risk of losses arising from such events is characterised as a fiduciary risk. The capital requirement for this fiduciary risk is dealt with under operational risk (see paragraphs 64 to 69).

(iii) Displaced Commercial Risk

76. The term “displaced commercial risk” refers to the risk arising from assets managed on behalf of IAH which is effectively transferred to the IIFS’s own capital because the IIFS follows the practice of foregoing part or all of its *Muḍārib* share of profit on such funds, when it considers this necessary as a result of commercial pressure in order to increase the return that would otherwise be payable to the IAH. This practice may also be required by the supervisory authority as mentioned in paragraph 74 above. This applies particularly to unrestricted PSIA. The rate of return paid to the IAH is thus “smoothed” at the expense of the profits attributable to the IIFS’s shareholders. Such a situation would most often arise as a result of rate of return risk (otherwise referred to as profit rate risk), where the IAH’s funds are invested in assets such as *Murābahah* or *Ijārah* with a relatively long maturity and at a rate of return which no longer meets current market expectations. However, it might also arise in respect of other market risks (such as price risk) or credit risk when an IIFS wishes to protect its IAH from the effects of the poor overall performance of a portfolio of assets under its management (subject to the *Sharī’ah* prohibition of the *Muḍārib* making good an overall loss to the investor). While in principle the IIFS has full discretion as to whether it performs this displacement of commercial risk, in practice it may find itself virtually obliged to do so (as a

result of commercial and/or supervisory pressure), and this has implications for its capital adequacy which needs to be considered by its supervisory authority as discussed in paragraph 77. It should be noted that displaced commercial risk does not relate to cover an overall loss attributable to IAH by reallocating profit from shareholders, as *Sharī'ah* rules and principles do not permit this.

(iv) Supervisory Discretion

77. In jurisdictions where an IIFS has practiced the type of income smoothing for IAH that gives rise to displaced commercial risk and has incurred a constructive or implied obligation to continue to do so in the future, the supervisory authority should require regulatory capital to cater for displaced commercial risk.

78. A supervisory authority may also consider that IIFS in its jurisdiction are virtually obliged for competitive reasons to practice the displacement of commercial risk. Also, supervisory authority may be concerned that the triggering of withdrawals of PSIA funds in the absence of income smoothing for IAH could give rise to systemic risk.

79. In such an environment, the supervisory authority has discretion to require the IIFS to which the circumstances mentioned in paragraphs 77 and 78 apply, to include a specified percentage of assets financed by PSIA in the denominator of the CAR (represented by α in the Supervisory Discretion Formula as set out in **Appendix A**). This would apply to RWA financed by both unrestricted and restricted PSIA, unless the practice of income smoothing for IAH by the IIFS had been confined to the unrestricted PSIA.

(v) Reserves

80. The IIFS can take precautionary steps by setting up prudential reserve accounts to minimise the adverse impact of income smoothing for PSIA on its shareholders' returns and to meet potential but unexpected losses (UL) that would be borne by the IAH on investments financed by PSIA, namely:

- (a) Profit equalisation reserve (PER)
PER comprises amounts appropriated out of the gross income¹⁵ from the *Muḍārabah* to be available for smoothing returns paid to the investment account holders and the shareholders, and consists of a PSIA portion and a shareholder's portion; and/or
- (b) Investment risk reserve (IRR)
IRR comprises amounts appropriated out of the income of investment account holders after deduction of the *Muḍārib* share of income, to meet any future losses on the investments financed by the PSIA.

¹⁵ In some countries, the appropriation of income is to be made out of income after taking into consideration the tax effect.

C. MINIMUM CAPITAL REQUIREMENTS FOR ISLAMIC FINANCING ASSETS

81. The minimum capital requirements for the seven classes of Islamic financing assets are set out below, taking into account both credit risk and market risk as appropriate.

C.1 MURĀBAHAH AND MURĀBAHAH FOR THE PURCHASE ORDERER

1. Introduction

82. This section sets out the minimum capital adequacy requirement to cover the credit and market risks arising from entering into contracts or transactions that are based on the *Shari'ah* rules and principles of *Murābahah* and *Murābahah* for the Purchase Orderer (MPO).

83. In *Murābahah* and MPO, the capital adequacy requirement for credit risk refers to the risk of a counterparty not paying the purchase price of an asset to the IIFS. In the case of market (price) risk, the capital adequacy requirement is with respect to assets in the IIFS's possession which are available for sale either on the basis of *Murābahah* or MPO and also on assets which are in possession due to cancellation of PP in non-binding and binding MPO.

84. The supervisory authority has discretion to apply to IIFS the relevant provisions of this section for other forms of sale contract, namely *Musāwamah* and *Bay' Bithaman Ajil*.

85. This section is broadly divided into (a) *Murābahah* and non-binding MPO and (b) binding MPO, as the types of risk faced by the IIFS are different at the various stages of the contract for the two categories. This classification and the distinctions between a non-binding MPO and a binding MPO are subject to the criteria and opinions set by the respective SSB of the IIFS or any other SSB as specified by the supervisory authority.

86. A *Murābahah* contract refers to an agreement whereby the IIFS sells to a customer at acquisition cost (purchase price plus other direct costs) plus an agreed profit margin, a specified kind of asset that is already in its possession. An MPO contract refers to an agreement whereby the IIFS sells to a customer at cost (as above) plus an agreed profit margin, a specified kind of asset that has been purchased and acquired by the IIFS based on an PP by the customer which can be a binding or non-binding PP.

Murābahah and Non-binding MPO

87. In a *Murābahah* transaction, the IIFS sells an asset that is already available in its possession, whereas in a MPO transaction the IIFS acquires an asset in anticipation that the asset will be purchased by the orderer/customer.

88. This price risk in *Murābahah* contracts ceases and is replaced by credit risk in respect of the amount receivable from the customer following delivery of the asset. Likewise, in a non-binding MPO transaction, the IIFS is exposed to credit risk on the amount receivable from the customer when the latter accepts delivery and assumes ownership of the asset.

Binding MPO

89. In a binding MPO, the IIFS has no 'long' position in the asset that is the subject of the transaction, as there is a binding obligation on the customer to take delivery of the asset at a pre-determined price. The IIFS is exposed to counterparty risk in the event that the orderer in a binding MPO does not honour his/her obligations under the PP, resulting in the IIFS selling the asset to a third party at a selling price which may be lower than the cost to the IIFS. The risk of selling at a loss is mitigated by securing a HJ upon executing the PP with the customer, as commonly practised in the case of binding MPO. The IIFS would have recourse to the customer for any shortfall in the HJ to compensate for the loss.

Collateralisation

90. As one of the CRM techniques, the IIFS can secure a pledge of the sold asset/underlying asset or another tangible asset ("collateralised *Murābahah*"). The collateralisation is not automatically provided in a *Murābahah* contract but must be explicitly stated or must be documented in a separate security agreement at or before the time of signing of the *Murābahah* contract. The IIFS may employ other techniques such as pledge of

deposits or a third party financial guarantee. The RW of a financial guarantor can be substituted for the RW of the purchaser provided that the guarantor has a better credit rating than the purchaser and that the guarantee is legally enforceable.

91. The types of asset transacted under *Murābahah* and MPO are typically either chattels or real estate. In financing transactions that involve chattels or real estate which are collateralised, pricing of the *Murābahah* assets and determination of required amount of HJ would normally take into consideration the market value and forced-sale value of the assets; and the CRM would take into account of any 'haircut' applicable to the collateralised assets. Thus, fluctuations in the market value and forced sale value of the collateralised assets are dealt with under credit risk assessment.

2. Credit Risk

Murābahah and Non-binding MPO

92. The credit exposure shall be measured based on accounts receivable in *Murābahah* (the term used herein includes MPO), which is recorded at their cash equivalent value i.e. amount due from the customers at the end of the financial period less any provision for doubtful debts.

93. The accounts receivable (net of specific provisions) amount arising from the selling of a *Murābahah* asset shall be assigned a RW based on the credit standing of the obligor (purchaser or guarantor) as rated by an ECAI that is approved by the supervisory authority. In case the obligor is unrated, a RW of 100% shall apply.

Binding MPO

94. In a binding MPO, an IIFS is exposed to default on the purchase orderer's obligation to purchase the commodity in its possession. In the event of the orderer defaulting on its PP, the IIFS will dispose of the asset to a third party. The IIFS will have recourse to any HJ paid by the orderer, and (a) may have a right to recoup from the orderer any loss on disposing of the asset, after taking account of the HJ, or (b) may have no such legal rights. In both cases, this risk is mitigated by the asset in possession as well as any HJ paid by the purchase orderer.

95. In case (a), the IIFS has the right to recoup any loss (as indicated in the previous paragraph) from the orderer, that right constitutes a claim receivable which is exposed to credit risk, and the exposure shall be measured as the amount of the asset's total acquisition cost to the IIFS, less the market value of the asset as collateral subject to any haircut, and less the amount of any HJ. The applicable RW shall be based on the standing of the obligor as rated by an ECAI that is approved by the supervisory authority, and in the case the obligor is unrated, a RW of 100% shall apply.

96. In case (b) the IIFS has no such right, and the cost of the asset to the IIFS constitutes a market risk (as in the case on a non-binding MPO), but this market risk exposure is reduced by the amount of any HJ that the IIFS has the right to retain.

97. In applying the treatment as set out in paragraph 95, the IIFS shall ensure that the PP is properly documented and it is legally enforceable. In the absence of a proper documentation and legal enforceability, the asset is to be treated similar to a non-binding MPO which is exposed to price risk, where the measurement approach is set out in paragraphs 101 to 102.

98. Upon selling the asset, the accounts receivable (net of specific provisions) amount shall be assigned a RW based on the credit standing of the obligor as rated by an ECAI that is approved by the supervisory authority. In case the obligor is unrated, a RW of 100% shall apply.

(i) Exclusions

99. The capital requirement is to be calculated on the receivable amount, net of specific provisions, any amount that is secured by eligible collateral as defined in paragraph 36 and/or

any amount that is past due by more than 90 days. The portions that are collateralised and past due are subject to the relevant RW as set out in paragraphs 38 and 43 respectively.

(ii) Preferential RW

100. Subject to meeting the minimum requirements as set out in paragraph 42, the RW of collateralised *Murābahah* may be given preferential RW as set out below for the following types of collateralised asset:

- 75% for retail customers or working capital financing;
- 35% for a *Murābahah* contract secured by a residential real estate unless otherwise determined by the supervisory authorities; or
- 100% for a *Murābahah* contract secured by a commercial real estate or 50% in 'exceptional circumstances'

The supervisory authority has discretion to apply these preferential RW under appropriate circumstances.

3. Market Risk

Murābahah and Non-binding MPO

101. In the case of an asset in possession in a *Murābahah* transaction and an asset acquired specifically for resale to a customer in a non-binding MPO transaction, the asset would be treated as inventory of the IIFS and using the simplified approach the capital charge for such a market risk exposure would be 15% of the amount of the position (carrying value), which equates to a RW of 187.5%. The 15% capital charge is also applicable to assets held by an IIFS in respect of incomplete non-binding MPO transactions at the end of a financial period.

102. Assets in possession on a 'sale or return' basis (with such an option included in the contract) are treated as accounts receivable from the vendor and as such would be offset against the related accounts payable to the vendor. If these accounts payable have been settled, the assets shall attract a capital charge of 8% (i.e. a RW of 100%), subject to (a) the availability of documentation evidencing such an arrangement with the vendor, and (b) the period for returning the assets to the vendor not having been exceeded.

Binding MPO

103. In a binding MPO the orderer has the obligation to purchase the asset at the agreed price, and the IIFS as the seller is only exposed to credit risk as indicated in paragraph 94 above.

Foreign Exchange Risk

104. The funding of an asset purchase or the selling of an asset may well open an IIFS to foreign exchange exposures; therefore, the relevant positions should be included in the measures of foreign exchange risk described in paragraphs 47 to 54.

4. Summary of Capital Requirement at Various Stages of the Contract

105. The following tables set out the applicable period of the contract that attracts capital charges:

(a) *Murābahah* and Non-binding MPO

Applicable Stage of the Contract	Credit RW	Market Risk Capital Charge
Asset available for sale (asset on balance sheet)*	Not applicable	15% capital charge (187.5% RW)
Asset is sold and delivered to a customer, and the selling price (accounts receivable) is due from the customer	Based on customer's rating or 100% RW for unrated customer (see paragraphs 92 to 93)	Not applicable
Maturity of contract term or upon full settlement of the purchase price, whichever is earlier	Not applicable	Not applicable

* Also includes an asset which is in possession due to cancellation of PP by a non-binding MPO customer. Any HJ taken, if any, is not considered as eligible collateral and shall not be offset against the value of the asset.

(b) Binding MPO

Applicable Stage of the Contract	Credit RW **	Market Risk Capital Charge
Asset available for sale (asset on balance sheet)*	Asset acquisition cost less market value of asset as collateral (net of any haircut) less any HJ x 100% RW (see paragraphs 94 to 97)	Not applicable
Asset is sold and delivered to a customer (accounts receivable is due from a customer)	Based on customer's rating or 100% RW for unrated customer (see paragraph 98)	Not applicable
Maturity of contract term or upon full settlement of the selling price, whichever is earlier	Not applicable	Not applicable

* Also includes an asset which is in possession due to cancellation of PP by a customer.

** This Credit RW is applicable only when IIFS will have recourse to any HJ paid by the customer, and (depending on the legal situation) may have a right to recoup from the customer any loss on disposing of the asset, after taking account of the HJ.

If the IIFS has no such right, the cost of the asset to the IIFS constitutes a market risk (as in the case on a non-binding MPO), but this market risk exposure is reduced by the amount of any HJ that the IIFS has the right to retain.

C.2 SALAM

1. Introduction

106. This section sets out the minimum capital requirement to cover credit and market (price) risks arising from entering into contracts or transactions that are based on the *Shar'ah* rules and principles of *Salam*. The IIFS is exposed to the (a) credit (counterparty) risk of not receiving the purchased commodity after disbursing the purchase price to the seller, and (b) price risk that the IIFS incurs from the date of execution of a *Salam* contract, which is applicable throughout the period of the contract and beyond the maturity date of the contract as long as the commodity remains on the balance sheet of the IIFS.

107. This section is applicable to (a) *Salam* contracts that are executed without any Parallel *Salam* contracts and (b) *Salam* contracts that are backed by independently executed Parallel *Salam* contracts.

108. A *Salam* contract refers to an agreement to purchase, at a predetermined price, a specified kind of commodity¹⁶ which is to be delivered on a specified future date in a specified quantity and quality. The IIFS as the buyer makes full payment of the purchase price upon execution of a *Salam* contract or within a subsequent period not exceeding two or three days as deemed permissible by its SSB.

109. In certain cases, an IIFS enters into a back-to-back contract, namely Parallel *Salam*, to sell a commodity with the same specification as the purchased commodity under a *Salam* contract to a party other than the original seller. The Parallel *Salam* allows the IIFS to sell the commodity for future delivery at a predetermined price (thus hedging the price risk on the original *Salam* contract) and protects the IIFS from having to take delivery of the commodity and warehousing it.

110. The non-delivery of commodity by a *Salam* customer (i.e. counterparty risk) does not discharge the IIFS's obligations to deliver the commodity under a Parallel *Salam* contract, and thus exposes the IIFS to potential loss in obtaining the supply elsewhere.

111. The obligations of an IIFS under *Salam* and Parallel *Salam* are not inter-conditional or interdependent, which implies that there is no legal basis for offsetting credit exposures between the contracts.

112. In the absence of a Parallel *Salam* contract, an IIFS may sell the subject-matter of the original *Salam* contract in the spot market upon receipt, or, alternatively, the IIFS may hold the commodity in anticipation of selling it at a higher price. In the latter case, the IIFS is exposed to price risk on its position in the commodity until the latter is sold.

2. Credit Risk

113. The receivable amount generated from the purchase of a commodity based on a *Salam* contract shall be assigned a RW based on the credit standing of a seller/counterparty as rated by an ECAI that is approved by the supervisory authority. In case the seller/counterparty is unrated, a RW of 100% shall apply.

(i) Exclusions

114. The capital requirement is to be calculated on the receivable amount, net of specific provisions, of any amount that is secured by eligible collateral as defined in paragraph 36 and/or any amount which is past due by more than 90 days. The portions that are collateralised and past due are subject to the relevant RW as set out in paragraphs 38 and 43 respectively.

¹⁶ A commodity is defined as a physical product which is and can be traded on a secondary market, e.g. agricultural products, minerals (including oil) and precious metals. The commodity may or may not be traded on an organised exchange.

(ii) Applicable Period

115. The credit RW is to be applied from the date of the contract made between both parties until the maturity of the *Salam* contract, which is upon receipt of the purchased commodity.

(iii) Offsetting Arrangement between Credit Exposures of *Salam* and Parallel *Salam*

116. The credit exposure amount of a *Salam* contract is not to be offset against the exposure amount of a Parallel *Salam* contract, as an obligation under one contract does not discharge an obligation to perform under the other contract.

3. Market Risk

117. The price risk on the commodity exposure in *Salam* can be measured in two ways, either the maturity ladder approach (see paragraphs 56 to 60) or the simplified approach. Under the simplified approach, the capital charge will equal to 15% of the net position in each commodity, plus an additional charge equivalent to 3% of the gross positions, long plus short, to cover basis risk and forward gap risk. The 3% capital charge is also intended to cater for potential losses in Parallel *Salam* when the seller in the original *Salam* contract fails to deliver and the IIFS has to purchase an appropriate commodity in the spot market to honour its obligation.

118. The long and short positions in a commodity, which are positions of *Salam* and Parallel *Salam*, may be offset under either approach for the purpose of calculating the net open positions provided that the positions are in the same group of commodities.

Foreign Exchange Risk

119. The funding of a commodity purchase or selling of a commodity may well leave an IIFS open to foreign exchange exposures, and in that case the relevant positions should be included in the measures of foreign exchange risk described in paragraphs 47 to 54.

(i) Treatment of Capital Charge under Prohibition of Parallel *Salam*

120. In jurisdictions where the supervisory authority and/or SSB take the position that an IIFS cannot enter into Parallel *Salam*, the commodity position shall be calculated in accordance with the simplified approach. The capital charge of 15% shall be applicable on the long position of *Salam* without the additional charge of 3%.

(ii) Supervisory Discretion

121. Under the maturity ladder approach, the supervisory authority has discretion to allow netting between different categories of commodities where the commodities are deliverable against each other or represent close substitutes for each other (provided the exchange of similar commodities would not result in *riba*) and have a minimum correlation of 0.9 between the price movements that can be established over a minimum period of one year (see paragraph 58).

4. Summary of Capital Requirement at Various Stages of the Contract

122. The following tables set out the applicable period of the contract that attracts capital charges:

(a) *Salam* with Parallel *Salam*

Applicable Stage of the Contract	Credit RW	Market Risk Capital Charge
Payment of purchase price by the IIFS to a <i>Salam</i> customer	Based on customer's rating or 100% RW for unrated customer No netting of <i>Salam</i> exposures against Parallel <i>Salam</i> exposures See paragraphs 113 to 116	<u>Two approaches are applicable</u> <u>Maturity Ladder Approach (see paragraphs 56 to 60)</u> <u>The Simplified Approach</u> 15% capital charge (187.5% RW equivalent) on net position (i.e. netting of <i>Salam</i> exposures against Parallel <i>Salam</i> exposures) plus 3% capital charge (37.5% RW equivalent) on gross positions (i.e. <i>Salam</i> exposures plus Parallel <i>Salam</i> exposures) See paragraphs 117 to 119
Receipt of the purchased commodity by the IIFS	Not applicable	See paragraphs 117 to 119
The purchased commodity is sold and delivered to a buyer	Not applicable	Not applicable

(b) *Salam* without Parallel *Salam*

Applicable Stage of the Contract	Credit RW	Market Risk Capital Charge
Payment of purchase price by the IIFS to a <i>Salam</i> customer (seller)	Based on customer's rating or 100% RW for unrated customer See paragraphs 113 to 116	<u>The Simplified Approach</u> 15% capital charge (187.5% RW equivalent) on long position of <i>Salam</i> exposures See paragraph 120
Receipt of the purchased commodity by the IIFS	Not applicable	
The purchased commodity is sold and delivered to a buyer	Not applicable	Not applicable

C.3 *ISTISNĀ`*

1. Introduction

123. This section sets out the minimum capital adequacy requirement to cover credit and market (price) risks arising from entering into contracts or transactions that are based on the *Sharī`ah* rules and principles of *Istisnā`*.

124. An *Istisnā`* contract refers to an agreement to sell to or buy from a customer a non-existent asset which is to be manufactured or built according to the ultimate buyer's specifications and is to be delivered on a specified future date at a predetermined selling price. The IIFS as the seller has the option to manufacture or build the asset on its own or to engage the services of a party other than the *Istisnā`* ultimate buyer as supplier or subcontractor, by entering into a Parallel *Istisnā`* contract (please refer to paragraph 132).

125. The exposures under *Istisnā`* involve credit and market risks, as describe below. Credit exposures arise once the work is billed to the customer, while market (price) exposures arise on unbilled work-in-process (WIP).

126. There is a capital requirement to cater for the credit (counterparty) risk of the IIFS not receiving the selling price of the asset from the customer or project sponsor either in pre-agreed stages of completion and/or upon full completion of the manufacturing or construction process. (The risk of a customer failing to complete such a transaction in project finance is referred to as 'off-take risk' – see **Appendix B**).

127. This section also sets out the capital adequacy requirement to cater for the market risk that an IIFS incurs from the date of manufacturing or construction, which is applicable throughout the period of the contract on unbilled WIP inventory.

128. This section is applicable to both (a) *Istisnā`* contracts that are executed without any Parallel *Istisnā`* contracts and (b) *Istisnā`* contracts that are backed by independently executed Parallel *Istisnā`* contracts.

129. This section makes distinctions between two main categories of *Istisnā`*:

(a) Full Recourse *Istisnā`*

The receipt of the selling price by the IIFS is dependent on the financial strength or payment capability of the customer for the subject matter of *Istisnā`*, where the source of payment is derived from the various other commercial activities of the customer and is not solely dependent on the cash flows from the underlying asset/project; and

(b) Limited and Non-recourse *Istisnā`*

The receipt of the selling price by the IIFS is dependent partially or primarily on the amount of revenue generated by the asset being manufactured or constructed by selling its output or services to contractual or potential third party buyers. This form of *Istisnā`* faces "revenue risk" arising from the asset's ability to generate cash flows, instead of the creditworthiness of the customer or project sponsor.

130. In full, limited and non-recourse *Istisnā`* contracts, the IIFS assumes the completion risk¹⁷ that is associated with the failure to complete the project at all, delay in completion, cost overruns, occurrence of a *force majeure* event and unavailability of qualified personnel and reliable seller(s) or subcontractors in a Parallel *Istisnā`*.

¹⁷ In conventional project financing, the completion risk is normally borne by the project sponsor and not the bank because the project sponsor has most often been asked to provide an undertaking to cover cost overruns.

131. The selling price of an asset sold based on *Istisnā`* is agreed or determined on the contractual date and such a contract is binding. The price cannot be increased or decreased on account of an increase or decrease in commodity prices or labour cost. The price can be changed subject to the mutual consent of the contracting parties due to alteration or modifications to the contract or unforeseen contingencies, which is a matter for the commercial decision of the IIFS and can result in a lower profit margin.

Istisnā` with Parallel *Istisnā`*

132. In cases where an IIFS enters into Parallel *Istisnā`* to procure an asset from a party other than the original *Istisnā`* customer (buyer), the price risk relating to input materials is mitigated. The IIFS remains exposed to the counterparty risk of the Parallel *Istisnā`* seller in delivering asset on time and in accordance with the *Istisnā`* ultimate buyer's specifications. This is the risk of not being able to recover damages from the Parallel *Istisnā`* seller for the losses resulting from the breach of contract.

133. The failure of the Parallel *Istisnā`* seller to deliver a completed asset which meets the buyer's specifications does not discharge the IIFS's obligations to deliver the asset ordered under an *Istisnā`* contract, and thus exposes the IIFS to potential loss in making good the shortcomings or obtaining the supply elsewhere.

134. The obligations of an IIFS under *Istisnā`* and Parallel *Istisnā`* contracts are not inter-conditional or interdependent, which implies that there is no legal basis for offsetting credit exposures between the contracts.

2. Credit Risk

Full Recourse *Istisnā`*

135. The receivable amount generated from selling of an asset based on an *Istisnā`* contract with full recourse to the customer (buyer) shall be assigned a RW based on the credit standing of the customer as rated by an ECAI that is approved by the supervisory authority. Please refer to paragraph 22 for the RW. In case the buyer is unrated, a RW of 100% shall apply.

Limited and Non-Recourse *Istisnā`*

136. When the project is rated by an ECAI, the RW based on the credit rating of the buyer is applied to calculate the capital adequacy requirement. Otherwise, the RW shall be based on the 'Supervisory Slotting Criteria' approach for Specialised Financing (Project Finance) as set out in **Appendix B** which carries RW as given below:

Supervisory Categories	Strong	Good	Satisfactory	Weak
External Credit Assessments	BBB- or better	BB+ or BB	BB- to B+	B to C-
Risk Weights	70%	90%	115%	250%

137. The limited and non-recourse *Istisnā`* financing structure is required to meet the characteristics as set out below in order to qualify for the above RW:

- (a) the segregation of the project's liabilities from the balance sheet of the *Istisnā`* ultimate buyer (or project sponsor) from a commercial and accounting perspective which is generally achieved by having the *Istisnā`* contract made with a special purpose entity set up to acquire and operate the asset/project concerned;
- (b) the ultimate buyer is dependent on the income received from the assets acquired/ projects to pay the purchase price;
- (c) the contractual obligations give the manufacturer/constructor/IIFS a substantial degree of control over the asset and the income it generates, for example under BOT (built, operate and transfer) arrangement where the manufacturer builds a highway and collects tolls for a specified period as a consideration for the selling price; and
- (d) the primary source of repayment is the income generated by the asset/project rather than relying on the capacity of the buyer.

(i) Exclusions

138. The capital requirement is to be calculated on the receivable amount, net of specific provisions, any amount that is secured by eligible collateral as defined in paragraph 36 and/or any amount which is past due by more than 90 days. The portions that are collateralised and past due are subject to the relevant RW as set out in paragraphs 38 and 43 respectively.

139. Any portion of an *Istisnā`* contract covered by an advanced payment shall carry a RW of 0%, or the amount of the advanced payment shall be offset against the total amount receivable or amounts owing from progress billings.

(ii) Applicable Period

140. The credit RW is to be applied from the date when the manufacturing or construction process commences and until the selling price is fully settled by the IIFS, either in stages and/or on the maturity of the *Istisnā`* contract, which is upon delivery of the manufactured asset to the *Istisnā`* ultimate buyer.

(iii) Offsetting Arrangement between Credit Exposures of *Istisnā`* and Parallel *Istisnā`*

141. The credit exposure amount of an *Istisnā`* contract is not to be offset against the credit exposure amount of a Parallel *Istisnā`* contract because an obligation under one contract does not discharge an obligation to perform under the other contract.

3. Market Risk

Full Recourse *Istisnā`*

(a) *Istisnā`* with Parallel *Istisnā`*

142. There is no capital charge for market risk to be applied in addition to provisions in paragraphs 135 to 141 above, subject to there being no provisions in the Parallel *Istisnā`* contract that allow the seller to increase or vary its selling price to the IIFS, under unusual circumstances. Any variations in a Parallel *Istisnā`* contract that are reflected in the corresponding *Istisnā`* contract which effectively transfers the whole of the price risk to an *Istisnā`* customer (buyer), is also eligible for this treatment.

(b) *Istisnā`* without Parallel *Istisnā`*

143. A capital charge of 1.6% (equivalent to a 20% RW) is to be applied to the balance of unbilled WIP inventory to cater for market risk, in addition to the credit RW stated in paragraphs 135 to 141 above.

144. This inventory is held subject to the binding order of the *Istisnā`* buyer and is thus not subject to inventory price as described in paragraphs 55 to 63. However this inventory is exposed to the price risk as described in paragraph 131.

Foreign exchange risk

145. Any foreign exchange exposures arising from the purchasing of input materials, or from Parallel *Istisnā`* contracts made, or the selling of a completed asset in foreign currency should be included in the measures of foreign exchange risk described in set out in paragraphs 47 to 54.

4. Summary of Capital Requirement at Various Stages of the Contract

146. The following tables set out the applicable period of the contract that attracts capital charges:

(a) Full Recourse *Istisnā`*

(i) *Istisnā`* with Parallel *Istisnā`*

Applicable Stage of the Contract	Credit RW	Market Risk Capital Charge
Unbilled work-in-process inventory	Based on ultimate buyer's rating or 100% RW for unrated buyer	Nil provided that there is no provision in the Parallel <i>Istisnā`</i> contract that allows the seller to increase or vary the selling price
Amounts receivable after contract billings	No netting of <i>Istisnā`</i> exposures against Parallel <i>Istisnā`</i> exposures See paragraphs 135 to 141	See paragraph 142
Maturity of contract term or upon full settlement of the purchased price by an <i>Istisnā`</i> buyer, whichever is the earlier	Not applicable	Not applicable

(ii) *Istisnā`* without Parallel *Istisnā`*

Applicable Stage of the Contract	Credit RW	Market Risk Capital Charge
Unbilled work-in-process inventory	Based on ultimate buyer's rating or 100% RW for unrated buyer	1.6% capital charge (equivalent to 20% RW) on work-in-process inventory See paragraphs 143 to 144
Progress billing to customer	Based on ultimate buyer's rating or 100% RW for unrated buyer See paragraphs 135 to 141	Not applicable
Maturity of contract term or upon full settlement of the purchased price by an <i>Istisnā`</i> buyer, whichever is the earlier	Not applicable	Not applicable

(b) Limited and Non-Recourse *Istisnā`*
Istisnā` with Parallel *Istisnā`* (for project finance)

Applicable Stage of the Contract	Credit RW	Market Risk Capital Charge
Unbilled work-in-process inventory	Based on buyer's ECAI rating, if available, or supervisory slotting criteria that ranges from 70% to 250% RW	Not applicable
Amounts receivable after contract billings	No netting of <i>Istisnā`</i> exposures against Parallel <i>Istisnā`</i> exposures See paragraphs 136 to 137	
Maturity of contract term or upon full settlement of the purchased price by an <i>Istisnā`</i> customer, whichever is the earlier	Not applicable	Not applicable

C.4 IJĀRAH AND IJĀRAH MUNTAHIA BITTAMLEEK

1. Introduction

147. This section sets out the minimum capital requirement to cover counterparty risk and residual value risk of leased assets, arising from an IIFS entering into contracts or transactions that are based on the *Sharī'ah* rules and principles of *Ijārah* and *Ijārah Muntahia Bittamleek* (IMB), also known as *Ijārah wa Iqtinā*. The section also covers the market (price) risk of assets acquired for *Ijārah* and IMB.

148. In an *Ijārah* contract (either operating or IMB), the IIFS as the lessor maintains its ownership in the leased asset whilst transferring the right to use the asset, or usufruct, to an enterprise as the lessee, for an agreed period at an agreed consideration. All liabilities and risks pertaining to the leased asset are to be borne by the IIFS including obligations to restore any impairment and damage to the leased asset arising from wear and tear and natural causes which are not due to the lessee's misconduct or negligence. Thus, in both *Ijārah* and IMB, the risks and rewards remain with the lessor, except for the residual value risk at the term of an IMB which is borne by the lessee. The lessor is exposed to price risk on the asset while it is in the lessor's possession prior to the signature of the lease contract, except where the asset is acquired following a binding promise to lease as described in paragraph 150 below.

149. In an IMB contract, the lessor promises to transfer to the lessee its ownership in the leased asset to the lessee at the end of the contract as a gift or as a sale at a specified consideration, provided that (a) the promise is separately expressed and independent of the underlying *Ijārah*; or (b) a gift contract is entered into conditional upon fulfilment of all the *Ijārah* obligations, and thereby ownership shall be automatically transferred thereupon.

150. In both operating *Ijārah* and IMB, the IIFS either possesses the asset before entering into a leased contract or enters into the contract based on specific description of an asset to be leased and acquired in the future before it is delivered to the lessee. This agreement to lease may be considered as binding (binding PL) or as non-binding (non-binding PL) depending on the applicable *Sharī'ah* interpretations.

Operating Ijārah

151. This section sets out the minimum capital requirements to cater for the lessor's exposures to (a) the credit risk of the lessee as counterparty in servicing the lease rentals, and (b) the market (price) risk attaching to the residual value of the leased asset either at the end of the *Ijārah* contract or at the time of repossession upon default, i.e. the risk of losing money on the resale of the leased asset.

IMB

152. In IMB, once the lease contract is signed, the lessor is exposed to credit risk in respect of the lease payments receivable from the lessee (a credit risk mitigated by the asset's value as collateral¹⁸) and to a type of operational risk in respect of the need to compensate the lessee if the asset is permanently impaired through no fault of the latter. If the leased asset is permanently impaired and is uninsured, the IIFS suffers a loss equal to the carrying value of the leased asset, just as it would if any of its fixed assets were permanently impaired. In the event that the lessee exercises its right to cancel the lease, the lessor is exposed to the residual value of the leased asset being less than the refund of payments due to the lessee. In such case, the price risk, if any, is already reflected in a 'haircut' to be applied to the value of the leased asset as collateral. Therefore, the price risk, if any, is not applicable in the context of the IMB.

153. This section sets out the minimum capital adequacy requirement to cater for the credit risk of the lessee as counterparty with respect to servicing the lease rentals. The credit risk exposure in respect of the lease rentals is mitigated by the collateral represented by the value of the leased asset on repossession, provided that the IIFS is able to repossess the asset, which may be subject to doubt, especially in the case of movable assets. Insofar as there is doubt as to

¹⁸ The collateral used in the context of IMB is of the usufruct or use value of the asset, as the IIFS is the owner of the asset.

the lessor's ability to repossess the asset, the residual fair value of the asset that was assumed in fixing the lease rentals is also exposed to credit risk.

154. The IIFS may be exposed to losses in case a lessee acquiring an asset under IMB decides not to continue with the contract. In such a case, the lessor is required to refund to the lessee the capital payments (instalments of the purchase price) that were included in the periodic lease rentals (subject to deduction of any amounts due for unpaid rentals). If the value of the repossessed asset is less than the amount to be refunded (before any such deduction), the difference constitutes a loss to the lessor. This exposes the IIFS as lessor to a form of market risk.

155. In theory, a situation could arise in which, when an IMB contract arrives at its term, the lessee decides not to exercise its option to complete the purchase by making the contractually agreed final payment (The option to purchase places no obligation on the lessee to do so.). The IIFS may thus be exposed to market risk, in respect of a potential loss from disposing of the asset for an amount lower than its net book value. Generally, however, the lessor's exposure in such a case would not be significant, as the option to purchase can be exercised by making a payment of a token amount and the lessee would have no reason to refrain from exercising it. Moreover, the net book value of the asset at the term of the IMB (i.e. its residual fair value as assumed in fixing the lease rentals) would be zero or close to zero.

2. Credit Risk

156. In a PL (which can only be binding), when an IIFS is exposed to default on the lease orderer's obligation to execute the lease contract, the exposure shall be measured as the amount of the asset's total acquisition cost to the IIFS, less the market value of the asset as collateral subject to any haircut, and less the amount of any '*urbūn*' received from the lease orderer. The applicable RW shall be based on the standing of the obligor as rated by an ECAI that is approved by the supervisory authority, and in the case the obligor is unrated, a RW of 100% shall apply.

157. In applying the treatment as set out in paragraph 156, the IIFS must ensure that the PL is properly documented and is legally enforceable. In the absence of a proper documentation and legal enforceability, the asset is to be treated similarly to one in a non-binding PL which is exposed to market (price) risk, using the measurement approach as set out in paragraph 163(a).

Operating *Ijārah*

158. In addition to paragraph 156 above, the lessor is exposed to credit risk in respect of the estimated value of the lease payments in respect of the remaining period of the *Ijārah*. This exposure is mitigated by the market value of the leased asset which may be repossessed. The net credit risk exposure shall be assigned a RW based on the credit standing of the lessee/counterparty as rated by an ECAI that is approved by the supervisory authority. In the case that the lessee is unrated, a RW of 100% shall apply.

IMB

159. In addition to paragraph 156, the capital requirement for IMB is based on the following two components:

- (a) the total estimated future *Ijārah* receivable amount over the duration of the lease contract. This exposure is mitigated by the market value of the leased asset which may be repossessed. The net credit risk exposure shall be assigned a RW based on the credit standing of the lessee/counterparty as rated by an ECAI that is approved by the supervisory authority. In the case that the lessee is unrated, a RW of 100% shall apply; and
- (b) the price risk attached to the expected residual fair value of a leased asset is treated under paragraph 164.

160. The estimated future *Ijārah* receivable amount as indicated in paragraph 159(a) above shall be risk-weighted based on the credit standing of the lessee as rated by an ECAI or at 100%, after deduction of the value of the leased asset as collateral (subject to any haircut).

(i) Exclusions

161. The capital requirement is to be calculated on the receivable amount, net of specific provisions, of any amount that is secured by eligible collateral as defined in the paragraph 36 and/or any amount which is past due by more than 90 days. The portions that are collateralised and past due are subject to the relevant RW as set out in paragraphs 38 and 43 respectively.

(ii) Preferential RW

162. Subject to meeting the minimum requirements as set out in paragraph 42, preferential RW can be assigned for certain types of leased asset such as real estate. The supervisory authorities have discretion to apply RW appropriate for their circumstances.

3. Market Risk

163. In the case of an asset acquired and held for the purpose of either operating *Ijarah* or IMB, the capital charge to cater for market (price) risk in respect of the leased asset from its acquisition date until its disposal can be categorised into the following:

(a) Non-binding PL

The asset for leasing will be treated as inventory of the IIFS and using the simplified approach the capital charge applicable to such a market risk exposure would be 15% of the amount of the asset's market value (equivalent to a RW of 187.5%).

(b) Binding PL

In a binding PL, an IIFS is exposed to default on the lease orderer's obligation to lease the asset in its possession. In the event of the lease orderer defaulting on its PL, the IIFS will either lease or dispose of the asset to a third party. The IIFS will have recourse to any *hamish jiddiyyah* paid by the customer,¹⁹ and (i) may have a right to recoup from the customer any loss on leasing or disposing of the asset after taking account of the *hamish jiddiyyah*, or (ii) may have no such right, depending on the legal situation. In both cases, this risk is mitigated by the asset in possession as well as any *hamish jiddiyyah* paid by the lease orderer.

In case (i), the IIFS has the right to recoup any loss (as indicated in the previous paragraph) from the customer, that right constitutes a claim receivable which is exposed to credit risk, and the exposure shall be measured as the amount of the asset's total acquisition cost to the IIFS, less the market value of the asset as collateral subject to any haircut, and less the amount of any *hamish jiddiyyah*. The applicable RW shall be based on the standing of the customer as rated by an ECAI that is by the supervisory authority, and in the case the obligor is unrated, a RW of 100% shall apply.

In case (ii) the IIFS has no such right, and the cost of the asset to the IIFS constitutes a market risk (as in the case on a non-binding PL), but this market risk exposure is reduced by the amount of any *hamish jiddiyyah* that the IIFS has the right to retain.

Operating *Ijarah*

164. The residual value of the asset will be risk weighted at 100%. Upon expiry of the lease contract, the carrying value of the leased asset shall carry a capital charge of 15% until the asset is re-leased or disposed of.

IMB

165. In the event that the lessee exercises its right to cancel the lease, the lessor is exposed to the residual value of the leased asset being less than the refund of payments due to the

¹⁹ The amount can only be deducted for damages, i.e. difference between the asset acquisition cost and the total of lease rentals (when the asset is leased to a third party) or selling price (when the asset is sold to a third party), whichever is applicable.

lessee. In such a case, the price risk, if any, is already reflected in a 'haircut' to be applied to the value of the leased asset as collateral in credit risk. Therefore, the price risk, if any, is not applicable in the context of the IMB.

4. Summary of Capital Requirement at Various Stages of the Contract

166. The following tables set out the applicable period of the contract that attracts capital charges:

Operating Ijārah

Applicable Stage of the Contract	Credit RW	Market Risk Capital Charge
Asset available for lease (prior to signing a lease contract)	<p><u>Binding PL</u>*</p> <p>Asset acquisition cost</p> <p>less (a) market value of asset fulfilling function of collateral (net of any haircuts) and (b) any <i>'hamish jiddiyah</i></p> <p>multiply with the customer's rating or 100% RW for unrated customer.</p>	<p><u>Non-binding PL</u></p> <p>15% capital charge (equivalent to 187.5% RW) until lessee takes possession</p>
Upon consigning a leasing contract and the lease rental payments are due from the lessee	<p>Total estimated value of lease receivables for the whole duration of leasing contract shall be risk-weighted according to the lessee's rating. 100% RW for an unrated lessee.</p> <p>less recovery value of the leased asset</p>	<p>The residual value will be risk weighted at 100%</p>
Maturity of contract term and the leased asset is returned to the IIFS	Not applicable	15% capital charge of the carrying value of the asset

* *This Credit RW is applicable only when IIFS will have recourse to any hamish jiddiyah paid by the customer, and (depending on the legal situation) may have a right to recoup from the customer any loss on leasing or disposing of the asset to a third party, after taking account of the *'urbūn*.*

If the IIFS has no such right, the cost of the asset to the IIFS constitutes a market risk (as in the case on a non-binding PL), but this market risk exposure is reduced by the amount of any hamish jiddiyah that the IIFS has the right to retain.

IMB

Applicable Stage of the Contract	Credit RW	Market Risk Capital Charge
Asset available for lease (prior to signing a lease contract)	<u>Binding PL*</u> Asset acquisition cost less (a) market value of asset fulfilling function of collateral (net of any haircuts), and (b) any <i>hamish jiddiyyah</i> multiply with customer's rating or 100% RW for unrated customer	<u>Non-binding PL</u> 15% capital charge (187.5% RW equivalent) until lessee takes possession
Upon consigning a leasing contract and the lease rental payments are due from the lessee	Total estimated value of lease receivables for the whole duration of leasing contract will be risk-weighted according to the lessee's credit rating. 100% RW for an unrated lessee less recovery value of the leased asset	Not applicable
Maturity of contract term and the leased asset is sold and the asset ownership is transferred to the lessee	Not applicable	Not applicable

* This Credit RW is applicable only when IIFS will have recourse to any hamish jiddiyyah paid by the customer, and (depending on the legal situation) may have a right to recoup from the customer any loss on leasing or disposing of the asset to a third party, after taking account of the 'urbūn.

If the IIFS has no such right, the cost of the asset to the IIFS constitutes a market risk (as in the case on a non-binding PL), but this market risk exposure is reduced by the amount of any hamish jiddiyyah that the IIFS has the right to retain.

C.5 MUSHĀRAKAH AND DIMINISHING MUSHĀRAKAH

1. Introduction

167. This section sets out the minimum capital adequacy requirement to cover the risk of losing invested capital arising from entering into contracts or transactions that are based on the *Sharī'ah* rules and principles of *Mushārah* and Diminishing *Mushārah* where the IIFS and their customers/partner(s) contribute to the capital of the partnership and shares its profit or loss.

168. This section is applicable to both (a) *Mushārah* in which all the partners' share remain constant throughout the contract period; and (b) Diminishing *Mushārah* in which the share of the IIFS shall be gradually reduced during the tenure of the contract until it is fully sold to the other partner(s).

169. A *Mushārah* is an agreement between the IIFS and a customer to contribute capital in various proportions to an enterprise, whether existing or new, or to ownership of a real estate or moveable asset, either on a permanent basis, or on a diminishing basis where the customer progressively buys out the share of the IIFS ("Diminishing *Mushārah*"). Profits generated by that enterprise or real estate/asset are shared in accordance with the terms of *Mushārah* agreement whilst losses are shared in proportion to the respective contributor's share of capital.

170. An IIFS may enter into a *Mushārah* contract with a customer as a means of providing a financing to the latter on a profit sharing and loss bearing basis. In this case, the *Mushārah* is normally of the diminishing type, in which the customer gradually purchases the IIFS's partnership share over the life of the contract. This type of financing is one of the *Sharī'ah* compliant alternatives to avoid a conventional term loan repayable by instalments, and as such it is exposed to credit risk in respect of the customer's purchase payments as well as to the risk attaching to the IIFS's share of the underlying assets.

Mushārah

171. This section sets out the minimum capital adequacy requirement to cater for "capital impairment risk", the risk of losing the amount contributed to an enterprise or ownership of an asset. An IIFS acts as a partner in a *Mushārah* contract and is exposed to the risk of losing its capital upon making payment of its share of capital in a *Mushārah* contract. A *Mushārah* can expose the IIFS either to capital impairment risk or to 'credit risk', depending on the structure and purpose of the *Mushārah* and the types of asset in which the funds are invested. The invested capital is redeemable either by liquidation of the *Mushārah* assets at the end of the contract which has a fixed tenure or as mutually agreed by the partners, or upon divestment of partnership in an on-going *Mushārah* subject to giving a notice to other partners. The amount of capital redemption is represented by the value of a share of capital, which is dependent on the quality of the underlying investments or assets, and ability to generate profits and cash flows from the *Mushārah*.

172. As a partner to a *Mushārah* contract, the IIFS is not entitled to a fixed rate of return and is thus exposed to variable profits generated by the partnership which are shared on a basis as agreed in the *Mushārah* contract, whereas losses are to be borne by the IIFS and its partners according to their respective ratio of invested capital. Therefore, the IIFS is exposed to entrepreneurial risk of an active partner that manages the partnership and business risks associated with the underlying activities and types of investments or assets of the partnership.

173. For the purpose of determining the minimum capital adequacy requirement, this section makes distinctions between the three main categories of *Mushārah* as set out below:

- (a) Private commercial enterprise to undertake trading activities in foreign exchange, shares and/or commodities
This type of *Mushārah* exposes the IIFS to the risk of underlying activities, namely foreign exchange, equities or commodities.
- (b) Private commercial enterprise to undertake a business venture (other than (a))
This type of *Mushārah* exposes the IIFS to the risk as an equity holder, which is similar to the risk assumed by a partner in venture capital or a joint-venture, but

not to market risk. As an equity investor, the IIFS serves as the first loss position and its rights and entitlements are subordinated to the claims secured and unsecured creditors.

(c) Joint ownership of real estate or movable assets (such as cars) is divided into two sub-categories

(i) *Mushārah* with *Ijārah* sub-contract

Ownership of such assets can produce rental income for the partnership, through leasing the assets to third parties by means of *Ijārah* contracts. In this case, the risk of the *Mushārah* investment is essentially that of the underlying *Ijārah* contracts, i.e. credit risk mitigated by the collateral represented by the leased assets.

However, in some cases the lessee is not a third party but the IIFS's partner as customer. The existence of such an *Ijārah* sub-contract in addition to a *Mushārah* exposes the IIFS to credit risk in respect of the partner's obligation to service the lease rentals.

(ii) *Mushārah* with *Murābahah* sub-contract

The IIFS is entitled to its share of revenue generated from selling the assets to third parties by means of *Murābahah* contracts that expose the IIFS to credit risk in respect of the *Murābahah* receivables from the buyer/counterparty.

Diminishing *Mushārah*

174. This form of *Mushārah* is a means whereby an IIFS can provide term finance to a client on a profit and loss sharing basis. The IIFS enters into this type of *Mushārah* with the objective of transferring the ownership to the partner/customer, where the IIFS acts as a joint-owner of the asset with a promise by the partner to purchase the IIFS's share making a payment on one or more specified future dates. The IIFS's selling price is normally based on the fair value of the partnership share being transferred on the date of each purchase, which may expose the IIFS to the risk of selling its share of ownership below the acquisition price.

175. As a joint-owner, the IIFS is also entitled to its share of revenue generated from the assets of the *Mushārah*, such as *Ijārah* lease rentals in which the rental entitlements to the IIFS shall be adjusted periodically according to the IIFS's share of ownership in the asset.

176. The IIFS's position in a Diminishing *Mushārah* thus entails two kinds of exposure. The amounts due from the partner to purchase the agreed shares of the asset on the agreed dates are subject to credit risk in respect of the partner's ability and willingness to pay, with the shares of the partner in the asset providing credit risk mitigation as collateral. The capital invested by the IIFS is also subject to the risk that the amounts recoverable from the partner may be less than the amount invested because the value of the *Mushārah* assets has decreased (capital impairment risk).

2. Equity Position Risk

Mushārah

177. For *Mushārah*, the equity exposure can be measured based on the nature of the underlying investments as follows:

- (a) For investments held in the trading book, exposure is equal to the fair value; and
- (b) For investments held to maturity, exposure is equal to the historical cost less any provisions for impairment.

178. The *Mushārah* exposures, net of specific provisions, shall be measured as follows:

(a) *Private commercial enterprise to undertake trading activities in foreign exchange, shares or commodities*

The RW shall be based on the applicable underlying assets as set out in the market risk section in paragraphs 44 to 63.

The investment in foreign exchange and trading in gold/silver shall be measured according to the treatment as set out in paragraphs 47 to 54, which requires 8% capital charge on the greater of either net long or net short positions and 8% capital charge on the net position of gold/silver.

The RW of a *Musharakah* that invests in quoted shares shall be measured according to the equity position risk approach where positions in assets tradable in markets will qualify for treatment as equity position risk in the trading book, which would incur a total capital charge of 16% (equivalent to 200% RW) as set out in paragraphs 45 to 46. The capital charge can be reduced to 12% (equivalent to 150% RW) for a portfolio that is both liquid and well-diversified, subject to meeting the criteria as determined by the supervisory authorities.

Investment in commodities shall be measured according to either the maturity ladder approach or simplified approach as set out in paragraphs 55 to 61.

(b) *Private commercial enterprise to undertake a business venture (other than (a))*
There are two possible methods to calculate the equity exposures in this type of investment:

- (i) Simple risk-weight method: The RW shall be applied to the exposures (net of specific provisions) based on equity exposures in the banking book. The RW under simple risk weight method for equity position risk in respect of an equity exposure in a business venture shall entail a 400% for shares that are not publicly traded less any specific provisions for impairment. If there is a third party guarantee to make good impairment losses, the RW of the guarantor shall be substituted for that of the assets for the amount of any such guarantee.
- (ii) Slotting method: An IIFS is required to map its RW into four supervisory categories as set out in the **Appendix B** (specialised financing) and the **Appendix C** (Diminishing *Musharakah*) where the RW of each category is as follows:

Supervisory Categories	Strong	Good	Satisfactory	Weak
Risk Weights	90%	110%	135%	270%

The above RW under the slotting for specialised financing include an additional fixed factor of 20% RW to cater for potential decline in the *Musharakah's* net asset value.

(c) *Joint ownership of real estate and movable assets (such as cars)*
Musharakah with *Ijarah* sub-contract
Income producing *Musharakah* through leasing to third parties by means of *Ijarah* contracts exposes the capital contributor to the risk of that underlying *Ijarah* contract, i.e. counterparty risk mitigated by the value of leased assets.

This *Musharakah* investment shall be assigned a RW based on the credit standing of the counterparty/lessee, as rated by an ECAI that is approved by the supervisory authority, and 100% risk-weight on residual value of an *Ijarah* asset (operating lease). In case the counterparty is unrated, a RW of 100% shall apply. (Please refer to the treatment for *Ijarah* as set out in **Section C4**.)

Musharakah with *Murabahah* sub-contract
Income producing *Musharakah* through selling to third parties by means of *Murabahah* contracts exposes the capital contributor to the risk of that counterparty/buyer.

This *Musharakah* investment shall be assigned a RW based on the credit standing of the counterparty/buyer, as rated by an ECAI that is approved by the supervisory authority. In case the counterparty is unrated, a RW of 100% shall apply. (Please refer to the treatment for *Murabahah* as set out in **Section C1**.)

Diminishing *Mushārahah*

179. The equity exposure in a Diminishing *Mushārahah* contract, where the IIFS intends to transfer its full ownership in movable assets and working capital to the other partner over the life of the contract, is calculated based on the remaining balance of the amount invested (measured at historical cost including any share of undistributed profits) less any specific provision for impairment. This exposure shall be risk weighted according to the nature of the underlying assets as set out in paragraph 178 above. If there is a third party guarantee to make good impairment losses, the RW of the guarantor shall be substituted for that of the assets for the amount of any such guarantee.

3. Summary of Capital Requirements for *Mushārahah* Categories

180. The following table set out the *Mushārahah* categories that attract capital charges:

<i>Mushārahah</i> Category	Credit RW	Market Risk Capital Charge
Private commercial enterprise to undertake trading activities in the foreign exchange, share and/or commodity	Not applicable	Depends on the underlying asset as set out in the applicable market risk section
Private commercial enterprise to undertake business venture OTHER THAN trading activities in the foreign exchange, share and/or commodity	(a) <u>Simple risk-weight method</u> 400% RW of the contributed amount* to the business venture less any specific provisions (If there is a third party guarantee, the RW of the guarantor shall be substituted for that of the assets for the amount of any such guarantee) Or (b) <u>Slotting method</u> Between 90-270% RW of the contributed amount* to the business venture based on the four categories	Not applicable
Joint ownership of real estate and movable assets (<i>Mushārahah</i> with <i>Ijārah</i> sub-contract, <i>Mushārahah</i> with <i>Murābahah</i> sub-contract)	Based on lessee's (for <i>Ijārah</i> sub-contract) or customer's (for <i>Murābahah</i> sub-contract) rating or 100% RW for unrated lessee or customer	Please refer to the market risk capital charge requirements as set out under the sub-contracts

* In case of Diminishing *Mushārahah*, the contributed amount is based on the remaining balance of the invested amount.

C.6 MUDĀRABAH

1. Introduction

181. This section sets out the minimum capital adequacy requirement to cover the risk of losing invested capital arising from entering into contracts or transactions that are based on the *Sharī'ah* rules and principles of *Muḍārabah* where the IIFS assumes the role of capital provider. This section is applicable to both restricted and unrestricted *Muḍārabah* financing.

182. A *Muḍārabah* is an agreement between the IIFS and a customer whereby the IIFS would contribute capital to an enterprise or activity which is to be managed by the customer as the (labour provider or) *Muḍārib*. Profits generated by that enterprise or activity are shared in accordance with the terms of the *Muḍārabah* agreement whilst losses are to be borne solely by the IIFS unless the losses are due to the *Muḍārib*'s misconduct, negligence or breach of contracted terms.

183. A *Muḍārabah* financing can be carried out on either:

- (a) a restricted basis, where the capital provider allows the *Muḍārib* to make investments subject to specified investment criteria or certain restrictions such as types of instrument, sector or country exposures; or
- (b) an unrestricted basis, where the capital provider allows the *Muḍārib* to invest funds freely based on the latter's skills and expertise.

184. As the fund provider, the IIFS is exposed to the risk of losing its capital investment or 'capital impairment risk' upon making payment of the capital to the *Muḍārib*. Any loss on the investment is to be borne solely by the capital provider, but is limited to the amount of his capital. Losses that are due to misconduct, negligence or breach of contractual terms, are to be borne by the *Muḍārib*.

185. However, while it is not permissible for a *Muḍārib* to give a guarantee against such losses, such a guarantee may be given by a third party on the basis of *tabarru'* (donation). In such a case, the amount of the *Muḍārabah* capital so guaranteed may be considered as subject to credit risk with a risk weighting equal to that of the guarantor. In particular, such guarantees may be given when liquid funds are placed in an Islamic interbank market under a *Mudārabah* contract.

186. Apart from such placements, *Muḍārabah* contracts are commonly used for the investment purposes mentioned in paragraph 188 below.

187. In assigning the RW, consideration is given to the intent of the *Muḍārabah* investment, and to the nature of the underlying assets. The intent may be either (a) the purchase of assets for trading; (b) investing on an equity basis in an ongoing business venture with the intention of holding the investment for an indefinite period perhaps with a view to eventual sale (e.g. venture capital investments); or (c) project finance. The underlying assets may be tradable assets such as commodities, foreign exchange or securities, or business assets such as real property, plant and equipment and working capital. Real property and moveable property may also be purchased with a view to generating rental income by means of *Ijārah* contracts.

188. For the purpose of calculating the minimum adequacy capital requirement, this section makes distinctions between the three main categories of *Muḍārabah* as set out below:

- (a) *Private commercial enterprise to undertake trading activities in foreign exchange, shares or commodities*
This type of *Muḍārabah* exposes the IIFS to the risk of the underlying activities, namely foreign exchange, equity or commodities.
- (b) *Private commercial enterprise to undertake a business venture (other than (a))*
This type of *Muḍārabah* exposes the IIFS to risk as an equity holder, which is similar to the risk assumed by a partner in venture capital or a joint-venture, but not to market risk. As an equity investor, the IIFS serves as the first loss position and its rights and entitlements are subordinated to the claims secured and unsecured creditors.

(c) *Muḍārabah investments in project finance*

An IIFS advances funds to a customer who acts as *Muḍārib* in a construction contract for a third-party customer (ultimate customer). The ultimate customer will make progress payments to the *Muḍārib* who in turn make payments to the IIFS. The essential role of the IIFS in this structure is to provide bridging finance to the *Muḍārib* pending its receipt of the progress payments. In this *Muḍārabah* structure:

- (i) the IIFS has no direct or contractual relationship with the ultimate customer (but the IIFS may stipulate that payments by the ultimate customer to the *Muḍārib* be made to an account (“repayment account”) with the IIFS which has been opened for the purpose of the *Muḍārabah* and from which the *Muḍārib* may not make withdrawals without the IIFS’s permission); and
- (ii) the IIFS as investor advances funds to the construction company as *Muḍārib* for the construction project and is entitled to a share of the profit of the project but must bear 100% of any loss.

The IIFS is exposed to the risk on the amounts paid to the *Muḍārib*, and as these amounts are made on a profit sharing and loss bearing basis they are treated under credit risk as “equity positions in the ‘banking book’”. In principle, the IIFS’s credit exposure is to the *Muḍārib*, not to the ultimate customer; however, as described below, a structure may involve the “*Muḍārabah* repayment account” instead of making payments to the *Muḍārib*, which transfers much of the credit risk to the ultimate customer.

In addition to credit risk (i.e. that the *Muḍārib* has received payment from the ultimate customer but fails to pay the IIFS, or that the ultimate customer fails to pay) the IIFS is exposed to capital impairment in case the project results in a loss.

Direct payment by ultimate customer into account opened with the IIFS and effectively pledged to the IIFS

Much of the IIFS’s credit exposure to the *Muḍārib* may be transferred to the ultimate customer under this structure involving the “repayment account”. If the ultimate customer is a sovereign or otherwise has a very low risk weighting, this may affect the RW to be applied to the exposure, and other credit risk mitigants may be applied, as described below.

Provided the construction work proceeds normally and to the ultimate customer’s satisfaction, the risk attaching to the progress payments due from the ultimate customer to the *Muḍārib* will be the credit risk of the ultimate customer. However, this does not per se constitute a mitigation of the credit risk of the IIFS’s exposure to the *Muḍārib*. In such a case, if an independent engineer employed to certify that the work has reached a certain stage of completion has issued a certificate to that effect, so that a progress payment is due from the ultimate customer, from the point of view of the IIFS the amount of that progress payment due is no longer exposed to the risk of unsatisfactory performance by the *Muḍārib*, but only to the latter’s failure to pay the IIFS (the *Muḍārib* being exposed to possible default by the ultimate customer). Such an amount might thus arguably bear a RW based entirely on the credit standing of the *Muḍārib*, i.e. say 100%, rather than 400%. However, if a binding agreement exists between the IIFS and the ultimate customer whereby the latter will make the payment into a “repayment account” with the IIFS, the latter’s credit exposure in respect of the amount due is transferred from the *Muḍārib* to the ultimate customer.

Other structures may be used which have the effect of modifying the risk exposures of the investors in a *Muḍārabah*. The determination of the risk exposure (nature and amount) shall take into account any such structures and this shall also be reflected in the application of RW.

2. Equity Position Risk

189. The equity exposure can be measured based on the nature of the underlying investments as follows:

- (a) For investments held in the trading book, the exposure is equal to the fair value; or
- (b) For investments held to maturity, the exposure is equal to the historical cost less any provisions for impairment.

190. The *Muḍārabah* exposures, net of specific provisions, shall be measured as follows:

- (a) *Private commercial enterprise to undertake trading activities in foreign exchange, shares or commodities*

The RW shall be based on the applicable underlying assets as set out in the market risk section in paragraphs 44 to 63.

The investment in foreign exchange and trading in gold/silver shall be measured according to the treatment of as set out in paragraphs 47 to 54, which requires 8% capital charge on the greater of either net long or net short positions and 8% capital charge on the net position of gold/silver.

The RW of a *Muḍārabah* that invests in quoted shares shall be measured according to equity position risk approach where positions in assets tradable in markets will qualify for treatment as equity position risk in the trading book, which would incur a total capital charge of 16% (equivalent to 200% RW)) as set out in paragraphs 45 to 46. The capital charge can be reduced to 12% (equivalent to 150% RW) for a portfolio that is both liquid and well-diversified, subject to meeting the criteria as determined by the supervisory authorities.

Investment in commodities shall be measured according to either the maturity ladder approach or simplified approach as set out in paragraphs 55 to 61.

- (b) *Private commercial enterprise to undertake a business venture (other than (a))*

There are two possible methods to calculate the equity exposures in this type of investment:

- (i) Simple risk-weight method: The RW shall be applied to the exposures (net of specific provisions) based on equity exposures in the banking book. The RW under the simple risk-weight method for equity position risk in respect of an equity exposure in a business venture shall entail a 400% for shares that are not publicly traded. However, funds invested on a *Muḍārabah* basis may be subject to withdrawal by the investor at short notice, and in that case may be considered as being as liquid as shares that are publicly traded. The applicable RW in such a case is 300%.
- (ii) Slotting method: An IIFS is required to map its RW into four supervisory categories as set out in the **Appendix B** where the RW of each category is as follows:

Supervisory Categories	Strong	Good	Satisfactory	Weak
Risk Weights	90%	110%	135%	270%

The above RW under the method for specialised financing include an additional fixed factor of 20% RW to cater for potential decline in the *Muḍārabah's* net asset value.

- (c) *Muḍārabah investment in project finance*

The IIFS's overall credit exposure in respect of the *Muḍārabah* in such a case can be divided into three parts:

- (i) the amount receivable by the IIFS from the *Muḍārib* in respect of progress payments due to the *Muḍārib* from the ultimate customer for work certified as having reached a certain stage of completion – If a binding agreement exists as described in paragraph 188(c) whereby the amount will be paid by the ultimate customer into a “repayment account”

with the IIFS, a RW will reflect the credit standing of the ultimate customer.

In the absence of such an agreement, the RW would reflect the credit standing of the *Muḍārib* or 100% for unrated);

- (ii) the amount held in the “repayment account” with the IIFS, which would have a risk weighting of 0%;
- (iii) any remaining balance of the funds advanced by the IIFS to the *Muḍārib*, which would incur a RW of 400% unless otherwise rated, the treatment as set out in paragraph 190(b) applies.

3. Summary of Capital Requirements for *Muḍārabah* Categories

191. The following tables set out the *Muḍārabah* categories that attract capital charges:

<i>Muḍārabah</i> Category	Credit RW	Market Risk Capital Charge
Private commercial enterprise to undertake trading activities in the foreign exchange, share and/or commodity	Not applicable	Depends on the underlying asset as set out in the applicable market risk section
Private commercial enterprise to undertake business venture OTHER THAN trading activities in the foreign exchange, share and/or commodity	(a) <u>Simple risk-weight method</u> 400% RW* of the contributed amount to the business venture less any specific provisions Or (b) <u>Slotting method</u> Between 90-270% RW of the contributed amount to the business venture based on the four categories	Not applicable

* 300% RW may be applied if the funds may be subject to withdrawal by the investor at short notice

Muḍārabah Investment in Project Finance

Applicable Contract Stages	Credit RW	Market Risk Capital Charge
<u>Prior to certification</u> where funds are already advanced by the IIFS to the <i>Muḍārib</i>	Risk weight is based on the rating of either the ultimate customer or the <i>Muḍārib</i> (see paragraph 190(c) above). Otherwise, 400% RW is applied to unrated <i>Muḍārib</i> .	Not applicable
<u>After certification</u> where amount receivable by the IIFS from the <i>Muḍārib</i> in respect of progress payment due to the <i>Muḍārib</i> from the ultimate customer	Based on the credit standing of the ultimate customer on the amounts receivable by the IIFS from the <i>Muḍārib</i> or 100% RW for unrated ultimate customer – only if a risk mitigation structure is used (collateralisation of cash flows from the ultimate customer by the use of a project account held in the IIFS into which the ultimate customer makes the progress payments and from which the <i>Muḍārib</i> cannot withdraw funds without the IIFS's permission).	Not applicable

C.7 **SUKŪK held as investment (in the “banking book”)**

1. **Introduction**

192. This section sets out the minimum capital adequacy requirement to cover the credit risk and market risk arising from the holding of *sukūk* in the “banking book” by the IIFS. This section does not apply to *sukūk* in the trading book, which are exposed to market risk but not credit risk, and are treated in paragraph 45. As in principle *sukūk* are externally rated, the relevant risk weight will be based on these ECAI in accordance with the Standardised Approach. Where there are no acceptable ECAI ratings, the risk weights will be determined on the basis of the underlying assets as set out below, which may involve market risk as well as credit risk.

193. This section is applicable only to *sukūk* or certificates that represent the holder’s proportionate ownership in an undivided part of an underlying asset where the holder assumes all rights and obligations to such asset. This section does not cover certificates that give the holders the entitlement to receive returns on an asset of which the ownership is not transferred to the *sukūk* holders.

194. *Sukūk* can be broadly categorised into:

- (a) asset-based *sukūk*, where the underlying assets offer fairly predictable returns to the *sukūk* holders, such as in the case of *Salam*, *Istisnā`* and *Ijārah* (Note: the assets in question may be held by a *Mushārah* or *Muḍārah* which is securitised. This is not the same as the *Mushārah* or *Muḍārah sukūk* mentioned below); and
- (b) equity-based *sukūk*, where the returns are determined on a profit and loss sharing in the underlying investment which does not offer fairly predictable returns (e.g. *Mushārah* or *Muḍārah* for trading purposes).

195. Supervisory authorities have discretion to specify measurement approaches as they think appropriate for other types of *sukūk* which are not listed in this section, provided they are approved by a *Sharī`ah* board.

Salam sukūk

196. A *Salam sukūk* represents fractional ownership of the capital of a *Salam* transaction, where the *Salam* capital is constituted by an advance payment to a counterparty as supplier of a commodity (the subject-matter) to be delivered at a future date. This type of *sukūk* is non-tradable, since the subject-matter is considered to be a financial asset (a receivable). The gross return to the *sukūk* holders consists of the margin or spread between the purchase price of the subject-matter and its selling price following delivery. In certain *sukūk* issues, a third party gives an undertaking that the subject-matter will be sold at a price exceeding the purchase price by a specified margin. This may be achieved by means of a parallel *Salam* transaction in which a third party purchases the subject-matter for delivery on the same delivery date as in the original *Salam* contract.

Istisnā` sukūk

197. An *Istisnā` sukūk* represents a fractional share in the project financing of an undertaking to manufacture or construct an asset for a customer at a price to be paid in future instalments, the total of which equals the total face value of the *sukūk*, in addition to mark-up. The *sukūk* can be in the form of serial notes or certificates with different maturity dates that match the progress schedule of instalments as agreed between the buyer/customer of the asset and the manufacturer/IIFS. *Istisnā` sukūk* are tradable as the subject-matter is considered to be a non-financial asset (work-in-process inventory).

Ijārah sukūk

198. An *Ijārah sukūk* represents the holder’s proportionate ownership in a leased asset where the *sukūk* holders will collectively assume the rights and obligations of the lessor. The *sukūk* holder will enjoy a share of the lease rental in proportionate to the ownership share in the leased asset. An *Ijārah sukūk* is tradable from the issuance date as the subject-matter is a non-financial asset owned by the *sukūk* holders. As a part-owner, the *Ijārah sukūk* holder assumes a proportionate share of any loss if the leased asset is destroyed or of the cost of meeting the obligation to provide an alternative asset, failing which, the lessee can terminate the lease without paying future rentals.

Mushārah sukūk

199. A *Mushārah sukūk* represents the direct pro-rata ownership of the holder in the assets of a private commercial enterprise or project where the subscription money is normally employed in purchasing non-liquid assets or such as real estate or moveable assets. A *Mushārah sukūk* is a profit and loss sharing instrument where the exposure is of the nature of an equity position in the banking book, except in the case of investments (normally short-term) in assets for trading purposes. A *Mushārah* certificate can be tradable provided that non-cash and receivable assets are not less than 30% of market capitalisation.

Mudārah (Muqarāh) sukūk

200. *Sukūk* holders subscribe to the certificates issued by a *Mudārib* and share the profit and bear any losses arising from the *Mudārah* operations. The returns to the holders are dependent on the revenue generated by the underlying investment. The rule regarding tradability of the certificates is the same as for *Mushārah* certificates.

2. Salam sukūk

201. The credit risk in *Salam sukūk* is similar to that of the underlying *Salam* contract, where the credit risk exists upon the subscription of the *sukūk* until the delivery and sale of the subject-matter. As such, the RW is based on the counterparty (*Salam* supplier) unless the *Salam* capital is guaranteed by a third party in which case the RW is that of the issuer if lower than that of the supplier. The RW is 100% for an unrated counterparty (*Salam* supplier) or guarantor/ third party when the *Salam* capital is guaranteed by the third party, if any.

202. The market risk in *Salam sukūk* is likewise the same as that of the underlying contract, namely a long position in the underlying commodity. This risk can be measured according to either the maturity ladder approach or the simplified approach as set out in paragraphs 55 to 63.

203. A *Salam sukūk* which is structured with an undertaking from the issuer that the underlying commodity will be sold to a third party at a specified selling price (by means of a Parallel *Salam* contract) shall carry the RW of the buyer of that underlying commodity in the Parallel *Salam* contract.²⁰

3. Istisnā` sukūk

204. In *Istisnā`*, the credit risk occurs upon commencement of the manufacturing or construction works by the IIFS until the whole amount or all the instalments (progress billings) are paid by the purchaser/issuer.

205. The RW for *Istisnā` sukūk* is based on the counterparty/customer, which is 100% for an unrated buyer, unless a third party provides a guarantee in which case the third party's RW (if lower than that of the counterparty) will be applicable. In addition, a RW of 20% will be added to cater for the price risk to which the underlying *Istisnā`* is exposed. In the case of ECAI-rated *Istisnā` sukūk*, the ECAI rating will apply.

206. In the event the returns to the *sukūk* holder are from the cash flow of the underlying assets, which fall under the category of limited and non-recourse *Istisnā`*, the RW shall be based on the 'Supervisory Slotting Criteria' approach which carries RW of 70% to 250%.

207. Please refer to Section on *Istisnā`* for detailed treatment.

4. Ijārah and IMB sukūk

208. The RW for IMB rentals is based on the lessee's/ counterparty risk since the bearer of the residual value risk of the underlying asset is not borne by the *sukūk* holders. Please refer to Section on *Ijārah* and IMB for detailed treatment.

209. In the case of ECAI-rated *Ijārah* and IMB *sukūk*, the ECAI rating will apply.

²⁰ For this type of *Salam sukūk*, there is no capital charge for market risk that consists of basis and forward gap risks (namely the risk that the hedge may be impaired because the underlying commodity delivered may be of inferior quality or may be delivered later than the contractual date) as the underlying commodity is normally traded on an exchange that eliminates the risk of late/non-delivery or delivery of inferior quality of a commodity.

5. **Mushārahah sukūk**

210. The treatment of *Mushārahah sukūk* is based on the intent of the underlying investments in *Mushārahah* that can be categorised into:

(a) *Private commercial enterprise to undertake trading activities in foreign exchange, shares or commodities*

The risk weights (RW) shall be based on the applicable underlying assets as set out in the market risk section in paragraphs 44 to 63.

(b) *Private commercial enterprise to undertake business venture or project (other than (a))*

The RW for equity position risk in respect of an equity exposure in a business venture or project is measured according to either the simple risk weight method or the supervisory slotting criteria approach. The treatment as set out herein is not applicable to a *Mushārahah*/business venture that issues other types of *sukūk*, such as an *Ijārah sukūk*, of which provisions under the *Ijārah sukūk* shall be applied.

(c) *Joint ownership of real estate or movable assets (such as cars)*

Income producing *Mushārahah* investments through leasing to third parties by means of *Ijārah* shall carry the RW of the counterparty, that is, the lessee.

Income producing *Mushārahah* investments through selling to third parties by means of *Murābahah* shall carry the RW of the counterparty, that is, the buyer.

211. Please refer to Section on *Mushārahah* for detailed treatment.

6. **Muḍārahah (Muḍārahah) sukūk**

212. The treatment of *Muḍārahah sukūk* is based on the intent of the underlying investments in *Muḍārahah* that can be categorised into:

(a) *Private commercial enterprise to undertake trading activities in foreign exchange, shares or commodities*

The RW shall be based on the applicable underlying assets as set out in the market risk section in paragraphs 44 to 63.

(b) *Private commercial enterprise to undertake business venture or project (other than (a))*

The RW for equity position risk in respect of an equity exposure in a business venture or project is measured according to either the simple risk weight method or the supervisory slotting criteria approach.

213. Please refer to Section on *Muḍārahah* for detailed treatment. In the case of ECAI rated *Muḍārahah sukūk*, the ECAI rating will apply.

7. **Exclusion**

214. A *sukūk* which is issued by a sovereign shall carry the RW applicable to that sovereign, according to its respective rating as assigned by an ECAI that is approved by the supervisory authority.

8. Summary of Capital Requirements for Sukūk held in the “banking book”

215. The following table sets out the applicable credit RW and market risk capital charge, depending whether the *Sukūk* do or do not have an ECAI rating.

Sukūk Category	Credit RW	Market Risk Capital Charge
Externally rated	Applicable risk weight will be based on the ECAI ratings in accordance with the Standardised Approach	Not applicable
Non-rated	Applicable risk weight will be based on the underlying contract or on that of the issuer if there is recourse to the issuer	Applicable capital charge will be based on the underlying contract

APPENDIX A: CAPITAL RATIO FORMULA

(a) Standard Formula

$$\frac{\text{Eligible Capital}}{\left\{ \text{Total Risk-weighted Assets}^{21} (\text{Credit}^{22} + \text{Market}^{22} \text{ Risks}) \text{ Plus Operational Risks} \right.}$$

$$\left. \begin{array}{l} \text{Less} \\ \text{Risk-weighted Assets funded by PSIA}^{23} (\text{Credit}^{22} + \text{Market}^{22} \text{ Risks}) \end{array} \right\}$$

(b) Supervisory Discretion Formula

216. This formula is applicable in jurisdictions where supervisory authority considers the IIFS is obliged to smooth income to the Investment Account Holders (IAHs) as part of a mechanism to minimise withdrawal risk and is concerned with systemic risk.

$$\frac{\text{Eligible Capital}}{\left\{ \text{Total Risk-weighted Assets} (\text{Credit}^{22} + \text{Market}^{22} \text{ Risks}) \text{ Plus Operational Risks} \right.}$$

$$\left. \begin{array}{l} \text{Less} \\ \text{Risk-weighted Assets funded by Restricted PSIA}^{23} (\text{Credit}^{22} + \text{Market}^{22} \text{ Risks}) \\ \text{Less} \\ (1 - \alpha)^{24} [\text{Risk-weighted Assets funded by Unrestricted PSIA}^{23} (\text{Credit}^{22} + \text{Market}^{22} \text{ Risks})] \\ \text{Less} \\ \alpha [\text{Risk-weighted Assets funded by PER and IRR of Unrestricted PSIA}^{25} (\text{Credit}^{22} + \text{Market}^{22} \\ \text{Risks})] \end{array} \right\}$$

²¹ Total RWA include those financed by both restricted and unrestricted Profit Sharing Investment Accounts (PSIA).

²² Credit and market risks for on- and off-balance sheet exposures.

²³ Where the funds are commingled, the RWA funded by PSIA are calculated based on their pro-rata share of the relevant assets. PSIA balances include PER and Investment risk reserve (IRR) or equivalent reserves.

²⁴ α refers to the proportion assets funded by unrestricted PSIA which is to be determined by the supervisory authorities. The value of α would therefore vary based on supervisory authorities' discretion on a case-by-case basis.

²⁵ The relevant proportion of risk-weighted assets funded by the PSIA's share of PER and by IRR is deducted from the denominator. The PER has the effect of reducing the displaced commercial risk and the IRR has the effect of reducing any future losses on the investment financed by the PSIA.

APPENDIX B: SUPERVISORY SLOTTING CRITERIA FOR *ISTISNĀ`* IN LIMITED AND NON-RECOURSE PROJECT FINANCE AND *MUSHĀRAKAH* IN A BUSINESS VENTURE

	Strong	Good	Satisfactory	Weak
Financials				
Market conditions	Few competitors or substantial and durable advantage in location, cost, or technology Demand is strong and growing	Few competitors or better than average location, cost, or technology but this situation may not last Demand is strong and stable	Project/business venture has no advantage in location, cost, or technology Demand is adequate and stable	Project/business venture has worse than average location, cost, or technology Demand is weak and declining
Financial ratios	Strong financial ratios considering the level of project/ business venture risk; very robust economic assumptions.	Strong to acceptable financial ratios considering the level of project/ business venture risk; robust project/ business venture economic assumptions.	Standard financial ratios considering the level of project/ business venture risk.	Aggressive financial ratios considering the level of project/business venture risk.
Stress analysis	The project/business venture can meet its financial obligations under sustained, severely stressed economic or sectoral conditions	The project/business venture can meet its financial obligations under normal stressed economic or sectoral conditions. The project/ business venture is only likely to default under severe economic conditions	The project/business venture is vulnerable to stresses that are not uncommon through an economic cycle, and may default in a normal downturn	The project/business venture is likely to default unless conditions improve soon

APPENDIX B: SUPERVISORY SLOTTING CRITERIA FOR *ISTISNĀ`* IN LIMITED AND NON-RECOURSE PROJECT FINANCE AND *MUSHĀRAKAH* IN A BUSINESS VENTURE

	Strong	Good	Satisfactory	Weak
Financing structure				
Duration of the contract compared to the duration of the project/ business venture	Useful life of the project/ business venture significantly exceeds tenor of the financing contract	Useful life of the project/ business venture exceeds tenor of the financing contract	Useful life of the project/ business venture exceeds tenor of the financing contract	Useful life of the project/ business venture may not exceed tenor of the contract
Payment structure of selling price <i>(Note: applicable to <u>Istisnā`</u> only)</i>	Partly in advance and in instalments	Instalments	Instalments with limited bullet payment	Bullet payment or in instalments with balloon structure (higher instalment amounts towards end of the contract)
Political and legal environment				
Political risk, including transfer risk, considering project/business venture type and mitigants	Very low exposure; strong mitigation instruments, if needed	Low exposure; satisfactory mitigation instruments, if needed	Moderate exposure; fair mitigation instruments	High exposure; no or weak mitigation instruments
<i>Force majeure</i> risk (war, civil unrest, etc),	Low exposure	Acceptable exposure	Standard protection	Significant risks, not fully mitigated

APPENDIX B: SUPERVISORY SLOTTING CRITERIA FOR *ISTISNĀ`* IN LIMITED AND NON-RECOURSE PROJECT FINANCE AND *MUSHĀRAKAH* IN A BUSINESS VENTURE

	Strong	Good	Satisfactory	Weak
Political and legal environment (cont'd)				
Government support and project/business venture's importance for the country over the long term	Project/business venture of strategic importance for the country (preferably export-oriented) Strong support from government	Project/business venture considered important for the country. Good level of support from government.	Project/business venture may not be strategic but brings unquestionable benefits for the country. Support from government may not be explicit.	Project/business venture not key to the country No or weak support from government
Stability of legal and regulatory environment (risk of change in law)	Favourable and stable regulatory environment over the long term	Favourable and stable regulatory environment over the medium term	Regulatory changes can be predicted with a fair level of certainty	Current or future regulatory issues may affect the project/ business venture
Acquisition of all necessary supports and approvals for such relief from local content laws	Strong	Satisfactory	Fair	Weak
Enforceability of contracts, collateral and security	Contracts, collateral and security are enforceable	Contracts, collateral and security are enforceable	Contracts, collateral and security are considered enforceable even if certain non-key issues may exist	There are unresolved key issues in respect of actual enforcement of contracts, collateral and security

APPENDIX B: SUPERVISORY SLOTTING CRITERIA FOR *ISTISNĀ`* IN LIMITED AND NON-RECOURSE PROJECT FINANCE AND *MUSHĀRAKAH* IN A BUSINESS VENTURE

	Strong	Good	Satisfactory	Weak
Transaction Characteristics				
Design and technology risk	Fully proven technology and design	Fully proven technology and design	Proven technology and design-start-up issues are mitigated by a strong completion package	Unproven technology and design; technology issues exist and/or complex design
Construction Risk (for project finance only)				
Permitting and siting	All permits have been obtained	Some permits are still outstanding but their receipt is considered very likely	Some permits are still outstanding but the permitting process is well defined and they are considered routine	Key permits still need to be obtained and are not considered routine. Significant conditions may be attached
Type of construction contract	Fixed-price date-certain turnkey construction EPC (engineering and procurement contract)	Fixed-price date-certain turnkey construction EPC	Fixed-price date-certain turnkey construction contract with one or several contractors	No or partial fixed-price turnkey contract and/or interfacing issues with multiple contractors
Completion guarantees	Substantial liquidated damages supported by financial substance and/or strong completion guarantee from sponsors with excellent financial standing	Significant liquidated damages supported by financial substance and/or completion guarantee from sponsors with good financial standing	Adequate liquidated damages supported by financial substance and/or completion guarantee from sponsors with good financial standing	Inadequate liquidated damages or not supported by financial substance or weak completion guarantees

APPENDIX B: SUPERVISORY SLOTTING CRITERIA FOR *ISTISNĀ`* IN LIMITED AND NON-RECOURSE PROJECT FINANCE AND *MUSHĀRAKAH* IN A BUSINESS VENTURE

	Strong	Good	Satisfactory	Weak
Construction Risk (for project finance only) (cont'd)				
Track record and financial strength of contractor in constructing similar project/business ventures	Strong	Good	Satisfactory	Weak
Operating risk (for project finance only)				
Scope and nature of operations and maintenance (O & M) contracts	Strong long-term O&M contract, preferably with contractual performance incentives, and/or O&M reserve accounts	Long-term O&M contract, and/or O&M reserve accounts	Limited O&M contract or O&M reserve account	No O&M contract: risk of high operational cost overruns beyond mitigants
Operator's expertise, track record, and financial strength	Very strong, or committed technical assistance of the sponsors	Strong	Acceptable	Limited/weak, or local operator dependent on local authorities

APPENDIX B: SUPERVISORY SLOTTING CRITERIA FOR *ISTISNĀ`* IN LIMITED AND NON-RECOURSE PROJECT FINANCE AND *MUSHĀRAKAH* IN A BUSINESS VENTURE

	Strong	Good	Satisfactory	Weak
Off-take risk (for project finance only)				
(a) If there is a take-or-pay or fixed-price off-take contract:	Excellent creditworthiness of off-taker; strong termination clauses; tenor of off-take contract comfortably exceeds the maturity of the financing contract	Good creditworthiness of off-taker; strong termination clauses; tenor of off-take contract exceeds the maturity of the financing contract	Acceptable financial standing of off-taker; normal termination clauses; tenor of off-take contract generally matches the maturity of the financing contract	Weak off-taker; weak termination clauses; tenor of off-take contract does not exceed the maturity of the financing contract
(b) If there is no take-or-pay or fixed-price off-take contract	Project produces essential services or a product sold widely on a world market; output can readily be absorbed at projected prices even at lower than historic market growth rates	Project produces essential services or a product sold widely on a regional market that will absorb it at projected prices even at historical growth rates	Product is sold on a limited market that may absorb it only at lower than projected rates	Project output is demanded by only one of a few buyers or is not generally sold on a organised market
Supply risk (for project finance only)				
Price, volume and transportation risk of feed-stocks; supplier's track record and financial strength	Long-term supply contract with supplier of excellent financial standing	Long-term supply contract with supplier of good financial standing	Long-term supply contract with supplier of good financial standing – a degree of price risk may remain	Short-term supply contract or long-term supply contract with financially weak supplier – a degree of price risk definitely remains

**APPENDIX B: SUPERVISORY SLOTTING CRITERIA FOR *ISTISNĀ`* IN LIMITED AND NON-RECOURSE PROJECT FINANCE
AND *MUSHĀRAKAH* IN A BUSINESS VENTURE**

	Strong	Good	Satisfactory	Weak
Supply risk (cont'd) (for project finance only)				
Reserve risks (e.g. natural resource development)	Independently audited, proven and developed reserves well in excess of requirements over lifetime of the project	Independently audited, proven and developed reserves well in excess of requirements over lifetime of the project	Proven reserves can supply the project adequately through the maturity of the financing contract	Project relies to some extent on potential and undeveloped reserves
Strength of Sponsor				
Sponsor's (or partner's, in the case of <i>Mushārahah</i>) track record, financial strength, and country/sector experience	Strong sponsor (partner) with excellent track record and high financial standing	Good sponsor (partner) with satisfactory track record and good financial standing	Adequate sponsor (partner) with adequate track record and good financial standing	Weak sponsor (partner) with no or questionable track record and/or financial weaknesses
Sponsor (or partner, in the case of <i>Mushārahah</i>) support, as evidenced by equity, ownership clause and incentive to inject additional cash if necessary	Strong. Project/business venture is highly strategic for the sponsor (partner), i.e. core business and long-term strategy	Good. Project/business venture is strategic for the sponsor (partner), i.e. core business and long-term strategy	Acceptable. Project/business venture is considered important for the sponsor (partner) , i.e. core business	Limited. Project/business venture is not key to sponsor(partner)'s long-term strategy or core business

**APPENDIX B: SUPERVISORY SLOTTING CRITERIA FOR *ISTISNĀ`* IN LIMITED AND NON-RECOURSE PROJECT FINANCE
AND *MUSHĀRAKAH* IN A BUSINESS VENTURE**

	Strong	Good	Satisfactory	Weak
Security Package				
Assignment of contracts and accounts *	Fully comprehensive	Comprehensive	Acceptable	Weak
Pledge of assets, taking into account quality, value and liquidity of assets *	First perfected security arrangement in all project assets, contracts, permits and accounts necessary to run the project	Perfected security arrangement in all project assets, contracts, permits and accounts necessary to run the project	Acceptable security arrangement in all project assets, contracts, permits and accounts necessary to run the project	Little security or collateral for IIFS; weak negative pledge clause
IIFS' control over cash flow (e.g. independent escrow accounts)	Strong	Satisfactory	Fair	Weak
Reserve funds (payment of selling price in <i>Istisnā`</i> , O&M, renewal and replacement, unforeseen events, etc.)	Longer than average coverage period, all reserve funds fully funded in cash	Average coverage period, all reserve funds fully funded in cash	Average coverage period, all reserve funds fully funded in cash	Shorter than average coverage period, reserve funded from operating cash flows

* In *Mushārahah*, the collateralisation of underlying assets is restricted to losses arising from negligence and misconduct cases only.

APPENDIX C: SUPERVISORY SLOTTING CRITERIA FOR DIMINISHING *MUSHĀRAKAH* IN REAL ESTATE

	Strong	Good	Satisfactory	Weak
Financial strength				
Market conditions	The supply and demand for the business venture's type and location are currently in equilibrium. The number of competitive properties coming to market is equal or lower than forecasted demand.	The supply and demand for the business venture's type and location are currently in equilibrium. The number of competitive properties coming to market is roughly equal to forecasted demand.	Market conditions are roughly in equilibrium. Competitive properties are coming on the market and others are in the planning stages. The business venture's design and capabilities may not be state of the art compared to new project/business ventures.	Market conditions are weak. It is uncertain when conditions will improve and return to equilibrium. The business venture is losing tenants at <i>Ijarah</i> /lease expiration. New <i>Ijarah</i> /lease terms are less favourable compared to those expiring.
Stress analysis	The property's resources, contingencies and liability structure allow it to meet its financial obligations during a period of severe financial stress.	The property can meet its financial obligations under a sustained period of financial stress. The property is likely to default only under severe economic conditions.	During an economic downturn, the property would suffer a decline in revenue that would limit its ability to fund capital expenditures and significantly increase the risk of default.	The property's financial condition is strained and is likely to default unless conditions improve in the near term.

APPENDIX C: SUPERVISORY SLOTting CRITERIA FOR DIMINISHING *MUSHĀRAKAH* IN REAL ESTATE

	Strong	Good	Satisfactory	Weak
Cash-flow predictability				
(a) For complete and stabilised property.	<p>The property's leases are long-term with creditworthy tenants and their maturity dates are scattered. The property has a track record of tenant retention upon lease expiration. Its vacancy rate is low.</p> <p>Expenses (such as maintenance, insurance, security, and property taxes) are predictable.</p>	<p>Most of the property's leases are long-term, with tenants that range in creditworthiness. The property experiences a normal level of tenant turnover upon lease expiration. Its vacancy rate is low. Expenses are predictable.</p>	<p>Most of the property's leases are medium rather than long-term with tenants that range in creditworthiness. The property experiences a moderate level of tenant turnover upon lease expiration. Its vacancy rate is moderate. Expenses are relatively predictable but vary in relation to revenue.</p>	<p>The property's leases are of various terms with tenants that range in creditworthiness. The property experiences a very high level of tenant turnover upon lease expiration. Its vacancy rate is high. Significant expenses are incurred preparing space for new tenants.</p>
(b) For complete but not stabilised property	<p>Leasing activity meets or exceeds projection. The business venture should achieve stabilisation in the near future.</p>	<p>Leasing activity meets or exceeds projections. The project should achieve stabilisation in the near future.</p>	<p>Most leasing activity is within projections; however, stabilisation will not occur for some time.</p>	<p>Market rents do not meet expectations. Despite achieving target occupancy rate, cash flow coverage is tight due to disappointing revenue.</p>

APPENDIX C: SUPERVISORY SLOTting CRITERIA FOR DIMINISHING *MUSHĀRAKAH* IN REAL ESTATE

	Strong	Good	Satisfactory	Weak
(c) For construction phase	The property is entirely pre-leased through the tenor of the contract or pre-sold to an investment grade tenant or buyer.	The property is entirely pre-leased or pre-sold to a creditworthy tenant or investor.	Leasing activity is within projections but the building may not be pre-leased. The IIFS may be the permanent investor.	The property is deteriorating due to cost overruns, market deterioration, tenant cancellations or other factors. There may be a dispute with the party providing the permanent financing.
Asset characteristics				
Location	Property is located in highly desirable location that is convenient to services that tenants desire.	Property is located in desirable location that is convenient to services that tenants desire.	The property location lacks a competitive advantage.	The property's location, configuration, design and maintenance have contributed to the property's difficulties.
Design and condition	Property is favoured due to its design, configuration, and maintenance, and is highly competitive with new properties.	Property is appropriate in terms of its design, configuration and maintenance. The property's design and capabilities are competitive with new properties.	Property is adequate in terms of its configuration, design and maintenance.	Weaknesses exist in the property's configuration, design or maintenance.

APPENDIX C: SUPERVISORY SLOTTING CRITERIA FOR DIMINISHING *MUSHĀRAKAH* IN REAL ESTATE

	Strong	Good	Satisfactory	Weak
Property is under construction	Construction budget is conservative and technical hazards are limited. Contractors are highly qualified.	Construction budget is conservative and technical hazards are limited. Contractors are highly qualified.	Construction budget is adequate and Contractors are ordinarily qualified.	Business venture is over budget or unrealistic given its technical hazards. Contractors may be under qualified.
Strength of <i>Mushārah</i> partner(s)				
Financial capacity and willingness to support the property.	The partner has substantial resources and limited direct and contingent liabilities.	The partner's financial condition allows it to support the property in the event of a cash flow shortfall.	The partner is average to below average in financial resources.	The partner lacks capacity or willingness to support the property.

APPENDIX C: SUPERVISORY SLOTTING CRITERIA FOR DIMINISHING *MUSHĀRAKAH* IN REAL ESTATE

	Strong	Good	Satisfactory	Weak
Reputation and track record with similar properties.	Experienced management and high partner's quality. Strong reputation and lengthy and successful record with similar properties	Appropriate management and partner's quality. The partner or management has a successful record with similar properties	Moderate management and sponsors' quality. Management or sponsor track record does not raise serious concerns	Ineffective management and substandard partners' quality. Management and partner difficulties have contributed to difficulties in managing properties in the past
Relationships with relevant real estate actors	Strong relationships with leading actors such as leasing agents	Proven relationships with leading actors such as leasing agents	Adequate relationships with leasing agents and other parties providing important real estate services	Poor relationships with leasing agents and/or other parties providing important real estate services
Divestment and Liquidation				
Legal infrastructure	Legally enforceable to sell / liquidate the property	Legally enforceable to sell / liquidate the property	Legally enforceable to sell / liquidate the property	Ability to sell / liquidate the property is constrained and time consuming
Quality of the <i>Takaful</i> or insurance coverage	Appropriate	Appropriate	Appropriate	Substandard