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<td>Governor, Bangladesh Bank</td>
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<td>The Hon. Pehin Dato Paduka Haji Abdul Rahman bin Haji Ibrahim</td>
<td>Minister of Finance II, Ministry of Finance, Brunei</td>
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<td>H.E. Dr. Farouk El Okdah</td>
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<td>H.E. Hamad Al-Sayari</td>
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<td>H.E. Heng Swee Keat</td>
<td>Managing Director, Monetary Authority of Singapore</td>
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<tr>
<td>H.E. Sultan Bin Nasser Al Suwaidi</td>
<td>Governor, Central Bank of United Arab Emirates</td>
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* In alphabetical order of the country which the member represents
TECHNICAL COMMITTEE

Chairman
Dato’ Mohd Razif Abdul Kadir – Bank Negara Malaysia

Deputy Chairman
Dr. Abdulrahman A. Al-Hamidy – Saudi Arabian Monetary Agency

Members*

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<td>Dr. Mulya E. Siregar</td>
<td>Bank Indonesia</td>
</tr>
<tr>
<td>Mr. Hamid Tehranfar</td>
<td>Central Bank of the Islamic Republic of Iran</td>
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<tr>
<td>Dr. Muhammad Umer Chapra</td>
<td>Islamic Development Bank</td>
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<tr>
<td>Mr. Ibrahim Ali Al-Qadhi</td>
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<tr>
<td>Mr. Toufic M. Chambour</td>
<td>Central Bank of Lebanon</td>
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<tr>
<td>Mr. Mansur-Ur-Rehman Khan</td>
<td>State Bank of Pakistan</td>
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<tr>
<td>Mr. Mu’jib Turki Al Turki</td>
<td>Qatar Central Bank</td>
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<tr>
<td>Mr. Ibrahim Adam Habib</td>
<td>Bank of Sudan</td>
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* In alphabetical order of the country which the member represents

RISK MANAGEMENT WORKING GROUP

Chairman
Mr. Anwar Khalifa Ebrahim Al Sadah – Bahrain Monetary Authority

Deputy Chairman
Mr. Mansur-ur-Rehman Khan – State Bank of Pakistan

Members*

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<tr>
<td>Mrs. Elham Hassan</td>
<td>PricewaterhouseCoopers, Bahrain</td>
</tr>
<tr>
<td>Dr. Tariqullah Khan</td>
<td>Islamic Research and Training Institute, Islamic Development Bank</td>
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<tr>
<td>Dr. Ibrahim Karasneh (until 1 June 2004)</td>
<td>Central Bank of Jordan</td>
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<tr>
<td>Mr. Saif Mohammad Al-Bathali</td>
<td>Central Bank of Kuwait</td>
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<td>Ms. Rana Sanyoura</td>
<td>Ernst &amp; Young, Lebanon</td>
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<tr>
<td>Dr. John Lee Hin Hock</td>
<td>KPMG Consulting Sdn. Bhd., Malaysia</td>
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<tr>
<td>Mr. Alaa Eidin M. A. El Ghazaly</td>
<td>Qatar Central Bank</td>
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<td>Mr. Ahmed Al-Sheikh</td>
<td>Saudi Arabian Monetary Agency</td>
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<td>Mr. Suliman Abdullah Al-Saeed</td>
<td>Saudi Arabian Monetary Agency</td>
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<tr>
<td>Mr. Jameel Ahmad</td>
<td>State Bank of Pakistan</td>
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<tr>
<td>Mr. Musaad Mohamed Ahmed Abdel Karim</td>
<td>Sudanese French Bank, Sudan</td>
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<td>Mr. Toby Fiennes</td>
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* In alphabetical order of the country which the member represents
### ISLAMIC DEVELOPMENT BANK SHAR‘AH COMMITTEE*

**Chairman**  
Sheikh Mohamed Mokhtar Sellami

- Sheikh Abdul Sattar Abu Ghodda, Member  
- Sheikh Hussein Hamed Hassan, Member  
- Sheikh Mohammad Ali Taskhiri, Member  
- Sheikh Mohamed Hashim Bin Yahaya, Member  
- Sheikh Saleh Al Husayn, Member

*In alphabetical order*

### SHAR‘AH REPRESENTATION OF THE CENTRAL BANKS*

- Sheikh Dr. Ahmed Ali Abdalla, Member  
- Sheikh Dr. Mahmood Ahmad Ghazi, Member

*In alphabetical order*

### SECRETARIAT, ISLAMIC FINANCIAL SERVICES BOARD

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<td>Professor Rifaat Ahmed Abdel Karim</td>
<td>Secretary-General</td>
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<tr>
<td>Mr. Anthony Travis</td>
<td>PricewaterhouseCoopers, Switzerland, and Consultant, Risk Management Working Group</td>
</tr>
<tr>
<td>Professor Simon Archer</td>
<td>Consultant for Capital Adequacy, Risk Management, Corporate Governance, Supervisory Review Process and Transparency and Market Discipline Working Groups</td>
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<td>Mr. Abdullah Haron</td>
<td>Project Manager</td>
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## ACRONYMS

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<td>BOD</td>
<td>Board of Directors</td>
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<td>IAH</td>
<td>Investment Account Holders</td>
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<td>IIFS</td>
<td>Institutions (other than Insurance Institutions) offering only Islamic Financial Services</td>
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<td>Investment Risk Reserve</td>
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EXECUTIVE SUMMARY

This document (hereinafter collectively referred to as the Guiding Principles) sets out fifteen principles of risk management for institutions (other than insurance institutions) offering only Islamic financial services (IIFS). The essential feature of IIFSs’ activities is the requirement to comply with Shari’ah rules and principles especially the prohibitions of generating profits without bearing any risks. However, IIFSs’ fiduciary duty requires it to apply Shari’ah compliant risk mitigation techniques wherever appropriate. The Guiding Principles does not address risks specific to the insurance industry.

Certain issues are of equal concern to all financial institutions, including IIFS. While the Basel Committee on Banking Supervision (BCBS) has published documents setting out sound practices and principles pertaining to credit, market, liquidity and operational risks of financial institutions, the present Guiding Principles serves to complement the BCBS’s guidelines in order to cater for the specificities of IIFS.

The implementation of the Guiding Principles shall be undertaken in compliance with Shari’ah and within the legal framework of the jurisdictions in which IIFS operate and shall be commensurate with the size, complexity and nature of each IIFS. This Guiding Principles addresses the controls from the perspective of IIFS; however, each supervisory authority has a responsibility to establish an appropriate enabling environment for these controls to be effectively implemented.

Apart from a general requirement (Principle 1 below), all other principles are grouped into six categories of risks, and shall be used as the basis for IIFSs’ risk management process.

1. General Requirement

Principle 1.0: IIFS shall have in place a comprehensive risk management and reporting process, including appropriate board and senior management oversight, to identify, measure, monitor, report and control relevant categories of risks and, where appropriate, to hold adequate capital against these risks. The process shall take into account appropriate steps to comply with Shari’ah rules and principles and to ensure the adequacy of relevant risk reporting to the supervisory authority.

2. Credit Risk

Principle 2.1: IIFS shall have in place a strategy for financing, using various instruments in compliance with Shari’ah, whereby it recognises the potential credit exposures that may arise at different stages of the various financing agreements.

Principle 2.2: IIFS shall carry out a due diligence review in respect of counterparties prior to deciding on the choice of an appropriate Islamic financing instrument.

Principle 2.3: IIFS shall have in place appropriate methodologies for measuring and reporting the credit risk exposures arising under each Islamic financing instrument.

Principle 2.4: IIFS shall have in place Shari’ah-compliant credit risk mitigating techniques appropriate for each Islamic financing instrument.
3. Equity Investment Risk

**Principle 3.1:** IIFS shall have in place appropriate strategies, risk management and reporting processes in respect of the risk characteristics of equity investments, including *Muḍārabah* and *Mushārakah* investments.

**Principle 3.2:** IIFS shall ensure that their valuation methodologies are appropriate and consistent, and shall assess the potential impacts of their methods on profit calculations and allocations. The methods shall be mutually agreed between the IIFS and the *Muḍārib* and/or *Mushārakah* partners.

**Principle 3.3:** IIFS shall define and establish the exit strategies in respect of their equity investment activities, including extension and redemption conditions for *Muḍārabah* and *Mushārakah* investments, subject to the approval of the institution’s *Sharī’ah* Board.

4. Market Risk

**Principle 4.1:** IIFS shall have in place an appropriate framework for market risk management (including reporting) in respect of all assets held, including those that do not have a ready market and/or are exposed to high price volatility.

5. Liquidity Risk

**Principle 5.1:** IIFS shall have in place a liquidity management framework (including reporting) taking into account separately and on an overall basis their liquidity exposures in respect of each category of current accounts, unrestricted and restricted investment accounts.

**Principle 5.2:** IIFS shall assume liquidity risk commensurate with their ability to have sufficient recourse to *Sharī’ah*-compliant funds to mitigate such risk.

6. Rate of Return Risk

**Principle 6.1:** IIFS shall establish a comprehensive risk management and reporting process to assess the potential impacts of market factors affecting rates of return on assets in comparison with the expected rates of return for investment account holders (IAH).

**Principle 6.2:** IIFS shall have in place an appropriate framework for managing displaced commercial risk, where applicable.

7. Operational Risk

**Principle 7.1:** IIFS shall have in place adequate systems and controls, including *Sharī’ah* Board/Advisor, to ensure compliance with *Sharī’ah* rules and principles.

**Principle 7.2:** IIFS shall have in place appropriate mechanisms to safeguard the interests of all fund providers. Where IAH funds are commingled with the IIFS’s own funds, the IIFS shall ensure that the bases for asset, revenue, expense and profit allocations are established, applied and reported in a manner consistent with the IIFS’s fiduciary responsibilities.
1 INTRODUCTION

1. The Guiding Principles provides a set of guidelines of best practice for establishing and implementing effective risk management in IIFS. It is primarily intended to serve the fully-fledged banking institutions offering Islamic financial services. These IIFS include, but are not limited to, commercial banks, investment banks, finance houses and other fund mobilising institutions, as determined by the respective supervisory authorities, that offer services in accordance with Shari‘ah rules and principles. It should also be applied, where appropriate, to other institutions offering Islamic financial services as part of their business. This Guiding Principles has been endorsed by the Shari‘ah Advisory Committee of the Islamic Development Bank and co-opted Shari‘ah scholars representing central banks and monetary agencies, which are members of the Islamic Financial Services Board (IFSB).

2. The Guiding Principles sets out fifteen principles of risk management that give practical effect to managing the risks underlying the business objectives that IIFS may adopt. The text provides some examples of current practices, recognising that these practices may change as markets change and as technology, financial engineering and improved coordination between regulatory authorities makes other strategies available. However, the Guiding Principles does not detail every possible control procedure. The IFSB will keep these matters under review.

3. The principles contained in this Guiding Principles are designed to complement the current risk management principles issued by the BCBS and other international standard-setting bodies. Supervisory authorities shall decide on which the IIFS will adopt the Guiding Principles set out in the Guiding Principles.

4. In cases where the existing applicable international principles are Shari‘ah-compliant, these principles are retained and/or expanded. In this regard, the Guiding Principles treats such principles as general principles, and they are summarised under operational considerations in each section. In such cases where these principles are not Shari‘ah-compliant, the Guiding Principles states an alternative Shari‘ah-compliant approach.

5. The Guiding Principles provides specific guidance for each category of risk, drawn from discussion on industry practices. It outlines a set of principles applicable to the following six categories of risk:
   - Credit risk
   - Equity investment risk
   - Market risk
   - Liquidity risk
   - Rate of return risk
   - Operational risk

6. The IFSB recognises that the specific risk management practices of each IIFS will vary in scope and content depending on its activities. In certain countries, IIFS are already exploring advanced risk management practices. Nevertheless, all IIFS are expected to make meaningful risk assessments based on the principles described in the Guiding Principles. All supervisory authorities are encouraged to review their current recommendations, if any, in the light of the principles set forth in the Guiding Principles.

7. However, it is crucial for IIFS to recognise and evaluate the overlapping nature and transformation of risks that exist between and among the categories of the above-mentioned risks. In addition, IIFS may face consequential business risks relating to developments in the external marketplace. Adverse changes in IIFSs’ markets, counterparties, or products as well as changes in the economic and political environments in which IIFS operate and the effects of different Shari‘ah rulings are examples of business risk. These changes may affect IIFSs’
8. **IIFS are also exposed to reputational risk** arising from failures in governance, business strategy and process. Negative publicity about the IIFSs’ business practices, particularly relating to *Sharīʿah* non-compliance in their products and services, could have an impact upon their market position, profitability and liquidity. Reflecting the different nature of the business and the extent of risks faced by IIFS, supervisory authorities are urged to adopt a risk-based approach when assessing and evaluating IIFSs’ risk management activities (see the **Role of Supervisory Authority** in respect of risk management for IIFS as set out in paragraphs 138 to 152 below). The IFSB will issue a separate Guiding Principles in respect of key principles of supervisory review of IIFSs’ risks, including reputational risk.

### 1.1 General Requirement

**Principle 1.0:** IIFS shall have in place a comprehensive risk management and reporting process, including appropriate board and senior management oversight, to identify, measure, monitor, report and control relevant categories of risks and, where appropriate, to hold adequate capital against these risks. The process shall take into account appropriate steps to comply with *Sharīʿah* rules and principles and to ensure the adequacy of relevant risk reporting to the supervisory authority.

**Board of directors (BOD) and senior management oversight**

9. As with any financial institution, the risk management activities of IIFS require active oversight by the BOD and senior management. The BOD shall **approve the risk management objectives, strategies, policies and procedures** that are consistent with the IIFSs’ financial condition, risk profile and risk tolerance. Such approvals shall be **communicated** to all levels in the IIFS involved in the implementation of risk management policies.

10. The BOD shall **ensure the existence of an effective risk management structure** for conducting IIFSs’ activities, including adequate systems for measuring, monitoring, reporting and controlling risk exposures.

11. IIFS shall have in place an **appropriate body**, in **accordance with sound principles of corporate governance**, to oversee that IIFSs’ products and activities comply with *Sharīʿah* rules and principles as approved in each jurisdiction.

12. The BOD shall approve **limits** on aggregate financing and investment exposures to avoid concentration of risk and, where required, ensure that IIFS hold **adequate capital** against these exposures. The BOD shall **review the effectiveness** of the risk management activities periodically and make appropriate changes as and when necessary.

13. Senior management shall **execute the strategic direction** set by the BOD on an ongoing basis and **set clear lines of authority and responsibility** for managing, monitoring and reporting risks. The senior management shall ensure that the financing and investment activities are within the approved limits and must obtain approval from the BOD.

14. Senior management shall ensure that the **risk management function is independent** from the risk-taking activities and is reporting directly to the BOD or senior management outside the risk-taking unit. Depending on the scope, size and complexity of IIFSs’ business activities, the risk management function is carried out by personnel from an independent risk management unit or from a part of IIFSs’ general operations or compliance unit. Small IIFS without a separate risk management function shall develop other checks and balances to make use of limited staff.
This personnel shall define the policies, establishes procedures, monitors compliance with the established limits and reports to top management on risk matters accordingly.

**Risk management process**

15. IIFS shall have a **sound process for executing all elements of risk management**, including risk identification, measurement, mitigation, monitoring, reporting and control. This process requires the implementation of appropriate policies, limits, procedures and effective management information systems (MIS) for internal risk reporting and decision making that are commensurate with the scope, complexity and nature of IIFSs’ activities.

16. IIFS shall ensure an **adequate system of controls with appropriate checks and balances** are in place. The controls shall (a) comply with the *Sharī‘ah* rules and principles, (b) comply with applicable regulatory and internal policies and procedures; and (c) take into account the integrity of risk management processes.

17. IIFS shall ensure the **quality and timeliness of risk reporting available to regulatory authorities**. In addition to a formal standardised reporting system, IIFS shall be prepared to provide additional and voluntary information needed to identify emerging problems possibly giving rise to systemic risk issues. Where appropriate, the information contained in the report shall remain confidential and shall not be used for public disclosure.

18. IIFS shall make **appropriate and timely disclosure of information** to IAH so that the investors are able to assess the potential risks and rewards of their investments and to protect their own interests in their decision making process. Applicable international financial reporting and auditing standards shall be used for this purpose.
2 CREDIT RISK

Principle 2.1: IIFS shall have in place a strategy for financing, using various instruments in compliance with Sharī`ah, whereby it recognises the potential credit exposures that may arise at different stages of the various financing agreements.

Principle 2.2: IIFS shall carry out a due diligence review in respect of counterparties prior to deciding on the choice of an appropriate Islamic financing instrument.

Principle 2.3: IIFS shall have in place appropriate methodologies for measuring and reporting the credit risk exposures arising under each Islamic financing instrument.

Principle 2.4: IIFS shall have in place Sharī`ah-compliant credit risk mitigating techniques appropriate for each Islamic financing instrument.

2.1 Background

19. The Guiding Principles addresses the credit risk associated with specific features of Islamic financing contracts. The risk assessment and measurement processes undertaken by IIFS shall also be applicable to profit sharing assets (Muḍārabah and Mushārakah) which are classified under equity investments. Rigorous risk evaluation (including due diligence) and controls of these investments are necessary in view of their exposure to capital impairment. Section 3 of the Guiding Principles is dedicated to the control mechanisms for managing the risks of equity investments.

20. The credit risk principles in this section are also applicable to credit risks associated with securitisation and investment activities because, in the IIFS, an investment certificate or sukūk generally represents a direct pro rata beneficial ownership of the holder in the assets of the underlying project.

2.2 Definition and Profiles of Credit Risk

21. Credit risk is generally defined as the potential that a counterparty fails to meet its obligations in accordance with agreed terms. This definition is applicable to IIFS managing the financing exposures of receivables and leases (for example, Murāubahah, Diminishing Mushārakah and Ijārah) and working capital financing transactions/projects (for example, Salam, Istisnā´ or Muḍārabah1). IIFS need to manage credit risks inherent in their financings and investment portfolios relating to default, downgrading and concentration. Credit risk includes the risk arising in the settlement and clearing transactions.

22. The following premises relate to the sound processes of credit risk management in IIFS:

- The role of IIFS can embrace those of financiers, suppliers, Muḍārib and Mushārakah partners. IIFS concern themselves with the risk of a counterparty’s failure to meet their obligations in terms of receiving deferred payment and making or taking delivery of an asset. A failure could relate to a delay or default in payment, or in

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1 In cases where Muḍārabah is used 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, who has no direct or contractual relationship with the IIFS, will make progress payments to the Muḍārib who in turn make payment to the IIFS. The role of the IIFS is to provide bridging finance on a profit-sharing basis to the Muḍārib pending its receipt of the progress payments from the ultimate customer. The IIFS is exposed to credit risk on the amounts advanced to the Muḍārib.
delivery of the subject matter of *Salam* or Parallel *Istisnā*, entailing a potential loss of income and even capital for the IIFS.

- Due to the unique characteristics of each financing instrument, such as the non-binding nature of some contracts, the **commencement stage** involving credit risk varies. Therefore, credit risk shall be assessed separately for each financing instrument to facilitate appropriate internal controls and risk management systems.
- IIFS will consider other types of **risks that give rise to credit risk**. For example, during the contract life, the risk inherent in a *Murābahah* contract is transformed from market risk to credit risk. In another example, the invested capital in a *Muḍārabah* or *Mushārakah* contract will be transformed to debt in case of proven negligence or misconduct of the *Muḍārib* or the *Mushārakah*’s managing partner.
- In case of default, some jurisdictions prohibit IIFS from imposing any penalty except in the case of deliberate procrastination, thus increasing the probability of default. In most jurisdictions, IIFS are prohibited from using the amount of any penalty for their own benefit; they must donate any such amount to charity. This increases the cost of default.

### 2.3 Operational Considerations

23. IIFS shall have in place a framework for **credit risk management** that includes identification, measurement, monitoring, reporting and control of credit risks. Adequate capital should be held against credit risks assumed. IIFS shall also comply with relevant rules, regulations and prudential conditions applicable to their financing activities.

24. IIFS shall assess credit risk in a **holistic manner** and ensure that credit risk management forms a part of an integrated approach to the management of all financial risks. Given the nature of Islamic financing instruments, the sources of credit risk may be the same as that of market or operational risks. For example, in a *Salam* contract, changes in market risk factors such as commodity prices, as well as the external environment (for example, bad weather) become key determinants affecting the likelihood of default.

25. IIFS shall have in place:

- an appropriate credit strategy, including pricing and tolerance for undertaking various credit risks;
- a risk management structure with effective oversight of credit risk management; credit policies and operational procedures including credit criteria and credit review processes, acceptable forms of risk mitigation, and limit setting;
- an appropriate measurement and careful analysis of exposures, including market- and liquidity-sensitive exposures; and
- a system (a) to monitor the condition of ongoing individual credits to ensure the financings are made in accordance with the IIFS’s policies and procedures, (b) to manage problem credit situations according to an established remedial process; and (c) to ensure adequate provisions are allocated.

**Principle 2.1:** IIFS shall have in place a strategy for financing, using various instruments in compliance with *Sharī’ah*, whereby it recognises the potential credit exposures that may arise at different stages of the various financing agreements.

26. The BOD of IIFS shall define and set the institution’s **overall levels of risk appetite**, risk diversification and asset allocation strategies applicable to each Islamic financing instrument, economic activity, geographical spread, season, currency and tenor. IIFS shall be mindful of and take into account the permissible types of financing instruments available in different locations wherever IIFS undertake cross-border transactions. IIFS will take into account seasonal aspects resulting from a shifting or termination of use of certain financing instruments, thus affecting the overall concentration exposures of the IIFS’s financing portfolio. For example, the IIFS may offer
Salam contracts during a certain season where a product can most likely be delivered and sold at maturity.

27. IIFS’ financing strategies shall include a list of all types of applicable and approved transactions and financings. The approved list must include formal exclusions from any engagement by the IIFS in certain prohibited industries, such as pork meat, alcohol, gambling, etc. The approved list will be kept up to date and communicated to the relevant personnel within the IIFS, and an internal compliance function will be organised and empowered to ensure that such rules are applied.

28. IIFS shall be aware of the commencement of exposure to credit risk inherent in different financing instruments and in various jurisdictions when developing the strategy. The non-binding promise and legal enforcement aspects vary among IIFS or from one jurisdiction to another, which may give rise to operational risks and other risk management problems relating to Shari‘ah compliance.

29. When setting the level of risk appetite relating to counterparties, IIFS shall ensure that (a) the expected rate of return on a transaction is commensurate with the risks incurred; and (b) excessive credit risk (at both individual and portfolio levels) and risk concentration (for example financing instruments, economic activity, geographical spread) are being managed effectively.

**Principle 2.2: IIFS shall carry out a due diligence review in respect of counterparties prior to deciding on the choice of an appropriate Islamic financing instrument.**

30. IIFS shall establish policies and procedures defining eligible counterparties (retail/consumer, corporate or sovereign), the nature of approved financings and types of appropriate financing instruments. IIFS shall obtain sufficient information to permit a comprehensive assessment of the risk profile of the counterparty prior to the financing being granted.

31. IIFS shall have a policy for carrying out a due diligence process in evaluating counterparties, in particular, for transactions involving:

- New ventures with multiple financing modes: IIFS shall carry out due diligence processes on customers or sovereigns using multiple financing modes to meet specific financial objectives designed to address Shari‘ah, legal or tax issues of customers.
- Creditworthiness that may be influenced by external factors: Where significant investment risks are present in participatory instruments, especially in the case of Mudārah financings, additional counterparty reviews and evaluations will focus on the business purpose, operational capability, enforcement and economic substance of the proposed project including the assessment of realistic forecasts of estimated future cash flows. Risk mitigating structures should be put in place by IIFS as far as possible.

32. IIFS, in their policy for approval, shall engage appropriate experts, including a Shari‘ah advisor or Shari‘ah Board to review and ensure that new financing proposals that have not been proposed before or amendments to existing contracts are Shari‘ah-compliant at all times. IIFS may also engage an appropriate technical expert (for example an engineer) to evaluate the feasibility of a proposed new project and to assess and approve progress billings to be made under the contract.

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2 The process may include Value at Risk, stress testing and sensitivity analysis, amongst others.
3 Please refer to Section 3 on Equity Investment Risk.
33. In a financing involving several related agreements, IIFS need to be aware of the binding obligations arising in connection with credit risks associated with the underlying assets for each agreement. To be Sharī‘ah compliant, subject to the interpretation of its Sharī‘ah scholars, IIFS shall ensure that all components of the financial structure are contractually independent, although these may be executed in a parallel manner despite their interrelated nature.

**Principle 2.3: IIFS shall have in place appropriate methodologies for measuring and reporting the credit risk exposures arising under each Islamic financing instrument.**

34. IIFS shall develop and implement appropriate risk measurement and reporting methodologies relevant to each Islamic financing instrument in respect of managing their counterparty risks, which may arise at different contract stages (including counterparty performance risk in Salam and Istisnā‘ contracts). Depending on the Islamic financing instrument, the IIFS may employ an appropriate methodology that takes into account the price volatilities of the underlying assets. The selected methodology shall be appropriate given the nature, size and complexity of the IIFS's credit related activities. IIFS shall ensure that adequate systems and resources are available to implement this methodology.

**Principle 2.4: IIFS shall have in place Sharī‘ah-compliant credit risk mitigating techniques appropriate for each Islamic financing instrument.**

35. IIFS shall clearly define their credit risk-mitigating techniques including, but not limited to, having in place:

- a methodology for setting mark-up rates according to the risk rating of the counterparties, where expected risks should have been taken into account in the pricing decisions;
- permissible and enforceable collateral and guarantees;
- clear documentation as to whether or not purchase orders are cancellable; and
- clear procedures for taking account of governing laws for contracts relating to financing transactions.

36. IIFS shall establish limits on the degree of reliance and the enforceability of collateral and guarantees. They shall protect themselves against legal impediments that may restrict the accessibility of collateral when they need to enforce their rights in respect of a debt. IIFS shall formally agree with the counterparty at the time of signing the contract on the usage, redemption and utilisation of collateral if the counterparty defaults in payment.

37. IIFS shall have policies to define adequately the action to be taken by the IIFS when a customer cancels a non-binding purchase order. The policies will describe how the IIFS (a) monitor and control their exposures to suppliers, and especially during delivery between suppliers to the IIFS where a customer is acting as an agent; and (b) identify whether the risks associated with the assets will be borne by the supplier or the customer (which acts as agent and accepts the assets from the supplier). For example, the IIFS may enter into a purchase contract with a supplier on a “sale or return” basis, with an option to return the purchased item within a specified period.

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4 IIFS are expected to include in its process, an ongoing monitoring of quality and valuation of any collateral.
5 In some jurisdictions, a purchase order backed by a promise to purchase would constitute a binding contract according to contract law and would be legally enforceable if adequately evidenced.
6 IIFS shall be mindful that the counterparty risk will not commence prior to execution of other contracts or before certain events take place. In the case of certain Murābahah transactions, the long period preceding the delivery of imported goods from abroad gives rise to other risks which may not all be covered by takaful or insurance.
38. IIFS shall have appropriate credit management systems and administrative procedures in place to undertake early remedial action in the case of financial distress of a counterparty or, in particular, for managing problem credits, potential and defaulting counterparties. This system will be reviewed on a regular basis. Remedial actions will include both administrative and financial measures.

Administrative measures may inter alia include:
- negotiating and following-up pro-actively with the counterparty through maintaining frequent contact with the counterparty;
- setting an allowable timeframe for payment or to offer debt-rescheduling or restructuring arrangements (without an increase in the amount of the debt);
- using a debt-collection agency;
- resorting to legal action, including the attachment of any credit balance belongs to defaulter according to the agreement between them; and
- making a claim under Shari’ah-compliant insurance.

Financial measures may include, among others:
- imposing penalties, the proceeds of which should be disposed of in charitable causes in compliance with Shari’ah as decided by the IIFS Shari’ah Board/Committee; and
- establishing the enforceability of collateral or third party guarantees.

39. IIFS shall set appropriate measures for early settlements, which are permissible under their Shari’ah rules and principles for each Islamic financing instrument. Some customers may expect a discount, which the IIFS can give of their own volition as a commercial decision made on a case-by-case basis provided such provision is not stated in the contract. Alternatively, irrespective of industry practice, IIFS may grant a discretionary rebate, to their customers by reducing the amount of the debt in subsequent transactions.

40. IIFS shall assess and establish appropriate policies and procedures pertaining to the risks associated with their own exposures in parallel transactions. For instance, in the case of an Istisnā’ transaction, the IIFS enter into an Istisnā’ contract as sellers to provide manufactured goods or a building to a customer. The IIFS will then enter into another (parallel) Istisnā’ contract as buyers with a supplier (manufacturer or builder), using the specifications drawn up for the original contract. If the supplier fails to deliver the manufactured goods or the building according to the agreed specifications, IIFS would equally be in default of their obligation. If necessary, as in the case of some IIFS, a separate engineering department is established or an outside expert is engaged to evaluate, approve and monitor the technical aspects. IIFS may also stipulate that the party to the first contract must inspect the manufactured goods or building from time to time during the production or construction process to satisfy themselves that the specifications are being met.

41. IIFS shall establish appropriate policies and procedures that require them to honour their commitment to the parallel contract counterparty. In certain countries, where parallel contract is necessary to be transacted with the first Salam contract in order to mitigate market risk exposures, there must be no legal linkages between the two contracts.

42. IIFS shall have in place a system to ascertain and fulfil their obligations in respect of leased assets, which are permanently impaired through no default of the lessee. In case of such impairment, IIFS are required to provide the lessee with a replacement asset with similar specifications, if such specifications were agreed upon, or if the contract was renewed, or to refund the additional amounts (capital payments) included in the IMB lease rentals as compared

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7 In certain jurisdictions, the Shari’ah may differentiate between two kinds of defaulter; (a) the affluent or able (wilful defaulter or procrastinator); and (b) the insolvent defaulter who is unable to pay his debts due to reasons permitted by Shari’ah, to determine whether a penalty can be imposed which should be disposed of.
with those in an operating *ljārah*. IIFS shall establish appropriate risk management policies to mitigate losses arising from such damage during the term of the lease.

43. IIFS shall ensure, *whenever possible*, that there is *sufficient* *Shari‘ah*-compliant *insurance* coverage of the value of the assets, subject to availability. If necessary, IIFS shall engage an insurance advisor at an early stage to review the insurance coverage of the leased assets.

44. If a loss arises from negligence by the lessee, IIFS are permitted to *claim compensation from the lessee*. The IIFS (as lessors) bear the risks associated with the leased assets and cannot use lessees’ guarantees to recover the amount of the losses on the leased assets (unless these are due to misconduct, negligence or breach of contract on the part of the lessees).

45. IIFS shall have in place an appropriate *policy for determining and allocating provisions* for (a) doubtful debts including counterparty exposures; and (b) estimated impairment in value of leased assets.

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8 In the case of IMB, IIFS have the option to either provide a replacement asset with similar specifications, if such specifications were agreed upon, or if the contract was renewed, or refund the additional amounts (capital payments) included in the lease rental.
3 EQUITY INVESTMENT RISK

Principle 3.1: IIFS shall have in place appropriate strategies, risk management and reporting processes in respect of the risk characteristics of equity investments, including Muḍāribah and Mushārakah investments.

Principle 3.2: IIFS shall ensure that their valuation methodologies are appropriate and consistent, and shall assess the potential impacts of their methods on profit calculations and allocations. The methods shall be mutually agreed between the IIFS and the Muḍārib and/or Mushārakah partners.

Principle 3.3: IIFS shall define and establish the exit strategies in respect of their equity investment activities, including extension and redemption conditions for Muḍārabah and Mushārakah investments, subject to the approval of the institution’s Shari’ah Board.

3.1 Background

46. This section sets out the principles pertaining to the management of risks inherent in the holding of equity instruments for investment purposes. In particular, for IIFS, the relevant instruments are typically those based on the Muḍārabah and Mushārakah contracts. This section focuses on such instruments. The risks entailed by holding equity instruments for trading or liquidity purposes are dealt with under market risk in Section 4 below. While investments made via Muḍārabah and Mushārakah instruments may contribute substantially to IIFSs’ earnings, they entail significant market, liquidity, credit9 and other risks, potentially giving rise to volatility in earnings and capital.

47. The capital invested through Muḍārabah and Mushārakah may be used to purchase shares in a publicly traded company or privately held equity or invested in a specific project, portfolio or through a pooled investment vehicle. In the case of a specific project, IIFS may invest at different investment stages.

48. One distinct difference between Muḍārabah and Mushārakah financings is in terms of IIFSs’ involvement in the investments during the contract period. In Muḍārabah, the IIFS invest their money as silent partners and, the management is the exclusive responsibility of the other party, namely the Muḍārib. In contrast, in Mushārakah financing the IIFS (and its partner or partners) invest their funds together, and the IIFS may be silent partners, or may participate in management. Regardless of the authority under which the profit sharing instruments are used, both Mushārakah and Muḍārabah are profit-sharing financings, under which the capital invested by the provider of finance does not constitute a fixed return, but is explicitly exposed to impairment in the event of losses (capital impairment risk).

3.2 Definition and Profiles of Equity Investment Risk

49. The type of equity investment risk dealt with in this section may be broadly defined as the risk arising from entering into a partnership for the purpose of undertaking or participating in a particular financing or general business activity as described in the contract, and in which the provider of finance shares in the business risk.

9 One example of credit risk exposure arises from the Muḍārib’s obligation to pay the agreed share of profit to the IIFS as Rabb al-māl when such payment falls due. Failure to meet this obligation constitutes a case of misconduct and negligence in the part of the Muḍārib.
50. The characteristics of such equity investments include considerations as to the quality of the partner, underlying business activities and ongoing operational matters. By nature, this type of equity investment is exposed to a confluence of risks associated with Mudārib or Mushārakah partner, business activity and operations.

51. In evaluating the risk of an investment using the profit sharing instruments of Mudārabah or Mushārakah, the risk profiles of potential partners (Mudārib or Mushārakah partner) are crucial considerations for the undertaking of due diligence. Such due diligence is essential to the fulfilment of IIFSs’ fiduciary responsibilities as an investor of IAH funds on a profit-sharing and loss-bearing basis (Mudārabah) or a profit and loss sharing basis (Mushārakah). These risk profiles include the past record of the management team and quality of the business plan of, and human resources involved in, the proposed Mudārabah or Mushārakah activity.

52. Factors relating to the legal and regulatory environment affect equity investment performance, and need to be considered in the risk evaluation. These factors include policies pertaining to tariffs, quotas, taxation or subsidies and any sudden policy changes affecting the quality and viability of an investment.

53. IIFS are exposed to the risks attaching to a lack of reliable information on which to base their investment appraisals, such as an inadequate financial control system. The mitigation of these risks may require the investor to take an active role in monitoring the investment, or the use of specific risk mitigating structures.

54. Although timely allocation of profit can be agreed upfront, IIFS should be prepared for delays and variations in cash flow patterns and possible difficulties in executing a successful exit strategy.

55. The risks arising from the use of profit sharing instruments for financing purposes do not include credit risk in the conventional sense, but share a crucial characteristic of credit risk because of the risk of capital impairment.

3.3 Operational Considerations

**Principle 3.1:** IIFS shall have in place appropriate strategies, risk management and reporting processes in respect of the risk characteristics of equity investments, including Mudārabah and Mushārakah investments.

56. IIFS shall define and set the objectives of, and criteria for, investments using profit sharing instruments, including the types of investment, tolerance for risk, expected returns and desired holding periods. For example, a Mushārakah structure may contain an option for redemption whereby the IIFS as financiers have a contractual right to require their partner periodically to purchase, under a separate contract, a proportion of the IIFS’s share in the investment at net asset value or, if the contract so specifies on some agreed basis (Diminishing Mushārakah).

57. IIFS shall have, and keep under review, policies, procedures and an appropriate management structure for evaluating and managing the risks involved in the acquisition of, holding and exiting from profit sharing investments. IIFS shall ensure proper infrastructure and capacity are in place to monitor continuously the performance and operations of the entity in which IIFS invest as partners. These should include evaluation of Shari‘ah compliance, adequate financial reporting by, and periodical meetings with, partners and proper recordkeeping of these meetings.

58. IIFS shall identify and monitor the transformation of risks at various stages of investment lifecycles, for example, where the investee’s business involves innovative or new
products and services in the marketplace. IIFS that employ different financing instruments (where one of which include Mushārakah) at different contract stages shall have appropriate procedures and controls in place, as different stages may give rise to different risks.

59. IIFS shall analyse and determine possible factors affecting the expected volume and timing of cash flows for both returns and capital gains arising from equity investments.

60. IIFS shall use Sharī`ah compliant risk-mitigating techniques, which reduce the impact of possible capital impairment of an investment. This may include the use of Sharī`ah permissible security from the partner.

**Principle 3.2:** IIFS shall ensure that their valuation methodologies are appropriate and consistent, and shall assess the potential impacts of their methods on profit calculations and allocations. The methods shall be mutually agreed between the IIFS and the Muḍārib and/or Mushārakah partners.

61. IIFS shall agree with the Muḍārib and/or Mushārakah partners, before entering into any agreement, on the appropriate valuation methods and periods for which the profit is to be calculated and allocated taking into account market practices and liquidity features. Valuation and accounting play an important role in measuring the quality of an equity investment, especially in a privately held entity, for which independent price quotations are neither available nor sufficient in volume to provide a basis for meaningful liquidity or market valuation. An appropriate and agreed method to be applied to determine the profit of the investment can be in the form of a certain percentage of either gross or net profit earned by the Muḍārabah or Mushārakah business, or any other mutually agreed terms. In the case of a change of the partnership’s shares in a Mushārakah (for example in a Diminishing Mushārakah), the shares changing hands shall be valued at fair value or on some other mutually agreed basis.

62. IIFS shall assess and take measures to deal with the risks associated with potential manipulation of reported results leading to overstatements or understatements of partnership earnings. Reported earnings can be either gross or net. If for some reason the practices of smoothing profits over accounting periods and the establishment of escrow accounts to hold certain profit portions during the life of an equity investment are recognised and agreed by all the investing parties, the IIFS will incorporate their potential impact in the IIFS’s overall earnings.

63. IIFS may agree with the Muḍārib and/or Mushārakah partners to engage independent parties where necessary to carry out audits and valuations of the investments. Provided these are properly executed and completed, these measures will help to ensure transparency and objectivity in valuation and in the distribution of profits and the determination of amounts to be redeemed.

**Principle 3.3:** IIFS shall define and establish the exit strategies in respect of their equity investment activities, including extension and redemption conditions for Muḍārabah and Mushārakah investments, subject to the approval of the institution’s Sharī`ah Board.

64. IIFS shall establish the criteria for exit strategies, including the redemption of equity investments and the divestiture of under-performing investments. The criteria may include alternative exit routes and the timing of exit. In case of losses where improved business prospects exist, IIFS may indicate an investment extension period. IIFS’s expectations should be based on their assessment that there are plausible grounds for believing that there will be a business turnaround during the period resulting in the view that the investment will, in time, recover and yield profits.
65. IIFS shall recognise that, as a going concern, an investee may not always have the liquidity necessary to enable making profit distributions. Hence, IIFS shall agree with the investment partner the **methods for the treatment of retained profits** by the investee.
4 MARKET RISK

**Market Risk**

**Principle 4.1:** IIFS shall have in place an appropriate framework for market risk management (including reporting) in respect of all assets held, including those that do not have a ready market and/or are exposed to high price volatility.

4.1 **Background**

66. This section sets out principles in respect of market risk, which refer to the potential impact of adverse price movements such as benchmark rates, foreign exchange (FX) rates, equity prices and commodity prices, on the economic value of an asset. Market risk exposures may occur at certain times or throughout the contract.

4.2 **Definition and Profiles of Market Risk**

67. Market risk is defined as the risk of losses in on- and off-balance sheet positions arising from movements in market prices i.e. fluctuations in values in tradable, marketable or leaseable assets (including sukūk) and in off-balance sheet individual portfolios (for example restricted investment accounts). The risks relate to the current and future volatility of market values of specific assets (for example, the commodity price of a Salam asset, the market value of a sukūk, the market value of Murābahah assets purchased to be delivered over a specific period) and of foreign exchange rates.

68. In operating ḥijārah, a lessor is exposed to market risk on the residual value of the leased asset at the term of the lease or if the lessee terminates the lease earlier (by defaulting), during the contract. In IMB, a lessor is exposed to market risk on the carrying value of the leased asset (as collateral) in the event that the lessee defaults on the lease obligations.

69. In Salam, IIFS are exposed to commodity price fluctuations on a long position after entering into a contract and while holding the subject matter until it is disposed of. In the case of parallel Salam, there is also the risk that a failure of delivery of the subject matter would leave the IIFS exposed to commodity price risk as a result of the need to purchase a similar asset in the spot market in order to honour the parallel Salam contract.

70. When IIFS are involved in buying assets that are not actively traded with the intention of selling them, it is important to analyse and assess the factors attributable to changes in liquidity of the markets in which the assets are traded and which give rise to greater market risk. Assets traded in illiquid markets may not be realisable at prices quoted in other more active markets.

71. IIFS are also exposed to foreign exchange fluctuations arising from general FX spot rate changes in both cross-border transactions and the resultant foreign currency receivables and payables. These exposures may be hedged using Sharī'ah compliant methods.
4.3 Operational Considerations

**Principle 4.1:** IIFS shall have in place an appropriate framework for market risk management (including reporting) in respect of all assets held, including those that do not have a ready market and/or are exposed to high price volatility.

72. IIFS shall develop a **market risk strategy** including the level of acceptable market risk appetite taking into account of contractual agreements with fund providers, types of risk-taking activities and target markets in order to maximise returns while keeping exposures at or below the pre-determined levels. The strategy should be reviewed periodically by IIFS, communicated to relevant staff and disclosed to fund providers.

73. IIFS shall establish a **sound and comprehensive market risk management process and information system**, which (among others) comprise:
   - a conceptual framework to assist in identifying underlying market risks;
   - guidelines governing risk taking activities in different portfolios of restricted IAH and their market risk limits;
   - appropriate frameworks for pricing, valuation and income recognition; and
   - a strong MIS for controlling, monitoring and reporting market risk exposure and performance to appropriate levels of senior management.

Given that all the required measures are in place (e.g. pricing, valuation and income recognition frameworks, strong MIS for managing exposures, etc.), the applicability of any market risk management framework that has been developed should be assessed taking into account of consequential business and reputation risks.

74. IIFS should be able to **quantify market risk exposures** and assess exposure to the probability of future losses in their net open asset positions.

75. The risk exposures in the investment securities are similar to the risks faced by conventional financial intermediaries, namely market price, liquidity and foreign exchange rates. In this regard, IIFS shall ensure that their strategy includes the definition of their **risk appetite for these tradable assets and that this risk appetite is adequately supported by capital held for that purpose.**

76. In the **valuation of assets** where no direct market prices are available, IIFS shall incorporate in their own product programme a detailed approach to valuing their market risk positions. IIFS may employ appropriate forecasting techniques to assess the potential value of these assets.

77. **Where available valuation methodologies are deficient,** IIFS shall assess the need (a) to allocate funds to cover risks resulting from illiquidity, new assets and uncertainty in assumptions underlying valuation and realisation; and (b) to establish a contractual agreement with the counterparty specifying the methods to be used in valuing the assets.\(^\text{10}\)

**Restricted Investment Accounts**

78. IIFS have a fiduciary duty to apply the **same risk management policies and procedures** to assets held on behalf of restricted IAH as they do for assets held on behalf of shareholders and unrestricted IAH.

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\(^{10}\) It should be noted that similar arrangements are suggested to mitigate contract cancellation, which is explained under the Section 2 on Credit Risk.
79. Where IFS play the role of market maker to restricted IAH, this gives rise to liquidity risk, which should be managed according to appropriate procedures as set out in Section 5 below.
5 LIQUIDITY RISK

**Principle 5.1:** IIFS shall have in place a liquidity management framework (including reporting) taking into account separately and on an overall basis their liquidity exposures in respect of each category of current accounts and unrestricted investment accounts.

**Principle 5.2:** IIFS shall assume liquidity risk commensurate with their ability to have sufficient recourse to Shari`ah-compliant funds to mitigate such risk.

5.1 Background

80. This section sets out guidance pertaining to liquidity risks, which highlights the key elements for effective liquidity management within the scope of IIFSs’ exposures. IIFS solicit and attract various sources of funds to channel to their financing and investment activities. IIFS may have various kinds of obligations, such as requirements to repay current account holders on demand, to provide committed funds in Musharakah transaction, and to make available cash flows for expenses or profit payments.

5.2 Definition and Profiles of Liquidity Risk

81. Liquidity risk is the potential loss to IIFS arising from their inability either to meet their obligations or to fund increases in assets as they fall due without incurring unacceptable costs or losses.

Profiles of Fund Providers

82. There are two major types of fund providers: (a) current account holders; and (b) unrestricted IAH. These account holders require a degree of liquidity to be maintained by the IIFS to meet their requirements for withdrawals. Subject to contractual conditions, restricted IAH (while not fund providers) may also give rise to liquidity management considerations, in so far as IIFS may need to replace funds withdrawn by an investor pending realisation of the related assets.

83. As current account holders do not participate in the profits of the IIFSs’ business activities, a sound repayment capacity is required to meet fully cash withdrawal requests as and when they arise.

84. IIFS may rely heavily on funds provided by current account holders. Repayment by the IIFS of the principal amounts deposited by current account holders is guaranteed without any rights to share in profits, as the current account holders do not share in the risks of the IIFS.

85. Unrestricted IAH are investors who participate in the uncertainties of IIFSs’ business; therefore, they share in profits and bear losses arising from investments made on their behalf, to the extent of their share. Apart from general withdrawal needs, the withdrawals made by IAH may be the result of (a) lower than expected or acceptable rates of return; (b) concerns about the financial condition of the IIFS; and (c) non-compliance by the IIFS with Shari`ah rules and principles in various contracts and activities.

86. Where the principle of Muḍārabah is employed to source the funds, from an asset-liability management perspective, IIFS may be viewed as being hedged to the extent that the IAH bear the risks of the assets in which their funds are invested. This statement is true only if the Muḍārib (IIFS) has acted in accordance with its fiduciary duties under the Muḍārabah contracts and without misconduct or negligence.
87. IAH do not share in the risks on assets financed by current accounts, which are borne by shareholders alone.

88. As fiduciary agents, the IIFS are concerned with matching their investment policies with IAH and shareholders’ risk appetites. If these investment policies are not consistent with the expectations and risk appetites of IAH, the latter may withdraw their funds leading to a liquidity crisis for the IIFS. This applies particularly to unrestricted IAH.

5.3 Operational Considerations

 Principle 5.1: IIFS shall have in place a liquidity management framework (including reporting) taking into account separately and on an overall basis their liquidity exposures in respect of each category of current accounts, unrestricted and restricted investment accounts.

Liquidity Management Policy

89. IIFS must maintain adequate liquidity to meet their obligations at all times. In this regard and taking into consideration the nature of the IIFS, their business activities and their capital market environment, the IIFS shall have in place liquidity management policies, which shall be reviewed periodically, covering:

- strategy for managing liquidity involving effective BOD and senior management oversight;
- a framework for developing and implementing sound processes for measuring and monitoring liquidity;
- adequate systems in place for monitoring and reporting liquidity exposures on a periodic basis;
- adequate funding capacity, with particular reference to the willingness and ability of shareholders to provide additional capital when necessary;
- access to liquidity through fixed asset realisations and arrangements such as sale and lease-back; and
- liquidity crisis management.

90. The policies shall incorporate both quantitative and qualitative factors. Quantitative factors include the extent of diversity and sources of funds, concentration of the funding base, reliance on marketable assets, or availability of standby lines of external funding. Qualitative factors include assessing the general ability of the management, the particular skills in treasury management and public relations, the quality of MIS, IIFs’ reputation in the market, the willingness and ability of shareholders to provide additional capital and, in the case of a branch or subsidiary the willingness and ability of the head office or parent to provide liquidity.

91. Since liquidity infrastructures vary from country to country, IIFS operating across jurisdictions are expected to adhere to local requirements for liquidity management. In this regard, IIFS which are part of a group shall normally be expected to be able to stand alone, and thus, to monitor and manage their own liquidity separately. However, with the agreement of the supervisory authority, IIFS may take into account the assurance of liquidity provision by head office or parent to the branch or subsidiary.

Measuring and Monitoring Liquidity

92. IIFS need to identify any future shortfalls in liquidity by constructing maturity ladders based on appropriate time bands. The IIFS may have their own criteria for classifying cashflows, including behavioural methods, and may consider differentiating the types of cashflows as indicated below:
Known cashflows – the maturities and the amounts are known in advance. This category includes receivables from Murābahah, Ijārah, IMB receivables and Diminishing Mushārakah.

Conditional but predictable cashflows (Salam and Istisnā’) – conditionality is defined in terms of the type of contract or performance of work based on the agreed terms and conditions over an agreed period.

Conditional and unpredictable cashflows – in some cases, an investment in a Mushārakah is for an open-ended period and an exit strategy may be assessed periodically. The redemption of invested capital and possible levels of return on investment is conditional upon the performance of the activities.

93. When calculating net funding requirements (NFR), a substantial influence on the liquidity situation of IIFS relates to the management of their IAHs’ expectations. While the basis of an NFR calculation is to assume that the funds are repaid at the contractual maturity date, it may not be realistic to assume that all IAH will maintain their funds at the IIFS until maturity. Therefore, an internal assessment of their expectations and incentives will be part of an NFR calculation.

94. Due to IIFSs’ dual role in meeting their obligations to current account holders and managing the expectations of their IAH, the IIFS should make periodical cashflow analyses under various market scenarios and conditions. The scenarios may vary, depending on local market conditions, and may be based on (a) a “normal” operating environment (for example a steady state condition); and (b) scenarios of adverse circumstances (for example non-linear events and chaotic conditions). For example:

- The analysis shall include assumptions about the repayment of invested capital to the IAH. In the event of investment losses, the extent to which the losses will be mitigated by the use of the IRR needs to be considered.
- The scenarios shall be based on relevant assumptions based on factors affecting the IIFSs’ on- and off-balance sheet exposures. Liquidity levels and early withdrawal profiles computed under these scenarios will be back-tested periodically to validate the underlying assumptions of the measurement process.
- In analyses based on behavioural assumptions and scenarios, IIFS will assess and apply the liquidity measures that reflect the specificities of each portfolio. In the case of certain market practices, IIFS may have different types of portfolios (i.e. restricted investment accounts that are treated as off-balance sheet items). The size and characteristics of the assets, which IIFS hold in relation to the restricted investment portfolios, will determine their specific liquidity profiles.

95. IIFS shall establish the maximum amounts of cumulative liquidity mismatches which they consider acceptable (subject to regulatory requirements) and manageable for different time bands, as a percentage of total funds available. In certain jurisdictions where assets are clearly segregated according to sources of funds, IIFS monitor their liquidity exposures separately according to the nature and mix of their fund providers – current account holder and unrestricted IAH, which can be expected to vary substantially. The effects of liquidity shortages may vary according to the fund providers’ liquidity preferences; hence, separate limits on liquidity mismatches should be set up accordingly. These limits shall be regularly reviewed, taking into account the IIFSs’ liquidity situation, economic climate and market conditions.

Liquidity Risk Mitigation

Principle 5.2: IIFS shall assume liquidity risk commensurate with their ability to have sufficient recourse to Shari’ah-compliant funds to mitigate such risk.

96. IIFS shall assess the necessity and extent of their access to available funding sources. In managing their liquidity, IIFS have the following possible funding sources – natural
cash flows arising from their usual banking activities, the realisation of tradable invested assets, asset securitisation, and their capacity to access shareholders’ and/or head office funds.

97. IIFSs’ liquidity management policies shall include some form of contractually agreed orderly liquidation procedures, to avoid having to liquidate assets at unfavourable prices, resulting in the erosion of the IAH capital and damage to the IIFSs’ reputation and viability.

98. IIFS must have a liquidity contingency plan addressing various stages of a liquidity crisis. IIFS should define the classification of these stages but may consider differentiating the stages as follows:

- Identification of a liquidity gap or a situation which acts as a triggering event where withdrawals do not follow predictable patterns when, for example, the IIFS may suffer an institutional rating downgrade;
- A need to liquidate assets or investments in an orderly manner to meet such a liquidity gap or situation; and
- Emergency measures to be taken in the event that the previous steps fail to meet the liquidity gap adequately.

99. Where appropriate, IIFS shall include in their contingency plans the following factors and define appropriate action points at each stage:

- Holdings of tradable high quality liquid assets, which may be readily disposed of in sizeable amounts in deep markets taking into account the likelihood that it will not be possible to realise full book value;
- Profile of other assets and the degree of liquidity of these assets;
- Assessment of Shari’ah-compliant and available funding products in the market including possible cooperation agreements with either other IIFS or conventional institutions on an interest-free basis for accessing temporary funding, or sale and leaseback arrangements for longer term funding;
- Possible liquidity arrangements with the central bank (on an interest-free basis);
- Establishment of a crisis management team or personnel responsible for taking actions at different stages of the liquidity crisis; and
- Notification procedures for communication with IIFSs’ head office and/or supervisory authorities.

100. However, to the extent that IIFS intend to rely on the types of cooperation agreements mentioned above, they need to ensure that willing counterparties will exist for such arrangements.
# 6 RATE OF RETURN RISK

<table>
<thead>
<tr>
<th>Rate of Return Risk</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Principle 6.1:</strong> IIFS shall establish a comprehensive risk management and reporting process to assess the potential impacts of market factors affecting <em>rates of return on assets in comparison with the expected rates of return for investment account holders (IAH).</em></td>
</tr>
<tr>
<td><strong>Principle 6.2:</strong> IIFS shall have in place an appropriate framework for managing displaced commercial risk, where applicable.</td>
</tr>
</tbody>
</table>

## 6.1 Background

101. This section sets out principles in respect of rate of return risks. The rate of return risk is generally associated with overall balance sheet exposures where mismatches arise between assets and balances from fund providers.

102. Since IIFSs’ responsibility is to manage their IAHs’ expectations and their liabilities to current account holders, the rate of return risk is a strategic risk issue forming part of IIFSs’ balance sheet risk management.

## 6.2 Definition and Profiles of Rate of Return Risk

103. IIFS are exposed to rate of return risk in the context of their overall balance sheet exposures. An increase in benchmark rates may result in IAHs’ having expectations of a higher rate of return. Rate of return risk differs from interest rate risk in that IIFS are concerned with the result of their investment activities at the end of the investment-holding period. Such results cannot be pre-determined exactly.

104. A consequence of rate of return risk may be displaced commercial risk. IIFS may be under market pressure to pay a return that exceeds the rate that has been earned on assets financed by IAH when the return on assets is under-performing as compared with competitors’ rates. IIFS may decide to waive their rights to part or their entire Muḍārib share of profits in order to satisfy and retain their fund providers and dissuade them from withdrawing their funds. Displaced commercial risk derives from competitive pressures on IIFS to attract and retain investors (fund providers). The decision of IIFS to waive their rights to part or all of their Muḍārib share in profits in favour of IAH is a commercial decision, the basis for which needs to be subject to clear and well defined policies and procedures approved by the IIFS’s BOD.

105. **A Profit Equalisation Reserve (PER)** is the amount appropriated by IIFS out of their gross income, before allocating the Muḍārib share, in order to maintain a certain level of return on investment for IAH and increase owners’ equity. The basis for computing the amounts to be so appropriated should be pre-defined and applied in accordance with the contractual conditions accepted by the IAH and after formal review and approval by the IIFSs’ BOD. In certain jurisdictions, the supervisory authority lays down requirements relating to the maintenance of the PER.

106. **An Investment Risk Reserve (IRR)** is the amount appropriated by IIFS out of income of IAH, after allocating the Muḍārib share, in order to cushion the effects of the risk of future investment losses on IAH. The terms and conditions whereby IRR can be set aside and utilised should be determined and approved by the BOD.
6.3 Operational Considerations

**Principle 6.1:** IIFS shall establish a comprehensive risk management and reporting process to assess the potential impacts of market factors affecting rates of return on assets in comparison with the expected rates of return for investment account holders (IAH).

107. IIFS shall take necessary steps to ensure that the **management processes** relating to the identification, measurement, monitoring, reporting and control of the rate of return risk (including appropriate structure) are in place. Since the rate of return risks are emanating from various balance sheet positions, IIFS shall have in place competent staff to undertake the analysis of risk exposures arising from their consolidated balance sheet activities.

108. IIFS shall be aware of the **factors that give rise to rate of return risk**. The primary form of rate of return risk to which the IIFS are exposed comprises increasing long-term fixed rates in the market. In general, profit rates earned on assets reflect the benchmark of the previous period and do not correspond immediately to changes in increased benchmark rates.

109. IIFS shall assess the effect of the level of their dependency on current account holders’ funds. Although no returns are expected by current account holders, the sudden withdrawal of these funds would have an adverse impact on the overall potential rate of return for IIFS.

**Rate of Return Risk Management**

110. IIFS shall have in place **appropriate systems for identifying and measuring the factors** which give rise to rate of return risk.

111. When calculating a rate of return, IIFS shall employ a **gapping method** for allocating positions into time bands with remaining maturities or repricing dates, whichever is earlier. Fixed and floating rate assets of IIFS will be classified according to their receivable dates because the returns on these receivables represent the fund providers’ direct and beneficial ownership of the assets. Actual cash flows may indicate a gap for a given time band, affecting the rate of return for that period. Depending on the complexity and the nature of their business operations, IIFS may employ techniques ranging from simple gap to advance simulation or dynamic approaches to assess future cash flow variability and net income. The estimates derived from selected approaches may provide acceptable approximations of periodic future earnings’ variability; hence, the outcomes will yield different levels of expected returns to IAH.

112. The measurement of rate of return risk highlights the importance of **cash flow forecasting** for instruments and contracts where IIFS are required to simulate and assess their behavioural maturity, underlying assumptions and parameters, which must be reviewed periodically for reliability. The materiality of potential threats to future earnings and the usefulness of the resulting information shall be considered in determining the type and extent of forecasted behaviour for IIFS.

113. In assessing whether a potential threat is likely to have a material, likely and imminent impact on a balance sheet position, IIFS will ensure that they understand the **different characteristics of their balance sheet positions** in the different currencies and jurisdictions within which they operate.

114. In assessing exposure to rate of return risks, IIFS shall take into account the **non-contractual behavioural maturity** of the transactions in the context of the environment in which they operate and changing market conditions. For example, in case of early repayment made by
the customer (in Murābahah or Ijārah transactions) in certain countries, IIFS may accept full settlement but give rebates on subsequent transactions, while in other countries, the IIFS may give rebates immediately at their discretion without any reference to this in the contract.

115. IIFS are encouraged to employ balance sheet techniques to minimise their exposures using the following strategies, among others:

- determining and varying future profit ratios according to expectations of market conditions;
- developing new Sharī‘ah-compliant instruments; and
- issuing securitisation tranches of Sharī‘ah permissible assets.

Displaced Commercial Risk Management

**Principle 6.2: IIFS shall have in place an appropriate framework for managing displaced commercial risk, where applicable.**

116. IIFS shall have in place a policy and framework for managing the expectations of their shareholders and IAH. Where market rates of returns of competitors’ IAH are higher than those of IIFSs’ IAH, the IIFS will evaluate the nature and extent of the expectations of their IAHs and assess the amount of the gap between competitors’ rates and their own IAHs’ expected rates.

117. IIFS need to develop and maintain an informed judgement about an appropriate level of the balances of PER, bearing in mind that its essential function is to provide mitigation of displaced commercial risk. Some IIFS maintain the proportion relating to IAH in this reserve within the IAH equity, with the purpose of smoothing returns to IAH, and in particular, to enhance their returns if these are below those of competitors. This implies that there will be years in which the balance of this reserve will be increased, and others in which it will be depleted.
7 OPERATIONAL RISK

Principle 7.1: IIFS shall have in place adequate systems and controls, including Sharī'ah Board/Advisor, to ensure compliance with Sharī'ah rules and principles.

Principle 7.2: IIFS shall have in place appropriate mechanisms to safeguard the interests of all fund providers. Where IAH funds are commingled with IIFSs' own funds, IIFS shall ensure that the bases for asset, revenue, expense and profit allocations are established, applied and reported in a manner consistent IIFSs' fiduciary responsibilities.

7.1 Background

118. This section sets out principles pertaining to appropriate systems and controls to address IIFSs' operational risks. IIFS are exposed to risks arising from failures in their internal controls involving processes, people and systems. The controls should provide reasonable assurance of the soundness of operations and reliability of reporting.

7.2 Definition and Profiles of Operational Risk

119. IIFS shall consider the full range of material operational risks affecting their operations, including the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. IIFS shall also incorporate possible causes of loss resulting from Sharī'ah non-compliance and the failure in their fiduciary responsibilities.

120. IIFS are exposed to risks relating to Sharī'ah non-compliance and risks associated with the IIFSs' fiduciary responsibilities towards different fund providers. These risks expose IIFS to fund providers' withdrawals, loss of income or voiding of contracts leading to a diminished reputation or the limitation of business opportunities.

121. Sharī'ah non-compliance risk is the risk that arises from IIFSs’ failure to comply with the Sharī'ah rules and principles determined by the Sharī'ah Board of the IIFS or the relevant body in the jurisdiction in which the IIFS operate.

122. Sharī'ah compliance is critical to IIFSs’ operations and such compliance requirements must permeate throughout the organisation and their products and activities. As a majority of the fund providers use Sharī'ah-compliant banking services as a matter of principle, their perception regarding IIFSs' compliance with Sharī'ah rules and principles is of great importance to their sustainability. In this regard, Sharī'ah compliance is considered as falling within a higher priority category in relation to other identified risks. If IIFS do not comply with Sharī'ah rules and principles, their transactions must be cancelled and income generated from them shall be considered as illegitimate.

123. Fiduciary risk is the risk that arises from IIFSs’ failure to perform in accordance with explicit and implicit standards applicable to their fiduciary responsibilities. As a result of losses in investments, IIFS may become insolvent and therefore unable to (a) meet the demands of current account holders for repayment of their funds; and (b) safeguard the interests of their IAH. IIFS may fail to act with due care when managing investments resulting in the risk of possible forgone profits to IAH.
7.3 Operational Considerations

124. IIFS shall have in place a **comprehensive and sound framework for developing and implementing a prudent control environment** for the management of operational risks arising from their activities.

125. The above framework shall be **consistently implemented throughout IIFSs’ organisation** and understood by all relevant staff.

126. IIFS shall conduct **periodic reviews** to detect and address operational deficiencies. The reviews and evaluation of internal controls shall include independent audit coverage and assessment by internal and/or external auditors.

*Shari‘ah* Non-Compliance Risk

**Principle 7.1:** IIFS shall have in place adequate systems and controls, including *Shari‘ah* Board/Advisor, to ensure compliance with *Shari‘ah* rules and principles.

127. IIFS shall ensure that they **comply at all times with the *Shari‘ah* rules and principles** as determined by the relevant body in the jurisdiction in which they operate with respect to their products and activities.\(^\text{11}\) This means that *Shari‘ah* compliance considerations are taken into account whenever the IIFS accept deposits and investment funds, provide finance and carry out investment services for their customers.

128. IIFS shall ensure that their **contract documentation** complies with *Shari‘ah* rules and principles – with regard to formation, termination and elements possibly affecting contract performance such as fraud, misrepresentation, duress or any other rights and obligations.

129. IIFS shall undertake a **Shari‘ah compliance review** at least annually, performed either by a separate *Shari‘ah* control department or as part of the existing internal and external audit function by persons having the required knowledge and expertise for the purpose. The objective is to ensure that (a) the nature of the IIFS’s financing and equity investment and (b) their operations are executed in adherence to the applicable *Shari‘ah* rules and principles as per the fatwa, policies and procedures approved by the IIFS’s *Shari‘ah* Board.

130. IIFS shall keep track of **income not recognised** arising out of *Shari‘ah* non-compliance and assess the probability of similar cases arising in the future. Based on historical reviews and potential areas of *Shari‘ah* non-compliance, the IIFS may assess potential profits that cannot be recognised as eligible IIFSs’ profits.

Fiduciary Risk

**Principle 7.2:** IIFS shall have in place appropriate mechanisms to safeguard the interests of all fund providers. Where IAH funds are commingled with IIFSs’ own funds, IIFS shall ensure that the bases for asset, revenue, expense and profit allocations are established, applied and reported in a manner consistent with IIFSs’ fiduciary responsibilities.

131. IIFS shall establish and implement a **clear and formal policy for undertaking their different and potentially conflicting roles** in respect of managing different types of investment accounts. The policy relating to safeguarding the interests of their IAH may include the following:

- Identification of investing activities that contribute to investment returns and taking reasonable steps to carry on those activities in accordance with the IIFS’s fiduciary

\(^{11}\) In jurisdictions with no central *Shari‘ah* body, each IIFS has its own *Shari‘ah* Board or scholar whose opinions on the *Shari‘ah* rules and principles shall be adopted.
and agency duties and to treat all their fund providers appropriately and in accordance with the terms and conditions of their investment agreements;

- Allocation of assets and profits between the IIFS and their IAH will be managed and applied appropriately to IAH having funds invested over different investment periods;
- Determination of appropriate reserves at levels that do not discriminate against the right for better returns of existing IAH; and
- Limiting the risk transmission between current and investment accounts.

132. IIFS shall adequately disclose information on a timely basis to their IAH and the markets in order to provide a reliable basis for assessing their risk profiles and investment performance.

Restricted Investment Accounts

133. IIFS shall maintain separate accounts in respect of IIFSs’ operations undertaken for restricted IAH and ensure proper maintenance of records for all transactions in investments.

134. To help offset future shortfalls in rate of return for IAH in the case of recurring losses, IIFS may set up separate reserves according to the accounts classes or risks. The methods for setting up and using reserves shall be documented to include the basis for determining the transfers in and out of reserves, maximum thresholds for specific reserves and the use of and closure of specific reserves.

135. In the case of IIFS raising funds for specific investment purposes, IIFS shall ensure that the IAH meet certain eligibility qualifications that are consistent with the scale, timeframe and risk level of the investment opportunity. The eligibility requirements may include setting a minimum investment level.

136. IIFS shall have in place appropriate procedures and controls to ensure the adequacy of the quality of information given in respect of the investment and that the relevant rules and requirements are complied with fully, particularly when marketing an investment opportunity to potential investors.

137. In any case, where a separate wholly owned subsidiary or special purpose vehicle is set up by IIFS as a means to undertake specific investments or financings in particular Mushārakah, IIFS shall ensure that the risks arising in the subsidiary and/or special purpose vehicle are monitored and reported at the group level (risk management on a consolidated basis). An investment loss arising in a subsidiary or special purpose vehicle may give rise to reputational risk for the IIFS.
ROLE OF SUPERVISORY AUTHORITY

General requirement

138. The supervisory authority shall have an adequate understanding on the wide array of risks undertaken by IIFS and satisfy itself that IIFS have in place an adequate risk management and reporting process. The supervisory authority shall develop prudential guidelines and requirements for the management of these risks by IIFS.

Credit Risk

139. The unique nature of credit risk arising from different financing instruments requires the supervisory authority to maintain a detailed description of each financing instrument used by the IIFS in their jurisdiction and the risk exposures to which each instrument gives rise. The supervisory authority may decide to develop Sharī‘ah guidelines or minimum documentations in respect of agreements between IIFS and counterparties for the financing instruments used in their jurisdiction. Where possible, the supervisory authority shall undertake initiatives to harmonise standard documentation in areas including clauses covering notices, grace periods etc.

140. The adequacy of the policies and procedures to be implemented according to the nature and extent of the measures undertaken by IIFS to mitigate risks are subject to review by the supervisory authority in compliance with Sharī‘ah.

141. In the process of assessing the counterparty credit profile, the supervisory authority shall consider developing information sharing procedures. However, the supervisory authority needs to satisfy itself on the adequate confidentiality of certain IIFS customer information.

142. In jurisdictions where non-wilful defaults are recognised by practice, the supervisory authority shall establish criteria and procedures for dealing with non-wilful defaulters.

Equity Investment Risk

143. The supervisory authority shall satisfy itself that adequate policies and procedures are in place for equity investment risk management, taking into account the IIFS’s appetite and tolerance for risk. In addition, the supervisory authority shall ensure that IIFS have sufficient capital when engaging in equity investment activities. The supervisory authority may develop regulatory guidelines for measuring, managing and reporting the risk exposures when dealing with non-performance financing and providing provisions according to the Sharī‘ah rules and regulations.

Market Risk

144. The supervisory authority shall satisfy itself on the adequacy of IIFSs’ internal systems and controls and internal limits set by IIFS on their market risk management in relation to the activities undertaken. Supervisory authorities should require IIFS in their jurisdictions to develop guidelines for acceptable valuation techniques where direct market prices are not available, and should approve such guidelines. Alternatively, the supervisory authorities may themselves develop such guidelines.
Liquidity Risk

145. The supervisory authority shall satisfy itself that IIFS have adequate liquidity policies, systems and controls in place to manage their liquidity. The supervisory authority shall ensure that IIFS monitor and maintain adequate liquidity at all times for meeting the potential cash withdrawal requirements of their current account holders, unrestricted IAH and (in some cases) restricted IAH. The supervisory authority may establish appropriate minimum levels of liquidity for each category.

146. In the course of conducting their business, IIFS may face liquidity difficulties caused by mismatches between inflows and outflows of funds. Where appropriate, the central bank in its capacity as lender of last resort may provide Shari`ah compatible mechanisms for liquidity arrangements to IIFS. The supervisory authority shall define the procedures and requirements for IIFS to satisfy the necessary stipulated regulations before IIFS can resort to seeking funds from their supervisory authority.

Rate of Return Risk

147. The supervisory authority shall assess the capacity of IIFS to manage the rate of return risk. The supervisory authority needs to obtain sufficient information to assess the IAHs’ behavioural and maturity profiles and satisfy itself as to the adequacy and quality of IIFSs’ policies and procedures regarding the rate of return risk management.

148. In some jurisdictions, differences in the inclusion of various types of income in the profit to be allocated to IAH is a concern for the supervisory authority. Where the supervisory authority may have a policy of stating an expected rate of return for unrestricted IAH, the supervisory authority shall establish a framework within which this is to be undertaken by the IIFS operating in its jurisdiction. The framework may include amongst others, methods, applicable periods and recognisable income and expenses, and other calculation bases relating to the use of funds. This framework shall assist the supervisory authority to assess the efficiency of IIFS in terms of their profitability and prudent management.

Operational Risk

149. The supervisory authority shall satisfy itself that IIFS have in place a comprehensive and sound framework for developing and implementing a prudent control environment for the management of operational risks arising from their activities.

150. The supervisory authority shall satisfy itself that IIFS have adequate Shari`ah compliance mechanisms in place. These will include (a) a well-defined and adequately qualified and staffed organisational structure, (b) clear lines of authority and accountability; and (c) policies and procedures pertaining to the approval of products and activities that require adherence to Shari`ah rules and principles. The supervisory authority may require IIFS to have an independent and regular review of Shari`ah compliance in this regard.

151. The supervisory authority shall prescribe formal guidance for IIFS to ensure they fulfil their fiduciary duties towards their IAH.

152. The supervisory authority shall satisfy itself that the applicable auditing standards relevant to IIFS are being implemented correctly in respect of the assessment of the appropriateness of allocations, distributions and reporting of profits to IAH.
DEFINITIONS

The following definitions are intended to help readers to have general understanding on the terms used in the Guiding Principles and they are by no means an exhaustive list.

<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
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<tbody>
<tr>
<td><strong>Ijārah</strong></td>
<td>An <em>Ijārah</em> contract refers to an agreement made by IIFS to lease to a customer an asset specified by the customer for an agreed period against specified instalments of lease rental. An <em>Ijārah</em> contract commences with a promise to lease that is binding on the part of the potential lessee prior to entering the <em>Ijārah</em> contract.</td>
</tr>
<tr>
<td><strong>Ijārah Muntahia Bittamleek</strong></td>
<td>An <em>Ijārah Muntahia Bittamleek</em> (or <em>Ijārah wa Iqtina</em>) is a form of lease contract that offers the lessee an option to own the asset at the end of the lease period either by purchase of the asset through a token consideration or payment of the market value, or by means of a gift contract.</td>
</tr>
<tr>
<td><strong>Investment Risk Reserve</strong></td>
<td>Investment risk reserve is the amount appropriated by the IIFS out of the income of IAH, after allocating the <em>Muḍārib</em>’s share, in order to cushion against future investment losses for IAH.</td>
</tr>
<tr>
<td><strong>Istisnā’</strong></td>
<td>An <em>Istisnā’</em> contract refers to an agreement to sell to a customer a non-existent asset, which is to be manufactured or built according to the buyer’s specifications and is to be delivered on a specified future date at a predetermined selling price.</td>
</tr>
<tr>
<td><strong>Muḍārabah</strong></td>
<td>A <em>Muḍārabah</em> is a contract between the capital provider and a skilled entrepreneur whereby the capital provider would contribute capital to an enterprise or activity, which is to be managed, by the entrepreneur as the <em>Muḍārib</em> (or labour provider). Profits generated by that enterprise or activity are shared in accordance with the terms of the <em>Muḍārabah</em> agreement whilst losses are to borne solely by the capital provider unless the losses are due to the <em>Muḍārib</em>’s misconduct, negligence or breach of contracted terms.</td>
</tr>
<tr>
<td><strong>Murābahah</strong></td>
<td>A <em>Murābahah</em> contract refers to a sale contract whereby the IIFS sell to a customer at an agreed profit margin plus cost (selling price), a specified kind of asset that is already in their possession.</td>
</tr>
<tr>
<td><strong>Murābahah for the Purchase Orderer (MPO)</strong></td>
<td>An MPO contract refers to a sale contract whereby the IIFS sell to a customer at cost plus an agreed profit margin (selling price), a specified kind of asset that has been purchased and acquired by the IIFS based on a promise to purchase from the customer, which can be binding or non-binding.</td>
</tr>
<tr>
<td><strong>Mushārakah</strong></td>
<td>A <em>Mushārakah</em> is a contract between the IIFS and a customer to contribute capital to an enterprise, whether existing or new, or to ownership of a real estate or moveable asset, either on a temporary or permanent basis. Profits generated by that enterprise or real estate/asset are shared in accordance with the terms of <em>Mushārakah</em> agreement whilst losses are shared in proportion to each partner’s share of capital.</td>
</tr>
</tbody>
</table>
| **Diminishing Mushārakah** | Diminishing *Mushārakah* is a form of partnership in which one of the partner promises to buy the equity share of the other partner gradually until the title to the equity is completely transferred to the buying partner. The transaction starts with the formation of a partnership, after which buying and selling of the other partner’s equity take place at market value or the price agreed upon at the time of entering into the contract. The “buying and selling” is independent of the partnership contract and should not be stipulated in the partnership contract since the buying partner is only allowed to
<table>
<thead>
<tr>
<th>Term</th>
<th>Description</th>
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</thead>
<tbody>
<tr>
<td>Parallel Istisnā`</td>
<td>A Parallel Istisnā<code> is a second Istisnā</code> contract where a third party will be manufacturing for the IIFS a specified kind of asset, which corresponds to the specification of the first Istisnā` contract.</td>
</tr>
<tr>
<td>Parallel Salam</td>
<td>A Parallel Salam contract refers to a second Salam contract with a third party acquiring, from the IIFS, a specified kind of commodity, which corresponds to that of the commodity specified in the first Salam contract.</td>
</tr>
<tr>
<td>Profit Equalisation Reserve</td>
<td>Profit equalisation reserve (PER) is the amount appropriated by the IIFS out of the Muḍarabah income, before allocating the Muḍārib’s share, in order to maintain a certain level of return on investment for IAH and to increase owners’ equity.</td>
</tr>
<tr>
<td>Qard</td>
<td>A non-interest bearing loan intended to allow the borrower to use the loaned funds for a period with the understanding that the same amount of the loaned funds would be repaid at the end of the period.</td>
</tr>
<tr>
<td>Restricted Investment Accounts</td>
<td>The account holders authorise the IIFS to invest their funds based on Muḍarabah or agency contracts with certain restrictions as to where, how and for what purpose these funds are to be invested.</td>
</tr>
<tr>
<td>Salam</td>
<td>A Salam contract refers to an agreement to purchase, at a predetermined price, a specified kind of commodity not available with the seller, which is to be delivered on a specified future date in a specified quantity and quality. The IIFS as the buyers make full payment of the purchase price upon execution of a Salam contract. The commodity may or may not be traded over the counter or on an exchange.</td>
</tr>
<tr>
<td>Sukūk</td>
<td>Sukūk (certificates) represents the holder’s proportionate ownership in an undivided part of an underlying asset where the holder assumes all rights and obligations to such asset.</td>
</tr>
<tr>
<td>Unrestricted Investment Accounts</td>
<td>The account holders authorise the IIFS to invest their funds based on Muḍarabah or Wakalah (agency) contracts without laying any restriction. The IIFS can commingle these funds with their own funds and invest them in a pooled portfolio.</td>
</tr>
<tr>
<td>Wadi‘ah</td>
<td>An amount deposited whereby the depositor is guaranteed his/her fund in full.</td>
</tr>
<tr>
<td>Investment Wakalah</td>
<td>Wakalah is an agency contract, where the investment account holder (principal) appoints the IIFS (agent) to carry out on behalf of the principal the investment for a fee or for no fee, as the case may be.</td>
</tr>
</tbody>
</table>