



ISLAMIC FINANCIAL SERVICES BOARD

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IFSB-15

**REVISED CAPITAL ADEQUACY STANDARD  
FOR INSTITUTIONS OFFERING  
ISLAMIC FINANCIAL SERVICES  
[EXCLUDING ISLAMIC INSURANCE  
(*TAKĀFUL*) INSTITUTIONS AND ISLAMIC  
COLLECTIVE INVESTMENT SCHEMES]**

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December 2013

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The IFSB is an international standard-setting organisation which was officially inaugurated on 3 November 2002 and started operations on 10 March 2003. The organisation promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors. The standards prepared by the IFSB follow a lengthy due process as outlined in its Guidelines and Procedures for the Preparation of Standards/Guidelines, which involves, among others, the issuance of exposure drafts, holding of workshops and, where necessary, public hearings. The IFSB also conducts research and coordinates initiatives on industry-related issues, as well as organises roundtables, seminars and conferences for regulators and industry stakeholders. Towards this end, the IFSB works closely with relevant international, regional and national organisations, research/educational institutions and market players.

For more information about the IFSB, please visit [www.ifsb.org](http://www.ifsb.org).

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## ACRONYMS

AMA	Advanced measurement approach (for operational risk)
ASA	Alternative standardised approach (for operational risk)
BCBS	Basel Committee on Banking Supervision
BIA	Basic indicator approach (for operational risk)
BOT	Build, operate and transfer
CAR	Capital adequacy ratio
CCB	Countercyclical buffer
CCF	Credit conversion factor
CCR	Counterparty credit risk
CDOs	Collateralised debt obligations
CMF	Commodity <i>Murābahah</i> financing
CMLF	Commodity <i>Murābahah</i> for liquid funds
CMT	Commodity <i>Murābahah</i> transactions
CRE	Commercial real estate
CRM	Credit risk mitigation
DCR	Displaced commercial risk
DTAs	Deferred tax assets
ECA	Export credit agencies
ECAI	External credit assessment institution
FTV	Financing-to-value ratio
GDP	Gross domestic product
GN	Guidance Note
GNI	Gross national income
HJ	<i>Hamish Jiddiyah</i>
HLA	Higher loss absorbency
IAH	Investment account holders
IAIS	International Association of Insurance Supervisors
IAS	International Accounting Standards
ICAAP	Internal capital adequacy assessment process
IDB	Islamic Development Bank
IFSB	Islamic Financial Services Board
IFSB-1	Guiding Principles of Risk Management for IIFS
IFSB-2	Capital Adequacy Standard for IIFS
IFSB-4	Disclosures to Promote Transparency and Market Discipline for IIFS
IFSB-5	Guidance on Key Elements in the Supervisory Review Process for IIFS
IFSB-7	Capital Adequacy Requirements for <i>Sukūk</i> , Securitisations and Real Estate Investment
IFSB GN-1	Guidance Note on Recognition of Ratings by External Credit Assessment Institutions on <i>Sharī'ah</i> -Compliant Financial Instruments
IFSB GN-2	Guidance Note in Connection with the Risk Management and Capital Adequacy Standards: Commodity <i>Murābahah</i> Transactions
IFSB GN-3	Guidance Note on the Practice of Smoothing the Profits Payout to Investment Account Holders

IFSB GN-4	Guidance Note in Connection with the IFSB Capital Adequacy Standard: The Determination of Alpha in the Capital Adequacy Ratio for IIFS
IFSI	Islamic financial services industry
IIFS	Institution(s) offering Islamic financial services (excluding Islamic insurance/ <i>Takāful</i> institutions and Islamic collective investment schemes)
IMB	<i>Ijārah Muntahia Bittamlik</i> (also known as <i>Ijārah wa Iqtinā</i> )
IOSCO	International Organization of Securities Commissions
IRB	Internal rating-based approach (for market risk)
IRR	Investment risk reserve
LGD	Loss-given default
LOB	Line of business
MDB	Multilateral development bank
MPO	<i>Murābahah</i> for purchase orderer
NPF	Non-performing financing
OTC	Over-the-counter
PD	Probability of default
PER	Profit equalisation reserve
PL	Promise to lease
PP	Promise to purchase
PSE	Public sector enterprise/entity
PSIA	Profit-sharing investment account
PTI	Payment-to-income (ratio)
RCASWG	Revised Capital Adequacy Standard Working Group
RIAH	Restricted investment account holders
RPSIA	Restricted profit-sharing investment account
RRE	Residential real estate
RWs	Risk weights
RWAs	Risk-weighted assets
SAGs	Standards and guidelines
SIB	Systemically important bank
SME	Small and medium enterprise
SPE	Special-purpose entity
SSB	<i>Sharī'ah</i> Supervisory Board
TSA	The standardised approach (for operational risk)
UIAH	Unrestricted investment account holders
UPSIA	Unrestricted profit-sharing investment account
WIP	Work-in-process

## ***Bismillahirrahmanirrahim***

*Allahumma salli wasallim 'ala Sayyidina Muhammad wa'ala alihi wasahbihi*

### **SECTION I: INTRODUCTION**

#### **1.1 Background**

1. The Islamic Financial Services Board (IFSB) issued its *Capital Adequacy Standard* (hereinafter referred to as IFSB-2) for institutions offering Islamic financial services (IIFS) in December 2005. The IFSB-2 addressed the specific structure and contents of the *Sharī'ah*-compliant products and services offered by the IIFS and provided detailed guidance on calculating capital adequacy requirements for IIFS offering these products and services.

2. The IFSB supplemented IFSB-2 with a number of other publications in subsequent years related to the calculation of capital adequacy requirements in IIFS, in order either to cover additional products and services offered by IIFS or to provide further guidance on the application of various aspects of the current IFSB standards. These publications include:

- (a) March 2008: GN-1: *Guidance Note in Connection with the Capital Adequacy Standard: Recognition of Ratings by External Credit Assessment Institutions (ECAIs) on Sharī'ah-Compliant Financial Instruments*;
- (b) January 2009: IFSB-7: *Capital Adequacy Requirements for Sukūk, Securitisations and Real Estate Investment*;
- (c) December 2010: GN-2: *Guidance Note in Connection with the Risk Management and Capital Adequacy Standards: Commodity Murābahah Transactions*;
- (d) December 2010: GN-3: *Guidance Note on the Practice of Smoothing the Profits Payout to Investment Account Holders*; and
- (e) March 2011: GN-4: *Guidance Note in Connection with the IFSB Capital Adequacy Standard: The Determination of Alpha in the Capital Adequacy Ratio for IIFS*.

3. Two of these IFSB publications (IFSB-7 and GN-2) covered capital adequacy requirements for *Sukūk*, securitisations, real estate and commodity *Murābahah* transactions. In addition, for the calculation of credit risk based on the "standardised approach", GN-1 provided criteria for recognition of ECAIs for the purpose of determining the risk weightings of *Sharī'ah*-compliant financial assets. Moreover, GN-3 and GN-4, respectively, provided comprehensive guidance on, *inter alia*, the practice of smoothing the profit payouts to investment account holders (IAH) and the determination of the alpha factor in the capital adequacy ratio (CAR) for IIFS.

4. IFSB-2 and the other aforementioned publications were mainly based on Pillar 1 of Basel II,<sup>1</sup> with the necessary modifications and adaptations to cater for the specificities and characteristics of the *Sharī'ah*-compliant products and services offered by the IIFS. These standards and guidelines (SAGs) did not cover advanced approaches for the calculation of various risks such as foundation and advanced internal rating-based approaches for calculation of credit risk, the duration method for *Sukūk* held in the trading book (market risk), and the advanced measurement approach for operational risk. Also, these SAGs did not provide detailed guidance on the various components of regulatory capital in IIFS and left it to the discretion of supervisory authorities to decide the criteria for various instruments to be included in the different capital tiers. While these SAGs stopped short of explaining approaches other than the standardised approaches, the IFSB recommended that the supervisory authorities should allow IIFS in their jurisdictions to use other approaches for regulatory capital purposes if they have the ability to address the infrastructure issues adequately. It was stressed that the IFSB will monitor new developments, consult the industry in the future, and eventually make any necessary revisions to the

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<sup>1</sup> IFSB issued several other standards to complement Pillars 2 and 3 of Basel II; for example, IFSB standards on risk management, corporate governance and the supervisory review process (IFSB-1, IFSB-3 and IFSB-4, respectively) complemented Pillar 2, and the standard on disclosure to promote transparency and market discipline (IFSB-4) complemented Pillar 3 of Basel II.

capital adequacy framework for IIFS.

5. After the issuance of IFSB-2 in December 2005, according to the IFSB's assessment of the implementation of IFSB standards a number of supervisory authorities implemented this Standard in their jurisdictions, in various stages. A number of considerations, including requests from various IFSB member central banks and supervisory authorities to provide guidance on some additional areas, resulted in the issuance of subsequent SAGs on capital adequacy by the IFSB in later years, as mentioned in paragraphs 2 and 3. The IFSB has also operated a comprehensive programme of conducting workshops on "facilitating the implementation of IFSB standards" (commonly known as "FIS workshops") in recent years, mostly in the member countries. The IFSB's interaction with its members from the central banks and supervisory authorities, as well as its contacts with industry players and other stakeholders, provided feedback on the areas which need to be updated in relation to the calculation of capital adequacy in IIFS.

6. As a result of the financial and economic crisis that began in 2007, the global regulatory landscape witnessed a number of developments which resulted in the issuance of numerous publications by global standard-setting bodies such as the Financial Stability Board, the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS). Among other things, these global regulatory reforms included the issuance by the BCBS of a number of documents collectively labelled Basel III, aimed at strengthening the global capital and liquidity rules to promote a more resilient banking sector by enhancing its ability to absorb shocks arising from financial and economic stress, and by reducing the risk of spillover from the financial sector to the real economy. These initiatives have been designed, *inter alia*, to (a) raise the quality and quantity of the regulatory capital base; (b) enhance risk coverage; (c) supplement the risk-based capital requirement with a leverage ratio; (d) reduce procyclicality by introducing countercyclical and capital conservation buffers; and (e) address systemic risk and interconnectedness.

7. Based on the above considerations, and in line with the IFSB mandate to develop prudential SAGs to promote the soundness and stability of the Islamic financial services industry (IFSI), the Council of the IFSB, in its 17th meeting held at Islamic Development Bank Headquarters based in Jeddah, Saudi Arabia on 14 December 2010, approved the revision of IFSB-2 and IFSB-7 and the formation of the Revised Capital Adequacy Standard Working Group (RCASWG). The RCASWG is mandated to prepare a revised standard on capital adequacy for IIFS (hereinafter to be referred to as "the Standard") that will provide comprehensive guidance to supervisory authorities and IIFS in this area.

## 1.2 Objectives

8. In addition to aligning the IFSB SAGs with global capital standards, this Standard covers some additional areas not previously included in IFSB SAGs related to capital adequacy. It also endeavours to provide a more comprehensive guidance to supervisory authorities on the application of capital adequacy regulations for IIFS by combining and enhancing the contents of IFSB-2 and IFSB-7, thus providing a level playing field to IIFS vis-à-vis market players. Further, it provides the supervisors with necessary flexibility for its application across regions and on small to fairly large and sophisticated IIFS. The main objectives of this Standard are as follows:

- (a) to assist the IIFS and their supervisory authorities in the implementation of a capital adequacy framework that will ensure effective coverage of risk exposures of the IIFS and allocation of appropriate capital to cover these risks, thus enhancing the resilience of the IFSI;
- (b) to provide guidance on the maintenance of high-quality regulatory capital components by IIFS, which comply with *Sharī'ah* rules and principles;
- (c) to address the capital adequacy requirements of various risk exposures related to *Sharī'ah*-compliant products and services offered by IIFS;
- (d) to provide guidance on the capital adequacy treatment of an IIFS's involvement in *Sukūk* issuance and securitisation processes in various capacities, including as originator, servicer and credit enhancer; and

- (e) to adapt international best practices, as well as current and emerging standards, relating to capital adequacy for IIFS.

### 1.3 Scope and Coverage

9. This Standard is primarily intended to serve banking institutions offering Islamic financial services. These IIFS include, but are not limited to: fully fledged Islamic commercial banks; Islamic investment banks/companies; Islamic banking subsidiaries of conventional banks; Islamic banking branches/divisions/units of conventional banks (hereinafter collectively referred to as “Islamic windows”<sup>2</sup>); and such other financial institutions as may be determined by the respective supervisory authority. In addition, the risk-weighting methodology set out in this Standard may be applied to *Shari’ah*-compliant financing assets held by Islamic “window” operations that are not self-contained or by other institutions holding such assets.

10. The Standard will be applicable to any IIFS that falls within the scope as stated herein, on a fully consolidated basis at the holding company level within a group or sub-group of IIFS, or on a solo basis or on both fully consolidated and solo bases as determined by the respective supervisory authority. The Standard is not intended to be applied at the consolidated level to a group or sub-group that consists of entities other than IIFS as defined in the Standard. The application of this standard by supervisory authorities should be commensurate with the nature, size, complexity and type of products of the IIFS in the jurisdiction.

### 1.4 Implementation Date

11. Supervisory authorities are expected to start implementation of this Standard in their jurisdictions by 1 January 2015, but earlier implementation may be feasible, taking into account an adequate period for this Standard to be transformed into national supervisory regulations and guidelines for IIFS, as well as transitional arrangements explained in the relevant sub-sections related to enhancing the quality and quantity of capital and introducing new capital and leverage requirements. Such implementation should be undertaken in compliance with *Shari’ah* and within the legal and regulatory framework applicable in the jurisdiction.

### 1.5 Specificities of Islamic Financial Instruments

12. Islamic financial instruments are asset-based (*Murābahah*, *Salam* and *Istisnā`*, which are based on the sale or purchase of an asset; and *Ijārah*, which is based on selling the benefits of such an asset), profit-sharing (*Mushārahah* and *Muḍārahah*), or *Sukūk* (securities) and investment portfolios and funds which may be based on the above assets. In the case of the asset-based instruments, the IIFS’s gross return is the spread between the cost of the asset to the IIFS and the amount that can be recovered from selling or leasing it. Such instruments may therefore involve exposure to market (price) risk in respect of the asset, as well as credit risk in respect of the amount due from the counterparty. In the case of the profit-sharing instruments, *Mushārahah* and *Muḍārahah*, the exposure is of the nature of an equity position not held for trading similar to an “equity position in the banking book”<sup>3</sup> as described in Basel II,<sup>4</sup> and is likewise dealt with under credit risk, except in the case of investments (normally short-term) in assets for trading purposes, which are dealt with under market risk.

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<sup>2</sup> IFSB-5 defined “Islamic windows” as part of a conventional financial institution (which may be a branch or dedicated unit of that institution) that provides both fund management (investment accounts) as well as financing and investment that are *Shari’ah* compliant. Thus, these windows are potentially self-contained in terms of *Shari’ah*-compliant financial intermediation, as the funds generated are invested in *Shari’ah*-compliant assets.

<sup>3</sup> See paragraph 344 of Basel II, June 2006 version.

<sup>4</sup> Basel II – initially published in June 2004 by the Basel Committee on Banking Supervision – aimed to create a global standard governing the capital adequacy of internationally active banks. The BCBS issued a comprehensive version of the Basel II Framework on 4 July 2006. Basel II uses a “three-pillar” framework: (1) minimum capital requirements (addressing risk); (2) supervisory review process; and (3) transparency and market discipline. After the financial crisis that started in 2007, the BCBS issued a revised package of measures to enhance the three pillars of the Basel II framework and to strengthen the 1996 rules governing trading book capital. Some of the elements of Basel II have been further updated with the issuance of Basel III by the BCBS in December 2010.

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

## 1.6 Structure of the Standard

14. This Standard aims to constitute a combined, revised and updated version of IFSB-2 and IFSB-7. The combined and revised Standard is divided into six sections, which have been further enhanced with the relevant features covered in the IFSB Guidance Notes, including GN-1, GN-2, GN-3 and GN-4.<sup>5</sup> Detailed criteria for various components of capital have also been included in the Standard. The recognition and treatment of various components of capital, apart from common equity, were previously left to the discretion of the supervisory authorities. Further, the Standard also provides guidance on the application of new features introduced by the BCBS in its Basel III documents, with necessary adaptations for IIFS – namely, the capital conservation buffer, the countercyclical buffer and the leverage (or common equity to total exposures) ratio.

15. The Standard is structured as follows:

(a) Section I provides the background and objectives, as well as the scope and coverage, of the Standard. Further, it specifies the proposed date of starting implementation of the Standard. It also includes a brief overview on the specificities of Islamic financial instruments and the structure of the Standard.

(b) Section II outlines basic features and criteria for various components of capital to be applicable to IIFS, as well as regulatory adjustments and deductions attached to these components. This section also illustrates the application of the capital conservation buffer, countercyclical buffer and leverage ratio for IIFS, keeping in view their balance sheet structure and specificities in the application of these requirements.

(c) Section III further expands the guidance provided in the earlier IFSB SAG related to calculation of credit risk, market risk and operational risk, in order to incorporate recent enhancements in the global capital standards and cover some areas not previously included. *Inter alia*, the sub-section on credit risk mitigation has been restructured to cover new credit risk mitigation techniques. Sub-sections on market risk and operational risk have also been updated. Lastly, the sub-section on profit-sharing investment accounts (PSIAs) has been enhanced to provide a more comprehensive guideline on the treatment of PSIAs and adjustments in the CAR.

(d) Section IV sets out the minimum capital adequacy requirements for both credit and market risks for each of the *Sharī'ah*-compliant financing and investment instruments:

- (i) *Murābahah* and *Murābahah* for the purchase orderer;
- (ii) commodity *Murābahah* transactions (CMT);
- (iii) *Salam* and Parallel *Salam*;
- (iv) *Istisnā`* and Parallel *Istisnā`*;
- (v) *Ijārah* and *Ijārah Muntahia Bittamlīk*;
- (vi) *Mushārahah*, including *Diminishing Mushārahah*;
- (vii) *Muḍārahah*;
- (viii) *Qarḍ*, and
- (ix) *Wakālah*.

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<sup>5</sup> Though this Standard has benefited from various IFSB Guidance Notes mentioned in the text, and has incorporated several important points covered in these publications, the issuance of this Standard is not meant to replace any of these publications.



(e) Section V combines guidance on capital adequacy treatment of *Sukūk* and securitisation exposures of IIFS included in IFSB-2 and IFSB-7, and incorporates global regulatory developments related to originating, issuing and holding *Sukūk* in various stages of the securitisation process.

(f) Section VI specifies capital requirements for exposures of IIFS related to real estate financing and investment activities, when an IIFS utilises its own (shareholders') funds or those generated from PSIA and other fund providers. This section, which was originally part of IFSB-7, has been further updated to cover best practices of supervisory authorities to improve supervision of IIFS' real estate exposures.

16. This Standard stops short of examining various issues related to IFSB-5 (the supervisory review process) at length, such as capital planning, the internal capital adequacy assessment process (ICAAP), because the IFSB plans to prepare a revised version of the latter standard by incorporating global regulatory changes. Nevertheless, this Standard does provide necessary guidance on some important areas that need to be explained within the scope of this Standard, such as the treatment of Islamic windows, counterparty credit risk and concentration risk.

17. This Standard also does not cover advanced approaches for the calculation of capital requirements in respect of various risks, such as the foundation and advanced internal rating-based (IRB) approaches for calculation of credit risk capital requirements, and the advanced measurement approach (AMA) for the calculation of operational risk capital requirements. Supervisory authorities, at their discretion, may allow the IIFS in their jurisdiction to migrate to the advanced approaches provided that they are satisfied, *inter alia*, with: (a) the robustness of the internal models; (b) the availability of sufficient and reliable data; and (c) fulfilment of other related requirements. The IFSB is aware that in certain jurisdictions, supervisory authorities are allowing some IIFS to use some of the advanced approaches, in view of their increasing size and sophistication. Therefore, the IFSB intends to prepare a separate comprehensive guidance to address these approaches for the benefit of supervisory authorities and IIFS, taking due account of the specificities of IIFS.

18. The *Sharī'ah* rules and principles mentioned for explanatory purposes in the Standard do not encompass all the practices followed by IIFS in different jurisdictions, and the references to these rules and principles in this context are not intended to indicate that the IFSB has any opinion as to whether the products and services offered by the IIFS are in accordance with *Sharī'ah* rules and principles. In this regard, IIFS are expected to fulfil the requirements set by their supervisory authorities and *Sharī'ah* boards in determining and ensuring that their activities are in compliance with the *Sharī'ah* rules and principles.

## SECTION II: REGULATORY CAPITAL

### 2.1 Components of Capital

19. This section provides a definition of (regulatory) eligible capital for IIFS. The eligible capital shall be used as the numerator and total risk-weighted assets (RWAs) as denominator in calculating the CAR formula. The section will further explain the criteria and characteristics of each component of eligible capital.

20. Total eligible capital for IIFS is the sum of Tier 1 and Tier 2 capital. Tier 1 capital consists of Common Equity Tier 1 (CET1) and Additional Tier 1 (AT1). CET1 consists of common equity share capital, retained earnings and some other reserves, as mentioned in paragraph 24. AT1 capital consists of *Shari'ah*-compliant instruments and some reserves, as mentioned in paragraph 26. Together with CET1, AT1 capital is considered as "going concern" capital which absorbs losses while the IIFS is solvent.

21. Tier 2 (T2) capital consists of *Shari'ah*-compliant instruments and some reserves, as mentioned in paragraph 27. T2 capital is considered to be "gone concern" capital which absorbs further losses in the case of non-viability of the IIFS, and thus helps to protect the current account holders and other creditors of the IIFS. Various eligible adjustments/deductions shall apply to the respective type of capital, as explained in paragraph 31. In order for an instrument to be included in these components of capital, a set of relevant criteria provided in sections 2.1.1–2.1.3 should be met. The eligibility of various types of instruments for inclusion in AT1 or T2 is a matter for consideration by the supervisory authority in the light of the relevant criteria, notably with regard to loss absorbency.

22. The eligible capital requirements for IIFS shall be not less than 8% of total RWA at all times. IIFS shall maintain CET1 capital of at least 4.5% of RWA at all times. Tier 1 capital (CET1 plus AT1) must be at least 6.0% of RWA at all times. Total capital (Tier 1 capital plus Tier 2 capital) must be at least 8.0% of RWA at all times. In addition, IIFS shall be required to maintain a capital conservation buffer and a countercyclical buffer, as stipulated by their respective supervisory authorities. Guidance on these buffers is provided in sections 2.2 and 2.3. Furthermore, IIFS which are identified as Domestic Systemically Important Banks (D-SIBs) by the supervisor will be required to hold additional CET1 capital, as explained in section 2.6.

#### 2.1.1 Common Equity Tier 1 Capital

23. Common Equity Tier 1 (CET1) capital forms the highest quality of capital for IIFS. There are stringent criteria for an instrument to be considered as CET1 capital so as to ensure its permanence and loss absorption capacity.

24. CET1 capital comprises the sum of elements (a)–(f), minus (g), below:

- (a) *Common shares issued by the IIFS*: This is the main shareholders' equity issued by IIFS, which should be fully paid up and should meet the criteria of being classified as common shares.
- (b) *Stock surplus*: Stock surplus (share premium) from the issue of common shares.
- (c) *Retained earnings*: The amount of net earnings which is carried forward from previous financial periods shall be recognised and included in the calculation of CET1 capital. Retained earnings include interim profit or loss.
- (d) *Other disclosed reserves and comprehensive income, including interim profit or loss*: Dividends declared and payable are not included in CET1, as such amounts are classified as liabilities in accordance with International Financial Reporting Standards (IFRS) and would normally be so classified by accounting standards applicable in the jurisdiction. Other comprehensive income

includes interim profit or loss.<sup>6</sup>

- (e) For interim profit or loss, supervisory authorities may seek verification by external auditors or require other review procedures.
- (f) *Common shares issued by consolidated subsidiaries of IIFS*: Such common shares that are issued by IIFS's consolidated subsidiaries and held by third parties (minority interest) and meet the criteria of being included in CET1 provided below.
- (g) Regulatory adjustments/deductions applicable to CET1.

25. Specific criteria for common equity are set out below.

(a) *Loss absorbency*

Common equity represents the most subordinated claim in case of liquidation of the IIFS, having a claim on the residual assets after all senior claims have been repaid. In terms of sharing any losses as incurred, common equity serves as a first loss position and is able to absorb losses on a going concern basis.<sup>7</sup>

(b) *Issuance process and procedure*

At the issuance of common equity instruments, the IIFS should not create an expectation, or state in the contractual terms, that the instrument will be redeemed, cancelled or bought back (call option) under any circumstances. Common equity is directly issued and paid-in<sup>8</sup> such that no related party of the IIFS directly or indirectly purchases it or funds the purchase. The issuance receives the formal approval of the existing common shareholders of the issuing IIFS either directly or indirectly based on the approval of the board of directors or according to the applicable law in the jurisdiction.

(c) *Permanence*

The principal amount of common shares is perpetual in nature and is never repaid except in the case of liquidation. However, in some cases the law and the IIFS's statutes may permit common shares to be repurchased, subject to the approval of the supervisory authority.<sup>9</sup>

(d) *Distribution of profit or dividends*

There is no circumstance in which distribution of profits (or payment of dividends) is obligatory. Non-payment of dividends, therefore, is not a default event. Distributions shall be made out of distributable items which normally consist of profits for the year that are attributable to common equity and, subject to the approval of the supervisory authorities, retained earnings. (The level of distribution of profit must be independent of, and not linked or tied to, the amount paid in at issuance.) Distributions can only be made after meeting all legal and contractual obligations and payments to more senior capital instruments. There are no preferential distributions on the eligible instruments.

(e) *Equity in nature*

The paid amount is recognised as equity capital in the IIFS balance sheet and is classified as equity

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<sup>6</sup> The transitional provisions in Basel III, paragraphs 52, footnote 10, and 94(d), state that unrealised gains less losses recognised on the balance sheet initially remain part of capital, though they will be fully deducted from capital by 1 January 2018.

<sup>7</sup> Going concern capital allows an IIFS to continue its activities and helps to prevent insolvency. Going concern capital is considered to be CET1. The purest form of going concern capital is common equity.

<sup>8</sup> Reference to paid-in capital in various components of capital refers to capital that has been received with conclusiveness by the IIFS, is reliably valued, is fully under the IIFS's control, and does not directly or indirectly expose it to the credit risk of the investor. The payment, however, need not necessarily be made in cash; for example, shares issued in payment for the acquisition of another company are not paid for in cash. Commonly, an IIFS may be required to obtain prior supervisory approval to include in capital an instrument which has not been paid for in cash.

<sup>9</sup> Depending on the applicable law, exceptions may include discretionary repurchases or other means of reduction of capital. Repurchased common shares may be held as Treasury stock or, subject to the law and supervisory approval, they may be cancelled.

under the applicable accounting standards.<sup>10</sup>

(f) *Unsecured in nature*

The amount paid in at issuance is neither secured nor guaranteed by the IIFS or its related entity (parent/ subsidiary or sister of the company or Islamic window or other affiliate group). There should be no contractual terms or arrangements in the issue of eligible instruments that enhance the seniority of claims under the instruments in insolvency or liquidation.

(g) *Disclosure requirement*

Common equity is clearly stated and disclosed on the IIFS's balance sheet.<sup>11</sup>

### **2.1.2 Additional Tier 1 Capital**

26. Additional Tier 1 (AT1) capital consists only of instruments such that they have a high degree of loss absorbency. AT1 capital comprises the sum of elements (a)–(c), minus (d), below:

Add:

- (a) *instruments issued by IIFS* that meet the following (paragraph 27) criteria for inclusion in AT1 capital;
- (b) *any premium received* on the issue of instruments included in AT1 capital, and which is not included in CET1;
- (c) *instruments or qualifying capital* issued by consolidated subsidiaries of the IIFS to third-party investors that meet the criteria for inclusion in AT1 capital and are not included in CET1 (see paragraph 30(a) – minority interest);

Minus:

- (d) *regulatory adjustments/deductions applicable to AT1 capital.*

27. Specific criteria for classification of instruments as AT1 capital are set out below.

(a) *Loss absorbency*

Subject to *Sharī'ah* approval, an IIFS may issue *Mushārahah Sukūk* (with the underlying assets as the whole business of the bank) that are able to absorb losses so as to qualify for inclusion in AT1 capital.<sup>12</sup> In these *Mushārahah Sukūk*, the *Sukūk* holders are partners with the common shareholders in the equity capital of the IIFS, as per the terms of the *Mushārahah* agreement, and thus fully share the risks and rewards of the IIFS's operations.

(b) *Issuance process and procedure*

The instrument is issued and paid-up, and neither the IIFS nor a related party over which the IIFS exercises control or significant influence can purchase the instrument, or fund its purchase, either directly or indirectly. Repayment of principal through repurchase or buy-back is allowed subject to supervisory approval without any expectation of repayment being created by the IIFS.

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<sup>10</sup> Where associates and joint ventures are accounted for under the equity method, earnings of such entities are eligible for inclusion in the CET1 of the IIFS to the extent that they are reflected in retained earnings and other reserves of the IIFS and are not excluded by any of the regulatory adjustments set out in [section 2.1.5](#).

<sup>11</sup> The reference to the balance sheet is made in the context of the published financial statements of the IIFS, as required by respective legal and/or supervisory stipulations.

<sup>12</sup> The term “general obligation” is used to refer to this loss absorbency characteristic. It should be noted that this would not be the case with *Muḍārahah Sukūk*, since the *Rabb al-Māl* would not be liable for the general liabilities of the IIFS (and notably for the amount owed to current account holders). So-called general obligation *Muḍārahah Sukūk* are in fact a form of *Mushārahah Sukūk*.

(c) *Maturity and callability*

The *Mushārahah Sukūk* is perpetual in nature and has no maturity date. It must not have step-up features (i.e. periodic increases in the rate of return) and is without any other incentive to the issuer to redeem it.<sup>13</sup> If the instrument is callable, the issuer is permitted to exercise a call option only after five years and subject to certain requirements, such as: (i) prior supervisory approval; (ii) no call expectation is created by the IIFS; and (iii) ability to replace the called instruments with the same or better quality of capital, either before or concurrently with the call. The IIFS shall not exercise a call unless it successfully exhibits that its capital position is above the regulatory capital requirement after the call option is exercised. Instruments which qualify for AT1 capital cannot have any features that hinder recapitalisation (provisions that require the IIFS to compensate investors if a new instrument is issued at a lower price during a specified time frame). If an instrument is issued out of a special-purpose entity (SPE), proceeds must be immediately available without limitation to the IIFS in a form which meets or exceeds all of the other criteria for inclusion in AT1 capital.

(d) *Distribution of profits*

The contract should provide that non-distribution of profits would not constitute a default event. Distributions should not be linked to the credit rating of the IIFS, either wholly or in part.

(e) *Unsecured in nature*

The amount paid at issuance is neither secured nor guaranteed by the IIFS or any related entity. In addition, there should not be any arrangement that legally or economically increases the seniority of the instrument's claim.

### 2.1.3 Tier 2 (T2) Capital

28. T2 capital comprises the sum of elements (a)–(d), minus (e), below:

Add:

- (a) instruments issued by IIFS that meet the criteria of paragraph 29 for inclusion in T2;
- (b) general provisions or reserves held against future, presently unidentified losses on financing;<sup>14</sup>
- (c) any premium paid on issue of T2 capital instruments;
- (d) instruments or qualifying capital issued by consolidated subsidiaries of an IIFS to third-party investors that meet the criteria of T2 capital (see paragraph 31(a) – minority interest);

Minus:

- (e) regulatory adjustments/deductions applicable to T2 capital.

29. Specific criteria for classification of instruments as “additional capital” are set out below.

(a) *Loss absorbency*

It might be possible, subject to *Sharī'ah* compliance, for an IIFS to issue T2 capital instruments in the form of *Muḍārabah* or *Wakālah Sukūk*, the underlying assets of which would be convertible (as specified in the contract) into shares of common equity at the point of non-viability or insolvency. It is essential that the terms of conversion, notably the trigger point and the conversion ratio, are clearly specified in the *Sukūk* contract so as to avoid *gharar*. Prior to conversion, the underlying assets of such *Sukūk* would not be available to meet the claims of the IIFS's current account holders or other creditors (see footnote 12). After conversion of the *Sukūk* in case of the IIFS's non-viability or insolvency, T2 capital would rank *pari passu* with CET1, along with AT1 capital.

<sup>13</sup> An example of an “incentive to the issuer to redeem” is a call option held by the issuer combined with an investor right or option to convert the instrument into common shares if the call is not exercised. Such an incentive would conflict with the requirement of permanence.

<sup>14</sup> General provisions/general financing loss reserves eligible for inclusion in “additional capital” are subject to a limit of 1.25% of total RWAs for credit risk. Moreover, provisions related to identified deterioration of specific financing assets or known liabilities, whether individual or grouped, shall not be included in “additional capital”. General provisions are a type of reserve, not liabilities, as defined in International Accounting Standards (IAS 37).

(b) *Issuance process and procedure*

The instrument is issued and paid-up, and neither the IIFS nor a related party over which the IIFS exercises control or significant influence can purchase the instrument or fund the purchase of the instrument, either directly or indirectly. Issuance that takes place outside an operating entity of the IIFS or the holding company in the consolidated group such as through an SPE must follow specific requirements. For instance, the proceeds of issuance must be made immediately available to an operating entity or holding company in the consolidated group, in a form that meets or exceeds all the other criteria of Tier 2.

(c) *Maturity and callable option*

The original minimum maturity shall be at least five years. The instrument shall not have step-up facilities and be without any incentive to redeem by the issuer. For recognition in regulatory capital, any amortisation of the principal will be on a straight-line basis in the remaining five years before maturity. If the instrument is callable, the issuer is permitted to exercise a call option only after five years<sup>15</sup> and subject to certain requirements, such as: (i) prior supervisory approval; (ii) there is no call expectation created by the IIFS; and (iii) ability to replace the called instruments with the same or better quality of capital, either before or concurrently with the call. The IIFS shall not exercise a call unless it successfully exhibits that its capital position is above the regulatory capital requirement.

(d) *Distribution of profits*

The distribution of profits to the holders of the instruments should not be linked to the credit rating of the IIFS, either wholly or in part. Future scheduled payments should not be accelerated at the option of investors, except in the case of liquidation or bankruptcy.

(e) *Unsecured in nature*

The amount paid during issuance is neither secured nor guaranteed by the IIFS or any of its related entities. Besides, there should not be any arrangement that legally or economically increases the seniority of claim in case of liquidation.

#### **2.1.4 Treatment of PSIA, PER and IRR**

30. Profit-sharing investment accounts of an IIFS are not classified as part of the IIFS's capital because they do not meet the above-mentioned criteria of core or additional capital. Furthermore, all the investment risk reserve (IRR) and a portion of the profit equalisation reserve (PER) belong to the equity of investment account holders, and thus are not part of the capital of the IIFS. As the purpose of a PER is to smooth the profit payouts and not to cover losses, any portion of a PER that is part of the IIFS's reserves should also not be treated as part of the regulatory capital of the IIFS. It may be noted that the impact of PER and IRR has already been incorporated in the denominator of the supervisory discretion formula for calculation of the CAR, as discussed in Section III of this Standard.

#### **2.1.5 Regulatory Adjustments and Deductions**

31. The adjustments to regulatory capital are intended to make its quantification more conservative so that it is available at all times to absorb losses.<sup>16</sup> Elements which shall be recognised or adjusted in the calculation of eligible capital from a regulatory perspective are as follows, subject to the stated conditions:

(a) *Minority interest:*<sup>17</sup> Minority interest arising from the issue of capital instruments by a fully consolidated subsidiary of the IIFS may be treated as CET1 or AT1 capital subject to meeting the following conditions and criteria:

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<sup>15</sup> As an exception, a call option by the IIFS as an issuer is permitted only in case of a tax event or regulatory event, subject to meeting other conditions specified from (i) to (iii) in the sentence. Supervisory authorities shall permit an IIFS to exercise the call only if they consider that the IIFS was not in a position to anticipate the event at the time of issuance.

<sup>16</sup> In order to achieve this objective, the assets that may not have a stable value in stressed market conditions (e.g. goodwill) are deducted, and gains that have not been realised are not recognised in the calculation of regulatory capital.

Common Equity Tier 1 (CET1): The conditions are: (i) the subsidiary issuing the instrument should be an IIFS<sup>17</sup> itself; and (ii) the relevant instrument should meet all the criteria for being considered as common shares for regulatory purposes. The amount recognised in consolidated CET1 is equal to the total minority interest (meeting the above conditions) minus the *surplus CET1 of the subsidiary attributable to minority investors*. The surplus CET1 of the subsidiary (i.e. the amount in excess of 7.0% of RWA – which is the sum of the minimum CET1 requirement of the subsidiary plus the capital conservation buffer) should be multiplied by the percentage of CET1 that is held by minority shareholders in order to arrive at the amount of the *surplus CET1 of the subsidiary attributable to the minority shareholders*.

Tier 1 Capital (CET1 and AT1 Capital): The condition is that the relevant instruments issued by a fully consolidated subsidiary of the IIFS (which must itself be an IIFS) to third-party investors should meet all the criteria for being considered as Tier 1 (CET1 or AT1) capital. The amount recognised in Tier 1 capital is equal to the amount of the Tier 1 capital instruments issued to third parties minus the surplus Tier 1 capital of the subsidiary attributable to the third-party investors. The surplus Tier 1 capital of the subsidiary (i.e. the amount of 8.5% of RWA – which is the sum of the minimum Tier 1 capital requirement of the subsidiary plus the capital conservation buffer) should be multiplied by the percentage of the subsidiary's Tier 1 capital that is held by third-party investors. The amount of the Tier 1 capital that will be recognised in "additional capital" will exclude amounts already considered part of CET1.

Total Capital (CET1, AT1 and T2 Capital): The condition is that the relevant instruments issued by a fully consolidated subsidiary of the IIFS (which must itself be an IIFS) to third-party investors should meet all the criteria for being considered as CET1, AT1 or T2 capital. The amount recognised in consolidated total capital is equal to the amount of the total capital instruments issued to third parties (meeting the above condition) minus the *surplus total capital of the subsidiary attributable to the third-party investors*. The surplus total capital of the subsidiary (i.e. the amount in excess of 10.5% of RWA – which is the sum of the minimum total capital requirement of the subsidiary plus the capital conservation buffer) should be multiplied by the percentage of the subsidiary's total capital that is held by third-party investors in order to arrive at the amount of the *surplus total capital of the subsidiary attributable to the third-party investors*.

(b) *Unrealised gains and losses:* An IIFS shall derecognise from CET1 any component of equity resulting from changes in the fair value of liabilities due to its own credit risk variations.

(c) *Investment in own shares (Treasury shares) and capital:* An IIFS's investment in its own shares shall be deducted in the calculation of CET1 since such an investment has an effect similar to calling the shares – that is, to reduce the capital. Furthermore, in case of any contractual obligation of the IIFS to purchase its own shares, such shares will be deducted from CET1. IIFS should likewise deduct investments in their own additional capital in the calculation of additional capital.

(d) *Goodwill and other intangible assets:* Goodwill and other intangible assets should be deducted from CET1. Also deducted is goodwill that is part of the valuation of significant investments in the capital of banking, financial and *Takāful* entities which are outside the scope of regulatory consolidation. IIFS may use international financial reporting standards applicable in their jurisdictions to identify elements which fall under the definition of intangible assets.

(e) *Pension fund assets and liabilities:* An IIFS may have its own pension fund, while some IIFS may establish a pension fund in order to meet a regulatory requirement in a jurisdiction in which they operate. Where such pension funds are on the balance sheet or consolidated balance sheet of the IIFS, the net assets of the fund should be deducted from CET1 capital.

(f) *Deferred tax assets (DTAs):* Supervisory authorities may allow recognition of DTAs in their jurisdictions. Such DTAs may be used to reduce any subsequent period's income tax expense of the IIFS

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<sup>17</sup> Minority interest is capital in a subsidiary that is owned by other shareholders from outside the IIFS/group. It includes such third parties' interests in the common shares, retained earnings and reserves of the consolidated subsidiaries.

<sup>18</sup> Any institution that is subject to the same regulatory and supervision standards as a banking institution in the jurisdiction may be considered an IIFS.

as recognised in its income statement.<sup>19</sup> DTAs which have been recognised, but rely on the future profitability of the IIFS and are yet to be realised, shall be deducted from the calculation of CET1.<sup>20</sup> DTAs and associated "deferred tax liabilities" can be netted off only if the same taxation authority has levied the taxes and permitted the set-off.

(g) *Cash-flow hedge reserve*: If an IIFS has a cash-flow hedge reserve, the amount of this reserve that relates to the hedging (by means of *Shari'ah*-compliant hedging instruments which are reported at fair value in the IIFS's balance sheet) of items which are themselves not reported at fair values in the IIFS's balance sheet, including projected cash flows, should be derecognised in the calculation of CET1. This means that positive amounts should be deducted and negative amounts added back. The element of the cash-flow hedge reserve that gives rise to artificial volatility in common equity is thereby removed, since such an element reflects only the fair value of the hedging item but not that of the hedged item.

(h) *Securitisation exposure*: Any increase in equity capital resulting from a securitisation transaction shall be deducted from the calculation of CET1. Certain securitisation exposures arise from the provision of credit enhancement by the IIFS as originator by retaining a residual equity interest in a percentage of the securitised asset. In such cases, the capital treatment of the IIFS's residual equity share will be a risk weighting of 1250%.<sup>21</sup>

(i) *Investment in the capital of banking, financial and Takāful entities*: This derecognising adjustment applies to an investment by an IIFS in the capital of banking, financial or *Takāful* entities that are outside the scope of regulatory consolidation. Such investment is addressed and classified under two categories:

- (i) *Where the IIFS does not own more than 10% of the issued common shares of the entity*: The amounts below the 10% of the IIFS's common equity (after applying all other regulatory adjustments) will not be deducted and will continue to be risk-weighted. Thus, instruments in the trading book shall be treated as per the market risk rules, and instruments in the banking book shall be treated as per the standardised approach (or IRB approach, if applicable).
- (ii) *Where the IIFS owns more than 10% of the issued common shares of the entity,<sup>22</sup> or the entity is an affiliate<sup>23</sup> of the IIFS*: The IIFS shall deduct the amount of the investment in full,<sup>24</sup> even if the investment does not fall under the definition of common equity. The deduction should follow the "corresponding deduction" approach – that is, the deduction should be applied to the same component of capital for which the capital would qualify if it were issued by the bank itself.<sup>25</sup>

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<sup>19</sup> DTAs are amounts of income tax paid which have the effect of reducing the amount of income tax payable in subsequent periods and which are therefore recognised as assets. When DTAs are recognised but their realisation through reduction of future taxes payable is uncertain, they should be deducted from capital.

<sup>20</sup> All DTAs that depend on the future profitability of the bank to be realised and that arise from net operating losses are required to be deducted from CET1 in full.

<sup>21</sup> The risk weighting of 1250% will be used irrespective of the minimum capital requirement applicable in the jurisdiction, though it will be subject to supervisory discretion.

<sup>22</sup> Holdings of both the banking book and the trading book should be included in these calculations, after application of all the regulatory adjustments mentioned prior to this category. "Capital" includes common shares and, where applicable, convertible or subordinated *Sukūk* that qualify for recognition as regulatory capital.

<sup>23</sup> An affiliate of an IIFS is defined as a company that controls, or is controlled by, or is under common control with, the IIFS. Control of a company is defined as: (1) ownership, control, or holding with power to vote 20% or more of a class of voting securities of the company; or (2) consolidation of the company for financial reporting purposes.

<sup>24</sup> The objective of this deduction is to prevent the double counting of capital – that is, to ensure that the bank is not boosting its own capital with the capital that is also used to support the banking, *Takāful* or other financial subsidiary.

<sup>25</sup> This means that the amount to be deducted from common equity should be calculated as the total of all holdings which in aggregate exceed 10% of the IIFS's common equity multiplied by the common equity holdings as a percentage of the total capital holdings. This would result in a common equity deduction which corresponds to the proportion of total capital holdings held in common equity. Similarly, the amount to be deducted from additional capital should be calculated as the total of all holdings which in aggregate exceed 10% of the bank's common equity multiplied by the additional capital holdings as a percentage of the total capital holdings.



If, under the corresponding deduction approach, an IIFS is required to make a deduction from a particular component of capital and it does not have enough of that component of capital to satisfy that deduction, the shortfall will be deducted from the next-higher components of capital. (For example, if an IIFS does not have enough additional capital to satisfy the deduction, the shortfall will be deducted from CET1.)

(j) *Reciprocal cross-holdings in the capital of banking, financial and Takāful entities:* Any cross-holdings of capital that serve to inflate artificially the capital position of an IIFS will be required to be subject to a full deduction, using a “corresponding deduction approach” to such investments. This approach requires the IIFS to apply the deduction to the same component of capital for which the capital would qualify if it were issued by the IIFS itself.

(k) *Zakat obligations:* *Zakat* obligations shall be assessed when an IIFS as an entity has been in operation for at least 12 months. An IIFS shall have a framework and mechanism in place for the recognition and measurement of *zakat* obligations and shall disclose the amount of such obligations in its balance sheet. These requirements are, nevertheless, subject to the provisions of applicable national laws, regulatory requirements and applicable accounting standards.

## **2.1.6 Time Frame for Adoption of the New Capital Requirements**

32. Transitional arrangements are provided for IIFS to comply with the new eligible capital requirements. The time frame is intended to ensure that IIFS can meet the higher capital requirements over a reasonable time period. The recommended transitional arrangements are as follows:

<b>Elements</b>	<b>Transition Arrangement</b>
4.5% of CET1 over total RWAs	Commencing from 1 January 2015
6% of total Tier 1 over total RWAs	Commencing from 1 January 2015
8% of total regulatory capital over total RWAs	Commencing from 1 January 2014

In addition, the regulatory adjustments and deductions, including amounts above the aggregate 15% limit for significant investments in financial institutions, and deferred tax assets from temporary differences, would be fully deducted from CET1 by 1 January 2018.

## 2.2 Capital Conservation Buffer

### 2.2.1 Introduction

33. "Capital conservation buffer" refers to a specific percentage of common equity capital, in addition to CET1, that an IIFS should build up during benign periods and which can be utilised to absorb losses during periods of financial and economic stress. This buffer should be held above the regulatory minimum capital requirement and applies at all times.

34. The fundamental objective of holding a capital conservation buffer is to ensure that IIFS have the capacity to absorb losses in stressed times that may last several years. IIFS will be expected to build up such capital in the periods of economic expansion. This buffer is intended to achieve the macroprudential goal of protecting the banking system and the real economy from system-wide risks. Such risks can stem from exposure of the banking sector, including the Islamic banking sector, to various factors related to financial stability and other structural variables impacting systemic soundness and stability.

35. If the capital of an IIFS falls below the required buffer level, the relevant institution will be subject to various restrictions on discretionary distributions of profits, until the capital is restored to the required level. In addition, such an IIFS will be required to draw up and agree with the relevant supervisory authority a "capital conservation plan" in order to ensure that it has a credible strategy for early replenishment of the buffer. However, the IIFS will have the choice of raising new capital from the private sector instead of internal conservation of capital through reduced profit distributions. This option should be part of the capital conservation plan (see [section 2.2.4](#)) to be submitted to the supervisory authority by the IIFS, and will be subject to supervisory evaluation and approval.

### 2.2.2 The Framework

36. The capital conservation buffer shall amount to 2.5% of RWAs above the regulatory minimum capital requirements and should comprise only common equity. An IIFS should first use CET1 to meet the minimum capital requirements outlined in [section 2.1](#) – that is, 4.5% CET1 and 8% total capital requirement, if necessary. Only after meeting these requirements will CET1 be used for the capital conservation buffer.

37. If the capital position of an IIFS falls below the required level outlined in the previous paragraph, the supervisory authority shall apply various restrictions to the distribution of profits. These restrictions on profit distributions and the resultant preservation of capital will help in achieving a number of objectives, including, *inter alia*:

- (a) strengthening the IIFS's ability to deal with stressed economic conditions by providing an additional cushion of capital to absorb losses;<sup>26</sup>
- (b) enhancing the resilience of the banking sector during depressed market conditions;
- (c) offering an internationally harmonised framework for rebuilding depleted capital during the initial phases of recovery; and
- (d) reducing procyclicality by ensuring that IIFS have the capital to enable them to continue providing financing to customers during adverse market conditions, thus contributing to economic recovery.

38. Supervisory authorities shall apply restrictions to discretionary profit distributions of the IIFS whose capital requirements fall below the required level. The severity of such restrictions will depend on the extent to which the capital ratio of an IIFS falls below the minimum required level.

39. Supervisory authorities can apply limitations on some or all of the following items for IIFS whose capital falls below the stipulated minimum requirements. Such limitations should not, however, restrict the IIFS from conducting business as usual. The items subject to restrictions include, *inter alia*:

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<sup>26</sup> This loss absorption also includes the situation in which public funds would have to be injected in order to recapitalise an IIFS.

- (a) dividend payments to holders of common equity;
- (b) share buy-backs;
- (c) discretionary profit distributions to holders of other CET1 instruments; and/or
- (d) discretionary bonus payments to staff, provided this step is not in conflict with any contractual or legal obligations of the IIFS.

40. "Profits" for this purpose should be understood as being profits that are distributable (excluding the share of profits payable to PSIA) and are calculated prior to the deduction of elements subject to the restrictions mentioned in the previous paragraph relating to dividends, share buy-backs, distributions to holders of other CET1 instruments, and discretionary staff bonuses. Such profits also include: (a) interim profits not yet included in CET1 that have been generated since the most recent decision on the distribution of profits or any other actions mentioned in the previous paragraph; and (b) year-end profits not yet included in CET1 that have been generated since the most recent decision on the distribution of profits or any other actions mentioned in the previous paragraph. Any tax payable on the above two items should be deducted in making this calculation. In addition, such profits should be calculated after the deduction of *zakat* and transfers to PER, where applicable. The deduction related to tax should be made on the basis that none of the distributable items mentioned in the previous paragraph has been paid. This means that any tax impact related to such distributions shall be reversed.

41. The application of the capital conservation buffer requirement will be made at the consolidated group level. Therefore, any constraints on profit distributions mentioned in paragraph 38 shall be applied at the consolidated group level. In the case of Islamic window operations of conventional banks (as defined in footnote 2), the restrictions will be applied to the parent bank. In case supervisory authorities choose to require that capital be conserved in specific parts of the group, they can opt to apply this buffer on a solo (single entity) basis.

42. If the capital position of an IIFS falls below the minimum requirement, the relevant institution cannot use future predictions of recovery as a justification for making any of the types of distributions mentioned in paragraph 39. Furthermore, such an IIFS is not allowed to make any distribution out of profits in order to signal its financial strength – for example, its dividend-paying ability.

43. As the capital conservation buffer must consist of common equity, any capital raised through issuance of *Sukūk* cannot be considered as a part of the buffer, as *Sukūk* do not qualify for inclusion in common equity.

### 2.2.3 Capital Conservation Ratios

44. In order to meet the minimum requirements for CET1 (i.e. 4.5%, as mentioned in section 2.1) and the capital conservation buffer (i.e. 2.5%), an IIFS should have not less than 7.0% of CET1 at all times. If the CET1 level is below this requirement, the IIFS will be subject to restrictions on profit distributions as outlined in paragraph 38; that is, it will be required to “conserve” a specified percentage of profits in the succeeding financial year. The percentage of profits that would need to be conserved by the IIFS when operating in a specified range of CET1 capital is called the "capital conservation ratio". This ratio is explained in the following table.

CET 1 Capital Ratio	Minimum Capital Conservation Ratios (as a percentage of profits)
4.5% – ≤5.125%	100%
>5.125 % – ≤5.75%	80%
>5.75% – ≤6.375%	60%
>6.375% – ≤7.0%	40%
>7%	0%

45. The above table shows that when, for example, an IIFS has a CET1 in the range of 5.75% to 6.375%, it will be required to conserve 60% of its profits in the next financial year; that is, its total distributions of any of the types of items mentioned in paragraph 38 should not amount to more than 40% of profits after making the deductions mentioned in paragraph 39.

46. The CET1 ratio excludes any additional CET1 used to meet the 8% total capital requirements. For example, a bank with 8% CET1 and no additional capital would meet all minimum capital requirements, but would have a zero conservation buffer and therefore be subject to the 100% constraint on profit distributions.

47. If an IIFS wishes to make payouts in excess of the requirement outlined in the above table, it has the option to raise an amount of capital in the private sector equal to the amount shown as required by the minimum capital conservation ratio. The IIFS should outline any such proposal as a part of its capital conservation plan as delineated in the next sub-section.

#### **2.2.4 Capital Conservation Plan**

48. Where an IIFS fails to meet the required level of capital conservation buffer, it shall prepare a Capital Conservation Plan (hereinafter referred to as "Plan") clearly outlining the information mentioned below. The IIFS shall submit this Plan to the relevant supervisory authority within a suitably short time frame to be set by the latter. It is desirable that the IIFS should already have prepared such a Plan on a contingency basis. The Plan will include the following:

- (a) estimates of income and expenditure and a forecasted balance sheet;
- (b) measures to be taken to increase the IIFS's capital ratios;
- (c) a plan and time frame for the increase of capital with the objective of meeting fully the buffer requirement; and
- (d) any other information the supervisory authority deems necessary to carry out the assessment required, as indicated in the next paragraph.

49. The supervisory authority shall review the Plan submitted by the IIFS and shall approve it provided, based on its evaluation, it considers that the Plan provides a reasonable basis for conserving or raising sufficient capital that will enable the IIFS to meet the buffer requirements within a period acceptable to the supervisory authority. While reviewing the Plan, the supervisory authority should also evaluate whether the IIFS has deliberately reduced its CET1 so as to operate in the buffer range (i.e. below the capital conservation buffer requirement) in order to reduce its cost of capital for competitive purposes.

50. If the Plan is not approved by the supervisory authority, the latter may take one or more of the following steps, *inter alia*, as deemed necessary:

- (a) ask the IIFS to revise the Plan and resubmit it within a specified time period;
- (b) require the IIFS to raise new capital from private sources to specified levels within specified periods;  
or
- (c) impose more stringent restrictions on distributions than those required by section 2.2.2.

#### **2.2.5 Transitional Provisions**

51. The capital conservation buffer requirements will be subject to transitional arrangements between 1 January 2016 and 31 December 2018. Starting on 1 January 2019, it will be implemented at the full level of 2.5%. On 1 January 2016, it will start at 0.625% of RWAs and will increase by the same percentage every succeeding year until it reaches the final level of 2.5% of RWAs on 1 January 2019, as shown in the following table.

Starting Date	Required Level of Capital Conservation Buffer
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1 January 2016	0.625%
1 January 2017	1.25%
1 January 2018	1.875%
1 January 2019	2.50%

52. The requirements for a Capital Conservation Plan, and the restrictions on distributions when an IIFS fails to meet the requirements mentioned in the previous paragraph, shall apply during the transitional period between 1 January 2016 and 31 December 2018.

53. Supervisory authorities may impose a shorter transitional period than that specified in this subsection if this is required in order to mitigate excessive credit growth.

## **2.3 Countercyclical Buffer**

### **2.3.1 Factors Leading to Procyclicality**

54. In this sub-section, some factors leading to procyclicality are discussed, primarily with reference to the conventional banking sector. However, given the business model of IIFSs and the fact that they are part of the overall financial system, these factors may have relevance to IIFSs' operations, either directly or indirectly.

55. "Procyclicality of a financial system" refers to the effect of various components of the system on the financial institutions in general, and banks in particular, that tend to aggravate the economic cycle. During the expansion phase of the economic cycle, a number of factors make it easier for banking institutions to meet the minimum capital adequacy requirements. In particular, the influence of various micro-level factors on the behaviour of banks has the effect of aggravating the economic cycle. These factors include the following:

- (a) The profits of banking institutions tend to be buoyant, which increases their reserves – that is, their own capital.
- (b) The buoyancy of asset values – both in trading and banking books – and resultant lower risk of impairment (and associated lower provisions) have the effect of increasing the banks' profits and reserves.
- (c) Risk weights (RWs) applied to banking book assets – under both standardised and IRB approaches – tend to be less conservative in a favourable economic climate, owing to the more optimistic outlook reflected in ECAI ratings and in IRB estimates of probability of default (PD), respectively.

56. During the expansion phase of an economy, due to the aforementioned factors, banks are typically able to meet the regulatory capital requirements with ease, which allows them to provide more loans to both public and private sectors, which in turn contributes to an expansion of credit in the economy, which then feeds the economic expansion; that is, there is a positive feedback effect. This phenomenon continues until some economic shock such as the bursting of an asset price bubble triggers the reverse process – that is, the contraction phase of the economic cycle. In this phase, the deterioration of banks' asset quality and the resultant need for them to make loss provisions and recognise impairments tends to put significant pressure on the capital held by the banks. If banks are highly leveraged and capital becomes difficult and/or costly to raise, in order to maintain their capital ratios banks have to reduce their RWAs, and the resultant credit squeeze aggravates the downturn, making it deeper and possibly leading to a recession. Simultaneously, economic contraction affects banks' profits negatively and requires even more provisions for asset impairments and trading book losses. Thus, during a downturn, the combined impact of these factors exerts pressure on the capital adequacy position of the banks, including some of those which enjoyed a relatively comfortable capital position before the downturn.

57. The propensity to generate asset bubbles, and the resultant losses of capital, may be aggravated by perverse incentives, as in the originate-to-distribute model coupled with "sub-prime" credit practices. In addition, the subjective nature of some fair value measurements of assets and of loss provisions contributes to procyclicality.

### **2.3.2 Procyclicality in Islamic Finance**

58. Typically, the manner in which IIFS provide financing to their customers is more closely linked to investment in real assets and thus may be less prone to contribute to credit bubbles and non-performing assets; however, in the case of real estate, the cyclical nature of this asset class may contribute to procyclicality. In addition, many IIFS raise significant amounts of funds, not in the form of deposits (i.e. liabilities that are not loss-absorbent) but in the form of unrestricted or restricted PSIA, such as profit-sharing and loss-bearing *Mudārabah* contracts, which are typically loss-absorbent to a greater or lesser extent (see [section 3.4.1](#) for details). Depending upon the level of displaced commercial risk (DCR) incurred by an IIFS, its PSIA can be considered to lie in the range of fully risk absorbent to partially risk absorbent (see [section 3.4.2](#)). On the assets side, the financing and investment made by the IIFS is typically related to the sale, purchase, usufruct or provision of services related to various kinds of real

assets. (See [Section IV](#) for details of major modes of financing and investment used by IIFS.) Similar constraints on assets also apply to asset securitisations, the issuance of *Sukūk* and the structuring of *Sharī'ah*-compliant hedging instruments, thus making it easier to track down the underlying risks of such structures than in the case of certain conventional securitisations (see [section 5.2](#)). Thus, overall, the relationships between deposits, leverage, credit extension and capital requirements found in conventional finance are, at any rate, less mechanical in Islamic finance.

59. Notwithstanding the points highlighted in the previous paragraph, the influences of three micro-level factors outlined in paragraph 55 would apply to IIFS to a certain extent. In buoyant economic conditions, as is the case with conventional banks, the capital ratios of IIFS are enhanced as a result of, *inter alia*: increased profits, which lead to higher reserves; lower requirements for provisions against asset impairments; and lower credit RWs being applied to banking book assets. Furthermore, the tendency of some IIFS to invest in real sector-related asset classes such as equity investments and real estate may expose these institutions to the cyclical impacts on such assets of the economic cycle in economies that are highly dependent on exports of commodities such as hydrocarbons. The cyclical movements of the prices of these commodities have macroeconomic effects which impact the financial sector, including IIFS. In recent years, some IIFS have started raising term deposits (generally short-term) and making term loans based on reverse CMT. These practices have the effect of introducing a greater degree of procyclicality into the IIFS sector, because of the procyclical perceptions of the counterparty risk to which an IIFS as a financier is exposed, as well as its use of CMT-based term deposits which are not loss-absorbent.

60. As far as system-wide risks are concerned, IIFS have limited counterparty risk exposures compared to their conventional counterparts, except in the case of CMT and *Wakālah*-based transactions in interbank markets. Moreover, IIFS do not engage in highly speculative trading transactions. The application of the originate-to-distribute model of credit origination is also not practised by IIFS, except to a limited extent in the case of some *Sukūk* issuances and asset securitisations which have significantly reduced implications for procyclicality. On the other hand, IIFS are exposed to various negative consequences of economic cycles in a number of ways, as mentioned in the previous paragraph. Therefore, the IFSB considers it reasonable to expect IIFS to maintain a countercyclical buffer (CCB) that is also in line with other emerging international practices.

### **2.3.3 Procyclicality in Emerging Markets**

61. As most of the IFSB member jurisdictions may be classified as emerging economies, it is relevant to evaluate the incidence of procyclicality and any need for a CCB in such economies.

62. Financial deepening is closely related to the development of the economies concerned. Historically, most financial crises in developed economies have emerged due to factors internal to the financial systems, such as new exotic financial products, lax credit evaluations by financial institutions leading to asset price bubbles, misaligned compensation practices, etc. In developing (or emerging) markets, financial crises have emerged mainly due to external shocks such as extreme commodity price volatility, currency speculation (including misuse of the "carry trade" by banks) and/or sudden stops.<sup>27</sup> Thus, the fundamentals of financial supervision are subject to a different set of antecedents in the two types of economies.

63. It has been argued that the demand for credit is higher in emerging economies and that any additional capital buffers required for banks should not be allowed to dampen the growth prospects in these economies. The impact of countercyclical buffers in developing countries can be quite strong, where there is no perceived excessive growth of credit of dubious quality. Therefore, a careful examination is needed not to cause unwarranted loss of output and of sound credit growth in developing economies. As banks seek to comply with new capital rules, lower availability of credit may impact economic growth as

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<sup>27</sup> "Sudden stop" refers to a sudden slowdown in private capital inflows into emerging market economies. "Sudden stops" are typically followed by a sharp decrease in output, private spending and credit to the private sector. For the jurisdiction, reduction in private capital inflows could result in reversal from large current account deficits into smaller deficits or small surpluses.

well as negatively impacting the development of the financial sector and the financial inclusion of the population. The availability of credit might also be impacted if the banks considered the CCB as a new minimum and did not reduce their capital holdings even when they are allowed by the supervisory authority to release the CCB.

64. Notwithstanding the above, the imposition of new capital buffers in emerging economies that have financial market imperfections – in environments where the deposit protection schemes are either unavailable or inspire little confidence – may play an additional role as a signal to depositors that banks will have more capital backing, with a greater commitment to the screening and monitoring of credit origination, and be less vulnerable to credit losses which could impact depositors and unrestricted PSIA.<sup>28</sup> This phenomenon may help boost market confidence in the financial system and improve financial inclusion.

65. It is advisable, therefore, that supervisory authorities in the emerging economies, while contemplating the imposition of a CCB in their jurisdictions, consider a set of triggers and variables that are best suited to the objective of macroprudential supervision, while simultaneously ensuring that its imposition does not hamper the economic growth and financial sector development. A number of alternative triggers and macroeconomic variables that can be considered by supervisory authorities are discussed in [Appendix B](#) to this Standard.

#### **2.3.4 The Framework**

66. Supervisory authorities should set out requirements for the CCB in their jurisdictions<sup>29</sup> based on the guidance provided in this sub-section. As indicated above, the CCB has the macroprudential objective of reducing systemic risk by protecting the banking sector from periods of excessive aggregate credit growth. Whereas the minimum capital requirements and the capital conservation buffer have the mainly microprudential objectives of ensuring that individual banks remain solvent during stressed market conditions, the CCB has the macroprudential objective of ensuring that the banking sector has levels of capital sufficient to maintain an uninterrupted supply of credit to the various economic sectors during periods of stress. This is intended to ensure that the real sector is not constrained by reduced credit availability during a downturn and that capital in the banking sector has a cushion enabling it to absorb additional provisioning and credit losses during stressed market conditions. In addition, the CCB is intended to promote financial stability by inhibiting the build-up of asset price bubbles in times of economic expansion (by imposing increased capital requirements during such times) and consequent financial system imbalances. In other words, during a period of excessive credit supply in the initial phase of an economic cycle, the build-up of a CCB could increase the cost of credit, thus reducing the demand for it. It thus aims to reconcile microprudential policies with the goal of preserving the soundness of the whole financial system.

67. The main responsibility of the supervisory authority in this regard will be identifying the build-up of system-wide risk due to excessive credit growth in the jurisdiction. Such identification will be made on the basis of monitoring various metrics chosen by the supervisory authority, as elaborated in [Appendix B](#). After the supervisory authority identifies the presence of system-wide risk due to excessive credit growth based on selected metrics, it will apply its judgement to establish: (a) whether a CCB should be imposed in the jurisdiction; (b) what should be the level of the CCB as a percentage of RWAs; (c) whether the CCB should increase or decrease over time, depending upon the direction of system-wide risk; and (d) whether to increase the CCB requirement, in the event that system-wide risk starts to develop.

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<sup>28</sup> The assumption is that banks will have more capital to lose, and more capital to absorb losses, before depositors face losses.

<sup>29</sup> For the purpose of supervising and controlling the CCB regime, each jurisdiction should decide which supervising institution – central bank or financial supervision authority, if present in the jurisdiction – should be assigned this responsibility. The operation of the CCB regime shall require analysing both macroeconomic and supervisory information. Moreover, it would have implications for the conduct of monetary and fiscal policies in the jurisdiction. Therefore, it is advisable that, whichever authority is selected, timely and coordinated information-sharing and consistent decision-making is ensured between various supervisory authorities in the jurisdiction.



68. The CCB can be chosen in the range of 0–2.5%. However, a supervisory authority has discretion to implement any other macroprudential tools it deems fit for the jurisdiction. In addition, if the need arises, the level of the CCB can be set higher than 2.5% for all domestic banks and foreign banks with locally incorporated subsidiaries.<sup>30</sup> The CCB should consist wholly of CET1. An internationally active IIFS would use a weighted average of the buffers in effect in the jurisdictions to which it has a credit exposure.

69. When a supervisory authority decides to impose or increase the CCB requirement, it will make the announcement up to 12 months before the implementation date so that IIFS have enough time to meet the additional capital requirements. When a supervisory authority decides that it is appropriate to release the buffer partially or wholly, a shorter time frame could be applied so that the credit supply is not restricted by higher capital requirements at a time when economic conditions warrant a higher supply of credit.

70. Supervisory authorities should explain, on a regular basis, the range of metrics and reference tools used to arrive at the decisions relating to the CCB. The ultimate objective of using these qualitative and quantitative tools and any other variables is to gauge the build-up of system-wide risk due to excessive credit growth in order to guide the decisions related to the CCB. This Standard explains various possible metrics that can be taken into account by supervisory authorities in formulating CCB-related decisions, but stops short of providing a detailed explanation of these metrics, except for the internationally consistent credit-to-gross domestic product (GDP) gap measure proposed by BCBS.

71. Some additional supervisory guidance on the CCB has been provided in [Appendix B](#). This appendix delineates the calculation mechanism of various components of the credit-to-GDP gap measure, as well as suggesting additional tools and indicators that can support the supervisory authorities in estimating an appropriate level of the CCB in the jurisdiction. Further, it provides guidance to supervisory authorities at various phases of operating the CCB regime, and deals with some related operational issues – for example, application of CCB on domestic versus international IIFS and ceiling of the CCB.

### **2.3.5 Transitional Arrangements**

72. Based on the study of credit growth and other metrics leading to procyclicality in the jurisdiction, if the supervisory authority decides to implement the countercyclical buffer requirements, the CCB will be phased-in between 1 January 2016 and 31 December 2018, becoming fully effective on 1 January 2019. If applied by the supervisory authority, the countercyclical buffer requirement will initially be 0.625% of RWAs on 1 January 2016, and will increase each subsequent year by an additional 0.625 percentage points, to reach its final maximum of 2.5% of RWAs on 1 January 2019. Supervisory authorities have discretion to accelerate or extend the requirement for maintaining a CCB if excessive credit growth is experienced.

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<sup>30</sup> The international reciprocity provisions, however, would not apply to CCB levels in excess of 2.5% of RWAs.

## 2.4 Leverage Ratio

### 2.4.1 Factors Leading to Leverage

73. Financial leverage – that is, the use of non-equity funds – allows a financial institution (as with any firm) to increase the potential returns on its equity capital, with a concomitant increase in the riskiness of the equity capital and its exposure to losses since the non-equity funds are either not, or only partially, risk-absorbent. Consequently, leverage is commonly accomplished through the use of borrowed funds, debt capital or derivative instruments, etc. It is common for banks to engage in leverage by borrowing to acquire more assets, with the aim of increasing their return on equity. Similarly, the contingent exposure of the banks can expose them to risk of losses much greater than is observable on the balance sheet. Multiple-layer securitisations or resecuritisations, such as in the case of conventional collateralised debt obligations (CDOs) that invest in asset-backed securities,<sup>31</sup> are also a major source of increased bank leverage.

74. As explained in [section 2.3.1](#), capital requirements are considered procyclical, and the greater risk sensitivity of contemporary capital requirements can result in an incentive for banks to structure products so that they qualify for lower capital requirements. When this incentive is exploited collectively by the banks in a jurisdiction, the system will likely end up with high concentrations of structured products that are meant to finesse regulatory capital requirements and thus to increase returns on shareholders' equity. Among other tools to address the systemic problem of procyclicality<sup>32</sup> and reduce the incentives for banks to offer highly leveraged products, a leverage ratio can be applied by supervisory authorities as a supporting mechanism to risk-based capital requirements.

75. The financial crisis that started in 2007 demonstrated the disruptive effects of procyclicality coupled with high leverage, and showed that the collective action of individual banks can amplify the business cycle and create systemic risk on an increased scale. This phenomenon showed that the currently available microprudential regulation techniques used by supervisory authorities need to be complemented by macroprudential supervision in order to smooth the effects of the business and economic cycle. Indicators of excess leverage include a leverage ratio and measures of mismatches between assets and obligations. More importantly, a leverage ratio is a tool which can be standardised and implemented at the jurisdiction level. It is versatile enough to be used both as a macro- or microprudential policy tool and as a countercyclical instrument. This requirement also has the necessary flexibility to be customised for the risk profiles of specific banks.

### 2.4.2 Leverage in Islamic Finance

76. Generally speaking, Islamic finance is less prone to engage in highly leveraged products, because *Shari'ah* requires in principle that all financing be linked to transactions in the real economy – that is, production and trade transactions and activities. Similarly, there are restrictions on debt trading and engaging in products involving undue and excessive speculation (*gharar*). At the same time, risk-sharing means of raising funds are encouraged. The combination of these measures seriously limits the leverage effects in Islamic finance, although it does not completely eradicate this phenomenon, as highlighted later in this sub-section.

77. As far as IIFS are concerned, only to a limited extent do they use return-paying deposits to leverage their capital (as indicated in the next paragraph). They may use unremunerated current accounts for this purpose, but with few exceptions current accounts do not constitute the bulk of an IIFS's funding. Unrestricted PSAs (UPSAs) have historically been a major source of funds. Similarly, IIFS do not become involved in transactions involving *gharar* or other leveraged transactions such as CDOs or resecuritisations. Moreover, most IIFS follow the universal banking model, which makes their structure less prone to leveraged exposures.

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<sup>31</sup> In addition, credit risk transfer instruments may be used, such as structured credit products, through which portfolios of credit exposures can be sliced and repackaged to meet the needs of investors. Banks funded a growing amount of long-term assets with short-term liabilities in wholesale markets through the use of off-balance-sheet vehicles, exposing themselves to credit and liquidity risk by providing facilities to these vehicles. Moreover, they also held structured credit instruments on their own balance sheet, exposing themselves to embedded leverage and increasing their asset–liability mismatch and funding liquidity risk.

<sup>32</sup> The countercyclical buffer discussed in [section 2.3](#) is one of these measures.

78. Nonetheless, there are a few practices and transactions which may involve IIFS in leveraged transactions. For example:

- (a) Some IIFS offer reverse CMT-based<sup>33</sup> deposits to generate a form of return-paying term deposit. Some others use CMT on the assets side of the balance sheet, not just for liquidity management but also for providing uncollateralised financing to their customers. Reverse CMT-based deposits are a form of leverage, which, together with CMT-based term financing, has the potential to create unlimited debt in the system.
- (b) Some IIFS are involved with structured products that create cash-flow or delivery obligations linked to the performance of a defined underlying benchmark that is compliant with the principles of *Shari`ah*, such as equity markets, indices and commodities.
- (c) *Shari`ah*-compliant hedging contracts such as profit rate swaps and foreign currency swaps have the potential to increase leverage, as they are mainly CMT- or *Wa`d*-based contracts; for example, the profit rate swap can be used to transform a fixed-rate income stream into a floating-rate income stream, or vice versa. Such a transformation allows a bank to eliminate uncertainties or discrepancies between incoming and outgoing profit streams.
- (d) Some asset-based *Sukūk* have structures where the cash flows are de-linked to the underlying assets, while providing leverage to the originators and/or issuers.

79. Based on the factors highlighted above, the IFSB considers it prudent that supervisory authorities apply the leverage ratio requirements to IIFS,<sup>34</sup> as explained in the next sub-section. This will not only provide a level playing field for IIFS vis-à-vis conventional institutions, but also will be consistent with emerging international practices.

### **2.4.3 Computational Details**

80. The leverage ratio is a simple, transparent, non-risk-based measure that will act as a supplement to the risk-based capital requirements set out in this Standard. It will help to restrict the build-up of leverage in the Islamic banking sector which can expose IIFS to higher financial risk, with potential damage to the overall financial system, and to the economy if a de-leveraging process takes place.

81. The leverage ratio described below shall be applicable at the level of 3% and shall be calculated as the average of the monthly leverage ratio over the quarter, based on the definitions of capital and total exposure specified below. The formula for calculation of leverage ratio will be:

$$\text{Leverage ratio} = \text{Tier 1 capital} \div \text{Total exposure} \geq 3\%$$

#### **2.4.3.1 Capital**

82. The numerator of the leverage ratio shall be Tier 1 capital as defined in section 2.1.1 above. Based on section 2.1.5, items that are treated as complete deductions from capital do not contribute to leverage, and hence should be deducted from the denominator – that is, the exposure measure. This is to achieve consistent measures of the capital and exposure so as to avoid double counting in the calculation of the leverage ratio. Moreover, in order to achieve consistency, the deductions from CET1 shall also be made from the exposure.

83. For an IIFS's investment in the capital of banking, financial and *Takāful* entities, as outlined in paragraph 31(j), where a financial entity is included in the accounting consolidation but not in the regulatory consolidation, the investments in the capital of such an entity are required to be deducted to the extent that they exceed certain thresholds. Therefore, the assets of such entities included in the accounting consolidation should be excluded from the exposure measure in proportion to the capital that is excluded.

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<sup>33</sup> This transaction is also known as *tawwaruq* deposits, CMT deposits, international CMT deposits, etc., in various jurisdictions.

<sup>34</sup> The survey conducted by the IFSB Working Group found that most IIFS have their current leverage ratio well below the 3% leverage ratio proposed here.

### 2.4.3.2 Exposure

84. The calculation of total exposure for the leverage ratio should generally follow the accounting measures of exposures. All the on-balance sheet, non-derivative exposures shall be included net of specific provisions and valuation adjustments (e.g. credit valuation adjustments). The impact of credit risk mitigation (including physical or financial collateral, guarantees, *Urbun*, *Hamish Jiddiyah*, etc.) should not be considered, and on-balance sheet exposures should not be adjusted for the purpose of calculating the total exposure. Netting of financing exposures against PSIA/deposits shall not be allowed.<sup>35</sup> Specific details on the treatment of on- and off-balance sheet items in the calculation of total exposure are provided below.

85. *On-balance sheet items*: All the on-balance sheet items on the assets side of the IIFS's balance sheet shall be included. This includes all the *Shari'ah*-compliant alternatives to repurchase transactions and securities financing transactions. The accounting measures for IIFS shall be used for taking account of such transactions.<sup>36</sup> For *Shari'ah*-compliant hedging instruments, the accounting measure of the exposure shall be used. In addition, potential future exposures shall be computed according to the Current Exposure Method, as delineated in section 3.1.9.1.

86. *Off-balance sheet items*: The off-balance sheet items shall include, but are not limited to, letters of credit, guarantees, unconditionally cancellable commitments, liquidity facilities, and *Shari'ah*-compliant alternatives to repurchase agreements and securities financing transactions (see section 3.1.2). The last two items were covered in the previous paragraph. All off-balance sheet items shall carry a 100% credit conversion factor (CCF). For any commitments that are unconditionally cancellable at any time by the IIFS without prior notice, a CCF of 10% shall be applied. Securitised assets that are de-recognised from the balance sheet of the sponsor or originator would not be taken into account in the leverage ratio.

87. An appropriate proportion of assets financed by unrestricted PSIA shall be included in the exposure calculation, whether considered on- or off-balance sheet by the IIFS. The appropriate proportion of such assets is calculated by multiplying the relevant assets by the alpha parameter applicable to the IIFS for capital adequacy purposes. Assets financed by restricted PSIA shall not be included in the exposures unless they are a source of DCR to the IIFS, in which case they should be treated in a similar manner to UPSIA.

### 2.4.4 Additional Supervisory Guidance

88. As with regulatory capital measures, the leverage ratio shall apply at the level of the individual IIFS as well as on a consolidated basis.

89. A higher ratio may be required for any IIFS if warranted by its risk profile or circumstances. Supervisory authorities may use stress testing as a complementing tool to adjust the leverage ratio requirement at the jurisdiction and/or individual IIFS-level.

90. To reduce procyclicality, supervisory authorities can limit the build-up of leverage in an upturn by setting a ceiling on the leverage ratio. Supervisory authorities can also build a mechanism to relax the limit during downturns, since constant fixed caps on the leverage ratio could amplify procyclicality by encouraging IIFS to de-leverage during a downturn (and vice versa).

91. The leverage ratio can be used for both micro- and macroprudential surveillance; for example, as a macroprudential tool, a consistent leverage ratio can be applied for all IIFS in the jurisdiction as an indicator for monitoring vulnerability. As a microprudential tool, it can be used as a trigger for increased surveillance or capital requirements for specific IIFS under the supervisory review process.

92. This Standard is applicable to Islamic investment banks, which are thus subject to the above requirements in respect of the leverage ratio.

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<sup>35</sup> In principle, exposures in respect of assets financed by PSIA funds are borne by the IAH. However, for the purpose of calculating leverage, it is prudent to include these in the exposures of the IIFS, subject to the deduction of any related balance of IRR.

<sup>36</sup> The IIFS should make a specific disclosure if it follows accounting standards applicable to conventional financial institutions.

#### **2.4.5 Transitional Arrangements**

93. Supervisory authorities shall commence implementation of the leverage ratio from 1 January 2014. After implementation of this requirement, supervisory authorities shall assess various parameters suggested in this section and will evaluate the suitability of these parameters for their jurisdictions. More importantly, the following items can be evaluated by the supervisory authorities:

- (a) *Numerator*: Which capital measure shall be suitable – for example, CET1, or a more stringent measure, common equity, without any reserves?
- (b) *Denominator*: Will a wider definition of total exposure or respective adjustments be required? Alternatively, will the definition of exposure need further tightening or some other adjustments?
- (c) *Overall ratio*: Will a 3% requirement match the risk profile of IIFS in their jurisdiction? Is there any need to suggest a different requirement for IIFS compared to conventional banks in the jurisdiction?
- (d) *Accounting standards and practices*: What will be the impact of financial reporting standards and practices in the jurisdiction on the definition and calculation of the leverage ratio?
- (e) *Interaction with capital requirements*: How does the leverage ratio interact with the regulatory capital requirements?

94. The IFSB will work closely with the member supervisory authorities and, based on the feedback on the points highlighted above, will consider making any adjustments to the leverage ratio in this Standard at a suitable time.

## 2.5 Islamic Window Operations

### 2.5.1 Background

95. This sub-section outlines capital adequacy issues related to the treatment of Islamic window operations (hereinafter referred to as “Islamic windows”) of conventional banks as set out in paragraph 9, [section 1.3](#). Islamic windows are present in a majority of jurisdictions where Islamic finance is operating.<sup>37</sup> In most jurisdictions, Islamic windows are potentially self-contained in terms of *Sharīʿah*-compliant financial intermediation; that is, the operations of such windows are *Sharīʿah* compliant on both sides of the balance sheet. In a few jurisdictions, however, this term is used to refer to the operations of a conventional bank where financing is provided on a *Sharīʿah*-compliant basis for some products (such as home purchase plans based on *Ijārah Muntahia Bittamlīk*, or IMB), though such funds are not collected by the bank on a *Sharīʿah*-compliant basis. As mentioned in paragraph 9, for the purpose of this Standard, the guidance on Islamic windows will be mainly addressed to the self-contained window operations of conventional banks. Nevertheless, the following guidance has briefly covered the capital adequacy aspect of “assets-side only” operations of conventional banks for the guidance of supervisory authorities in [section 2.5.4](#).

96. Supervisory practices related to applying capital adequacy requirements for Islamic windows vary considerably across jurisdictions. In some jurisdictions, supervisory authorities require Islamic windows to maintain a separate amount of capital and to follow the applicable minimum capital adequacy ratio requirements, while simultaneously requiring regulatory capital and CAR requirements to be met at the consolidated<sup>38</sup> (i.e. parent) level. In other jurisdictions, there is no specific requirement for Islamic windows to maintain a separate amount of capital or to meet separate regulatory capital requirements. Instead, these requirements are only imposed at the overall bank level, which means that Islamic window operations are consolidated at the parent entity level. Similarly, there are capital adequacy issues related to the treatment of Islamic windows when the parent is based in another jurisdiction. In the following paragraphs, guidance is provided for capital adequacy calculations for each of these structures for Islamic windows.

### 2.5.2 Islamic Windows with Parent in the Same Jurisdiction

97. If the parent is based in the same jurisdiction, the supervisory authority may require the parent to maintain separate capital and calculate a separate CAR for the Islamic window, while simultaneously following the regulatory requirements at the overall bank level. In other cases, these regulatory capital requirements are applied only at the consolidated level, as mentioned in the previous paragraph.

#### 2.5.2.1 Islamic windows with separate capital requirements

98. In this case, supervisory authorities commonly require the conventional bank to allocate a specific amount of capital for the Islamic window operation at the onset. Such a requirement is normally accompanied by a requirement to establish a separate and self-accounting Islamic banking branch, division or department, with designated management. Moreover, Islamic windows are required to follow CAR requirements applicable in the jurisdiction. Thus, the Islamic windows’ own capital is clearly identified and segregated from the regulatory capital available for the conventional operation. Effectively, this means that if Islamic assets grow with the passage of time, Islamic windows will be required to increase their capital accordingly in order to meet the CAR. In this case, an Islamic window will in the first place be considered separately as a branch or division of the entity of which it is a part, and in the second place be considered on a consolidated basis at the overall bank level.

99. Supervisory authorities can use different approaches for calculating capital requirements at the parent level. In the first approach, the assets of the Islamic window operations are included in those of the parent for the latter’s capital adequacy calculation, while simultaneously requiring the window operations to fulfil the minimum capital adequacy requirements according to the previous paragraph. In the second

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<sup>37</sup> An IFSB survey conducted by the RCASWG found that Islamic windows are operating in 10 out of 16 jurisdictions that responded to the survey.

<sup>38</sup> For the purpose of this sub-section on Islamic windows, the term “consolidation” refers to consolidation of the window with its parent conventional bank of which it is a branch or division. This term should not be confused with the group consolidation of a parent company and its subsidiaries at the banking group level.

approach, where consolidation is not made at the parent level, the capital requirement shall be calculated by first computing the denominator of the CAR – that is, computing the RWAs of the window, based on the risk exposures of the assets (as per Section IV) – and making deductions from the denominator depending on whether the IFSB Standard Formula or Supervisory Discretion Formula is used (as per section 3.4.5). The amount of required capital for the window operations shall then be calculated as being the amount in the numerator of the CAR that will meet the regulatory capital requirement. The capital of a window so calculated shall be deducted from the common equity of the parent in the numerator of its CAR. The use of this approach for Islamic windows is subject to considerations of materiality and supervisory discretion.

### **2.5.2.2 Islamic windows with no separate capital requirements<sup>39</sup>**

100. When the supervisory authority does not require Islamic windows to maintain separate capital or to meet separate CAR requirements, the parent will simply calculate its regulatory capital and CAR at the overall bank level, which includes its Islamic window operations. Commonly in this case, the denominator of the CAR is not adjusted to cater for any DCR attached to the unrestricted PSIA (as per section 3.4.5). This means that the risk absorbency features of UPSIA (either on a full or a partial basis) are not considered when calculating the CAR for the parent bank; in effect, they are treated as liabilities. Supervisory authorities shall, *inter alia*, provide guidance on the following matters:

- (a) the applicable RWs for assets of Islamic windows in line with Sections III–VI of this Standard; and
- (b) the need for any adjustment in the calculation of CAR in line with section 3.4.5. The risk absorbency of the window's UPSIA should be taken into account with the use of the applicable alpha factor.

101. Supervisory authorities may consider applying separate minimum capital requirements in line with section 2.5.2.1 for Islamic windows that: (a) become of significant size in relation to the operations of the parent; or (b) gain sizeable market share in the Islamic banking assets in the jurisdiction.<sup>40</sup> In some jurisdictions, supervisory authorities have been recommending or requiring that the Islamic windows in their jurisdictions should convert to Islamic banking subsidiaries when they attain a significant size after several years of operations. Supervisory authorities may stipulate criteria (in terms of asset size of Islamic windows in absolute terms or as a percentage of the parent's balance sheet) for such conversion, based on the overall legal and regulatory framework in the jurisdiction as well as its overall strategic plan for the Islamic banking industry.<sup>41</sup>

### **2.5.3 Islamic Windows with Parent in another Jurisdiction**

102. Depending upon the applicable regulatory framework, in most cases, Islamic window operations of a conventional bank in a jurisdiction other than its home jurisdiction shall be effectively considered foreign branch operations of the latter. Most supervisory authorities in IFSB member countries require such Islamic windows to maintain separate regulatory capital and to meet the minimum CAR requirements. In a few jurisdictions, nevertheless, instead of stipulating minimum regulatory capital and CAR requirements for a foreign branch, the host supervisory authority requires a guarantee from the parent entity to make sure that the branch operations receive appropriate capital support from the parent. This raises the issue of the extent to which such a guarantee may be relied upon in stressed conditions.

103. Apart from the supervisor's requirements relating to minimum capital adequacy requirements as mentioned in the previous paragraph, supervisory authorities should provide guidance on the points highlighted in paragraph 100(i) and (ii) above (in section 2.5.2.2). Host supervisory authorities should also pay particular attention to ensuring that Islamic windows with a foreign parent that gain significant market share in the local market have adequate capital support.

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<sup>39</sup> A window should in principle be required to have separate capital, as this is a *Shari'ah* requirement.

<sup>40</sup> The survey conducted by the IFSB's RCASWG observed that, in some jurisdictions, quite a few Islamic windows are larger than some fully fledged IIFS in terms of total assets. In some other cases, the share of Islamic financing assets maintained by Islamic windows exceeds one-third of the total assets in the parent's balance sheet.

<sup>41</sup> It is relevant to mention here that several supervisory authorities in the IFSB member countries allow the establishment of fully fledged IIFS only. (Italic) ???

#### **2.5.4 Assets-side Islamic Operations of Conventional Banks**

104. As mentioned in paragraph 95, some conventional banks offer *Sharī'ah*-compliant products without generating the funds to be used on a *Sharī'ah*-compliant basis. In such operations, the only requirement for the bank would be to calculate appropriate RWs for its *Sharī'ah*-compliant assets based on the guidance provided in Sections III–VI of this Standard.

## **2.6 Domestic Systemically Important Banks**

### **2.6.1 Preamble**

105. Financial intermediation activity carried out by banking institutions, including the IIFS, involves significant risks, which may potentially have impacts on the economy as a whole. The injections of public funds to rescue some major financial institutions during the recent global financial crisis demonstrated that some financial institutions are so large and complex that if they were to become insolvent, the financial system and the economy as a whole may suffer significant damage. Therefore, a number of measures have been proposed by international standard-setting bodies in recent years to reduce the risk of large and complex global and domestic systemically important banks (SIBs) failing in the future. These proposals are aimed at ensuring that failing banks can be managed, as far as possible, without incurring costs to the state and public exchequer.

106. Looking at the profile of financial systems in the IFSB member countries and other jurisdictions, it is evident that a number of IIFS in some jurisdictions have systemic significance. Accordingly, these IIFS have the potential to be considered as D-SIBs by their supervisory authorities, once such assessment is conducted by the latter. Therefore, the IFSB finds it pertinent to provide a framework for the assessment and additional regulatory requirements for D-SIBs. Taking a non-prescriptive approach, the following framework provides a broad outline to supervisory authorities for selecting the D-SIBs and outlining the requirements for higher loss absorbency (HLA) as well as recovery and crisis management plans. In the dual banking environments, the following guidelines on D-SIBs can be used by supervisory authorities for assessing and stipulating additional policy measures for all the banking institutions in the jurisdiction, including the IIFS. As additional policy measures outlined below will be applicable to any bank selected as a D-SIB based on the supervisory assessment, whether conventional or Islamic, the remaining text will use the term “bank” (to accommodate conventional and Islamic banks) instead of “IIFS”.

### **2.6.2 The Rationale for Taking Additional Policy Measures**

107. The rationale for adopting additional policy measures for D-SIBs is based on the “negative externalities” – that is, undesirable side effects – created by D-SIBs which current regulatory policies do not fully address. These externalities include, *inter alia*:

- (a) In maximising their private benefits, individual financial institutions may rationally choose outcomes that, from a system-wide level, are sub-optimal because they do not take into account these externalities.
- (b) The impact of the failure or impairment of a large, interconnected financial institution at the domestic level can send shocks through the financial system which, in turn, can harm the real economy.
- (c) The moral hazard costs associated with direct support and implicit government guarantees may amplify risk-taking, reduce market discipline, create competitive distortions, and further increase the probability of distress in the future.

108. Based on the aforementioned potential outcomes of the failure of a large and interconnected bank or IIFS in the financial system, some additional policy measures are warranted for the overall tightening of the regulation and supervision of the financial sector at the national level. The additional requirements proposed below aim to minimise the probability that a D-SIB will fail, and to limit the costs to society and the state, if this should happen anyway. Thus, additional requirements aim at underpinning financial stability by making the D-SIBs more resilient, even under severe stress.



109. The assessment of D-SIBs will be made in terms of the *impact* that failure of a bank can have on the domestic financial system and wider economy, rather than the risk that a failure can occur.<sup>42</sup> To a certain extent, additional requirements for D-SIBs may increase their costs, as additional capital will need to be raised. Increased costs could influence the possibility that the relevant institutions would provide financing to the vital sectors of the economy, particularly in the period where the institution is adapting to the additional requirements. This may have a negative effect on the entire economy. Nevertheless, various studies on additional capital requirements for SIBs have shown that over the long term, the impact on the economy will be positive.<sup>43</sup> It is emphasised that a stable financial sector is a fundamental prerequisite for long-term growth and employment, and therefore the suggested requirements will significantly contribute to the financial stability of the relevant financial systems in the future.

110. The additional capital requirements will apply to consolidated groups and subsidiaries. However, national authorities may apply them to individual banks or branches of foreign banks in their jurisdictions in accordance with their legal and regulatory frameworks.

111. In line with the timeline stipulated for the G-SIBs, the banks identified as D-SIBs by their national supervisory authorities can be required to comply with additional capital requirements from January 2016.

### **2.6.3 Assessment Methodology**

112. Supervisory authorities should establish a methodology for assessing the degree to which banks are systemically important in a domestic context. Such a methodology should reflect the potential impact of, or the externality imposed by, a bank's failure on the domestic economy. All the banks in the local financial system will be assessed for their degree of systemic importance. With respect to the domestic operations of a foreign-incorporated bank, home authorities should assess banks for their degree of systemic importance at the consolidated group level, while host authorities should assess subsidiaries in their jurisdictions, consolidated to include any of their own downstream subsidiaries, for their degree of systemic importance. The consideration of a bank on a (globally) consolidated basis will help evaluate the spillover effects of the international operations of a failed bank on the domestic economy. Jurisdictions that are home to banking groups that engage in cross-border activity could be impacted by the failure of the whole banking group and not just the part of the group that undertakes domestic activity in the home economy.<sup>44</sup>

113. Supervisory authorities should undertake regular assessments of the systemic importance of the banks in their jurisdictions to ensure that their assessment reflects the current state of the relevant financial systems. The interval between assessments should be appropriate so as to reflect changes in the various selected factors – for example, one year. If there are important structural changes to the banking system such as mergers and acquisitions, supervisory authorities should re-assess the D-SIBs, along with the change in associated factors and other parameters, if needed.

114. Supervisory authorities should publicly disclose information that provides an outline of the methodology employed to assess the systemic importance of banks in their domestic economy. Public disclosure of the assessment process will provide appropriate incentives for banks to seek to reduce the systemic risk they pose to the reference system.

115. When identifying D-SIBs at group level, the total systemic importance of the group should be taken into account. The institutions in a group are closely interconnected and thus carry a risk of intra-group contagion in the event of financial problems in parts of the group. Consequently, the D-SIB capital requirement should be set at the group level with the same percentage requirement at the consolidated level and for each institution in the group, operating in the same jurisdictions. It cannot be ruled out that,

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<sup>42</sup> This can be thought of as a domestic, system-wide, loss-given-default (LGD) concept rather than a probability of default (PD) concept.

<sup>43</sup> The BCBS study estimated that the total effect of additional requirements for G-SIBs on the global economy will be positive. The full requirements are estimated to have a negative impact on global GDP of 0.3% during the phasing-in period, while the long-run permanent positive effects of a reduced likelihood of a future systemic banking crisis will result in a higher global GDP of 2.5%. [BCBS: "Assessment of the macroeconomic impact of higher loss absorbency for global systemically important banks", October 2011]. Similarly, the European Commission estimates that the positive effects of the CRD4 proposal will result in a higher EU GDP of around 2% in the long run.

<sup>44</sup> This is particularly important given the possibility that the home government may have to fund/resolve the foreign operations in the absence of relevant cross-border agreements.

a large extent, a bank will provide financing to its subsidiaries if these experience financial difficulties. Experience from the financial crisis confirms that an IIFS which allows its subsidiaries to fail will suffer reputational damage. Individually, a bank may be less systemically important, while it may get more significance due to its group affiliation.

116. It may be relevant to include a qualitative element in the identification of D-SIBs in order to identify even more institutions than otherwise selected using only a quantitative approach. This may be as a consequence of a large market share within special segments or geographical areas, or because the institution is particularly linked to the rest of the sector.

117. Supervisory authorities should decide the broad category of factors that will be used for assessing the impact of a D-SIB's failure. Among other things, supervisory authorities can use the factors mentioned in Appendix G. Supervisory authorities will have discretion as to the appropriate relative weights they place on these factors, depending on national circumstances. At their discretion, supervisory authorities can choose all, a few or a single factor for designating a bank in the list of D-SIBs. The use of these factors in calibrating the higher loss absorbency (HLA) requirement would provide justification for different intensities of policy responses across countries for banks that are otherwise similar across the four key bank-specific factors.

#### **2.6.4 Requirement for Higher Loss Absorbency**

118. Supervisory authorities should document the quantitative and qualitative methodologies used to calibrate the requirement for HLA that will be required for D-SIBs. The methodologies can also include jurisdiction-specific indicators. The HLA requirement would help reduce the probability of failure of D-SIBs in comparison to non-systemic institutions. The documentation and disclosure of assessment methodologies will help cross-country comparisons and provide greater transparency to various stakeholders.

119. Supervisory authorities shall have policy discretion to decide the level of HLA for selected D-SIBs based on the degree of domestic systemic importance. There should be a transparent analytical framework for deciding the HLA requirement for various categories or buckets of D-SIBs. Otherwise, supervisory authorities may opt to apply the same level of HLA for all the selected D-SIBs, if the implications of their failure for the domestic financial system and economy are not significantly different. In either case, it should be ensured that the assessment methodology provides appropriate incentives to selected D-SIBs banks which are subject to the HLA requirements to reduce (or at least not increase) their systemic importance over time. In the case where there are multiple D-SIB buckets in a jurisdiction, this could imply differentiated levels of HLA between D-SIB buckets. Similarly, banks with the same degree of systemic importance in their jurisdiction, regardless of whether they are domestic banks, subsidiaries of foreign banking groups or subsidiaries of G-SIBs, are subject to the same HLA requirements, other things being equal.

120. An action by the host authorities to impose a D-SIB HLA requirement leads to increases in capital at the subsidiary level which can be viewed as a shift in capital from the parent bank to the subsidiary, unless it already holds an adequate capital buffer in the host jurisdiction or the additional capital raised by the subsidiary is from outside investors. This could, in the case of substantial or large subsidiaries, materially decrease the level of capital protecting the parent bank. Under such cases, it is important that the home authority continues to ensure there are sufficient financial resources at the parent level – for example, through a solo capital requirement. Similarly, in cases where the subsidiary of a bank is considered to be a D-SIB by a host authority, home and host authorities should make arrangements to coordinate and cooperate on the appropriate HLA requirement, within the constraints imposed by relevant laws in the host jurisdiction. The host authority should provide a rationale for their decision, and an indication of the steps the bank would need to take to avoid/reduce such a requirement.

121. The HLA requirement should be met fully by CET1, which is the simplest and most effective way to increase the going concern loss-absorbing capacity of a bank. Supervisory authorities have the discretion to stipulate any additional requirements and other policy measures they consider to be appropriate to address the risks posed by a D-SIB. The HLA requirement for D-SIBs is over and above the capital buffers and minimum capital requirement, with a pre-determined set of consequences for banks that do not meet this requirement. Indicatively, supervisory authorities can select an HLA requirement of between 0.5% and

3.5% of CET1 to total risk-weighted assets, depending upon the chosen assessment methodology and relevant buckets, if any.

### **2.6.5 Other Measures**

122. In addition to the HLA requirement for D-SIBs, supervisory authorities may consider the following measures, which can help to strengthen their supervisory oversight over these institutions:

- (a) The management of a D-SIB showing noticeable problems is initially expected to take initiatives itself to bring the institution back on the right track. This may be in the form of internal restructuring, raising additional capital in the market, selling parts of the business, etc. If, despite such actions, the institution breaches the capital requirements, supervisory authorities should launch various initiatives to contribute to the recovery of the institution.
- (b) Failing to meet the capital conservation buffer will lead to restrictions on discretionary payments, as highlighted in paragraph 39. The restrictions shall prevent further erosion of capital or reduction of current profit for as long as the bank is below the buffer requirement. Furthermore, banks will be required to prepare and forward a capital conservation plan to the supervisory authority for approval. Following the recommendations of the supervisory authorities, D-SIBs will enter this “capital conservation phase” until the required capital levels are restored.
- (c) All D-SIBs should be required to prepare a recovery plan with more detailed guidelines on how the institution may restore the financial situation in the event of a material deterioration of its financial situation. Supervisory authorities should make an assessment of the recovery plan and, if necessary, may require that the institution prepares a revised plan. If the revised recovery plan fails to address the problems identified, the supervisory authority may order the institution to launch various measures such as reduction of risks, change in business strategy, etc.
- (d) In case of problems with a D-SIB, supervision of the institution should be further intensified. The supervisory authority should engage in a closer dialogue with the D-SIB at the management level in general, as well as at a more technical level in the most significant risk areas, in order to ensure an ongoing exchange of information and to support regular monitoring.
- (e) Supervisory authorities may deem it appropriate to set tightened requirements for D-SIBs in respect of corporate governance. Requirements for corporate governance should contribute to ensuring that the institutions have internal procedures and guidelines, which, to the extent possible, contribute to effective operation of the institution and thus reduce the risk that it will fail.

## SECTION III: PRINCIPLES FOR MINIMUM CAPITAL REQUIREMENTS

### 3.1 Credit Risk

123. Credit risk exposures in Islamic financing arise in connection with accounts receivable in *Murābahah* contracts, counterparty risk in *Salam* contracts, accounts receivable and counterparty risk in *Istisnā* contracts, lease payments receivable in *Ijārah* contracts, and *Sukūk* held in the banking book.<sup>45</sup> In the Standard, credit risk is measured according to the standardised approach of Basel II, as will be discussed below, except for certain exposures arising from investments by means of *Mushārahah* or *Muḍārabah* contracts included in assets in the banking book.<sup>46</sup> The latter are to be treated as giving rise to capital impairment risk as well as credit risk,<sup>47</sup> and are risk-weighted depending on the structure and purpose of the enterprise and the types of assets in which the funds are invested, as prescribed in section 3.1.3.

124. The assignment of RWs shall take into consideration the following:

- the credit risk rating of a debtor, counterparty or other obligor, or a security, based on external credit assessments. IIFS are to refer to their supervisory authorities for eligible external credit assessment institutions that are to be used in assigning credit ratings for the purpose of calculating credit RWs;
- credit risk mitigation techniques adopted by the IIFS;
- types of underlying assets that are sold, collateralised or leased by the IIFS; and
- amount of specific provisions made for the overdue portion of accounts receivable or lease payments receivable.

125. An IFS shall disclose the names of the ECAI that it has used for the purpose of assigning RWs to its assets. If there are two assessments by ECAI chosen by an IIFS which map into different risk weights, the higher RW will be applied. If there are three or more assessments with different risk weights, the assessments corresponding to the two lowest RWs should be referred to and the higher of those two RWs will be applied. (See section 3.1.13 for more details on ECAIs.)

#### 3.1.1 Individual Claims Based on External Credit Assessments

126. Below are the proposed credit RWs for the following counterparties:

Risk Weights						
Rating/Risk Score <sup>48</sup>	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated
ECA Country Risk Score <sup>49</sup>	1	2	3	4 to 6	7	
<b>Counterparty</b>	<b>Risk Weight (RW)</b>					
Sovereigns and central banks <sup>(a)</sup>	0% <sup>(b)</sup>	20%	50%	100%	150%	100%
Non-central government public sector entities (PSEs) <sup>(c)</sup>	Subject to supervisory authorities' discretion to treat as either IIFS, banks and securities firms (Option 1 or 2a) or as sovereigns					

<sup>45</sup> "Banking book" assets are any assets held by an IIFS that it does not intend to trade and which will in principle be held to maturity.

<sup>46</sup> Banks already authorised by the supervisory authority to use IRB for credit risk in their conventional banking business may, at the supervisor's discretion, be allowed to do so for their Islamic banking business.

<sup>47</sup> "Capital impairment risk" is the risk of losing part or the entire amount invested in an enterprise or the ownership of an asset. In the case of profit-sharing contracts (*Mushārahah* and *Muḍārabah*) used for financing purposes, an IIFS is exposed to the risk of losing part or all of its capital as a result of operating losses suffered by the enterprise or a fall in the value of its assets. Exposure to such a risk of capital impairment on financing assets is a specific type of credit risk which does not involve contractual default.

<sup>48</sup> The notations follow the methodology used by Standard & Poor's. The use of Standard & Poor's credit ratings is an example only; those of some other ECAIs could equally well be used.

<sup>49</sup> For the purpose of risk-weighting claims on sovereigns, supervisors may recognise the country risk scores assigned by export credit agencies (ECAs). Banks may choose to use the risk scores published by individual ECAs that are recognised by their supervisor; for example, the OECD methodology establishes eight risk score categories associated with minimum export insurance premiums that correspond to various RW categories.

Rating/Risk Score <sup>48</sup>	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated
<b>ECA Country Risk Score<sup>49</sup></b>	1	2	3	4 to 6	7	
Multilateral development banks (MDBs) <sup>(d)</sup>	20% <sup>50</sup>	50%	50%	100%	150%	50%
IIFS, banks and securities firms Option 1*	20%	50%	100%	100%	150%	100%
Option 2a**	20%	50%	50%	100%	150%	50%
Option 2b**/ <sup>(e)</sup>	20%	20%	20%	50%	150%	20%
Rating/Risk Score	AAA to AA-	A+ to A-	BBB+ to BB-	Below BB-		Unrated
Corporates <sup>(f)</sup>	20%	50%	100%	150%		100%

\*Credit assessment based on ECAI of sovereigns.

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

@ Applicable for original maturity ≤ 3 months which is not rolled over.

- (a) Supervisory authorities have the discretion to reduce the RW for exposures to the sovereigns and central banks that are denominated and funded in domestic currency. This lower RW may be extended to the risk-weighting of collateral and guarantees. Supervisory authorities may extend this treatment to portions of claims guaranteed by the sovereigns or central banks, provided the guarantee is denominated in the domestic currency and the exposure is funded in that currency.
- (b) Inclusive of international organisations/official entities that will receive a 0% RW as determined by supervisory authorities.
- (c) PSEs, such as regional government and local authorities, may be risk-weighted as sovereigns if they have the power to raise revenue and a specific institutional arrangement to reduce their default risk. An administrative body owned by the government or a local authority may be treated in the same manner as IIFS even though it has sovereign immunity but has no power to raise revenue or a specific institutional arrangement.
- (d) MDBs eligible for a 0% RW include: the Islamic Development Bank (IDB) group and its affiliate the Islamic Corporation for the Insurance of Investment and Export Credit (ICIEC); the World Bank Group comprising the International Bank for Reconstruction and Development (IBRD) and the International Finance Corporation (IFC); the Asian Development Bank (ADB); and the African Development Bank (AfDB).
- (e) Under Option 2b, the RWs are one category less favourable than that assigned to claims on the sovereigns subject to a floor of 20% when the exposure is denominated and funded in domestic currency.
- (f) An unrated corporate shall not be given a preferential RW compared to its sovereign. Supervisory authorities have discretion to require a RW higher than 100%, or to allow all corporates to be risk-weighted at 100%.

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

### Risk Weights<sup>51</sup>

<sup>50</sup> Apart from the MDBs listed in point (d), supervisory authorities will determine the eligibility of an MDB for 0% RW based on the following criteria: (i) a majority of an MDB's external assessments must be AAA; (ii) a shareholder structure comprising a significant proportion of sovereigns with long-term issuer credit assessments of AA- or better, or the majority of the MDB's fundraising is in the form of paid-in equity/capital and there is little or no leverage; (iii) strong shareholder support, demonstrated by the amount of paid-in capital contributed by the shareholders; the amount of further capital the MDBs have the right to call, if required, to repay their liabilities; and continued capital contributions and new pledges from sovereign shareholders; (iv) an adequate level of capital and liquidity (a case-by-case approach is necessary in order to assess whether each MDB's capital and liquidity are adequate); and (v) strict statutory lending requirements and conservative financial policies, which would include among other conditions a structured approval process, internal creditworthiness and risk concentration limits (per country, sector, and individual exposure and credit category), large exposures approval by the board or a committee of the board, fixed repayment schedules, effective monitoring of use of proceeds, status review process, and rigorous assessment of risk and provisioning to loan loss reserves.

Rating/Risk Score	A-1 / P-1	A-2 / P-2	A-3 / P-3 or unrated	Others <sup>52</sup>
Risk weight	20%	50%	100%	150%

128. The supervisory authorities have discretion to allow IIFS that operate within their jurisdiction to apply an internal-rating based approach if such institutions meet minimum requirements set by the supervisory authorities. The IFSB intends to issue a Guidance Note on the application of IRB and other advanced approaches for IIFS in due course.

### 3.1.2 Off-balance Sheet Exposures

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

130. Commitments with an original maturity up to one year and those with an original maturity over one year will receive a CCF of 20% and 50%, respectively. However, any commitments that are unconditionally cancellable at any time by the IIFS without prior notice, or that effectively provide for automatic cancellation due to deterioration in the creditworthiness of the borrower/financed party, will receive a 0% CCF.<sup>53</sup>

131. An import or export financing which is based on *Murābahah* where the underlying goods/shipment are collateralised and insured shall attract a 20% CCF to the IIFS that issues or confirms the letter of credit. This treatment of collateral assumes there are no obstacles to the exercise of rights over it by the issuer or confirmer. (See [section 3.1.7](#) for a discussion of pledge of assets as collateral.)

132. *Sharī'ah*-compliant alternatives to repurchase agreements and securitised lending/borrowing will receive a CCF of 100%. Further, a CCF of 50% will be applied to certain transaction-related contingent items such as performance bonds, bid bonds and warranties. Direct credit substitutes, such as standby letters of credit serving as financial guarantees against financing and securities, or irrevocable credit commitments, will receive a CCF of 100%.

133. *Sharī'ah*-compliant hedging contracts<sup>54</sup> that are traded over-the-counter (OTC) expose an IIFS to counterparty credit risk (CCR). CCR refers to the risk that the counterparty to a transaction could default before the final settlement of the transaction's cash flows. An economic loss would occur if the transactions, or portfolio of transactions, with the counterparty had a positive economic value at the time of default. Unlike a firm's exposure to credit risk through a financing arrangement, where the exposure to credit risk is unilateral and only the IIFS financing the transaction faces the risk of loss, CCR involves a bilateral risk of loss; that is, the market value of the transaction can be positive or negative to either counterparty to the transaction, depending on the movements in the market prices of the underlying variables.

134. A credit equivalent for *Sharī'ah*-compliant hedging techniques<sup>55</sup> can be derived using the Current

<sup>51</sup> The short-term assessments are considered to be issue-specific and can be used to derive RWs for claims arising from the rated facility. This short-term assessment can only be used for short-term claims against IIFS, banks and corporates.

<sup>52</sup> This category includes all non-prime and B or C ratings.

<sup>53</sup> Retail commitments are considered unconditionally cancellable in certain jurisdictions if the terms permit the financial institution to cancel them to the full extent under the related legislation. Accordingly, an IIFS must demonstrate that: (a) legally, it has the ability to cancel the facility; (b) it maintains adequate internal control systems and monitoring practices to support timely cancellation; and (c) such cancellation has not exposed the IIFS to legal action.

<sup>54</sup> *Sharī'ah*-compliant hedging instruments are *Sharī'ah*-compliant alternatives to derivative contracts.

<sup>55</sup> A survey conducted in 2001 for the Revised Capital Adequacy Standard Working Group showed that *Sharī'ah*-compliant alternatives to derivatives/hedging transactions are being used by only 14% of the IIFS (106 respondents from 18 jurisdictions). The survey showed that profit rate swaps and cross-currency swaps are the most common structures, being utilised by 14% and 13% of IIFS, respectively.

Exposure Method.<sup>56</sup> The credit equivalent exposure is based on the positive mark-to-market replacement cost of the contract. An add-on factor will be added to cover for potential future credit exposure. (See [Appendix C](#) for further details. Also see [section 3.1.9.1](#) for conditions for applying 0% RW to such contracts.)

### **3.1.3 Exposures in Investments Made under Profit-Sharing Modes**

135. An IIFS may provide financing and hold investments made under profit- and loss-sharing modes (*Mushārah*) or profit-sharing and loss-bearing modes (*Muḍārah*) which may be used, *inter alia*, to invest in the following:

- (a) a commercial enterprise to undertake a business venture (with the intention of holding the investment for an indefinite period or with a view to eventual sale, such as venture capital investments or privately held equity);
- (b) diminishing *Mushārah* in which the share of the IIFS can be gradually reduced during the tenure of the contract until the asset is fully sold to the partner(s);
- (c) an equity investment in a company or an Islamic collective investment scheme not held for short-term resale or trading purposes;<sup>57</sup>
- (d) a specific project; or
- (e) a joint ownership of real assets or movable assets (such as cars) on a *Mushārah* basis for onward lease or sale on an *Ijarah* or a *Murābah* basis, respectively (i.e. *Mushārah* with an *Ijarah* or *Murābah* sub-contract).

136. This section covers such exposures of the IIFS that are held not for trading but for the purpose of earning investment returns from medium- to long-term financing (i.e. held in the "banking book"). Such investments are:

- (a) not held with the intent of trading or short-term resale benefiting from actual or expected price movements (as in (a), above);
- (b) not marked-to-market on a daily basis;
- (c) not actively monitored with reference to market sources; and
- (d) exposed to credit risk in the form of capital impairment risk.<sup>58</sup>

137. In assigning the RW, consideration shall be given to the intent of the profit-sharing investment, and to the nature of the underlying assets. For the purpose of determining minimum capital requirements, the RW shall be applied based on [sections 3.1.3.1 to 3.1.3.5](#).

#### **3.1.3.1 Commercial enterprise to undertake a business venture**

138. Financing on a *Mushārah* or *Muḍārah* basis of a commercial enterprise to undertake a business venture can expose an IIFS to capital impairment risk as well as credit risk, to an extent that depends on the structure and purpose of the financing and the types of assets in which the funds are invested. Commonly, an IIFS would invest in a commercial enterprise with the intention of holding the investment for an indefinite period or with a view to eventual sale (as in the case of venture capital or

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<sup>56</sup> Current exposure is the larger of zero or the market value of a transaction, or portfolio of transactions, within a netting set with a counterparty that would be lost upon the default of the counterparty, assuming no recovery on the value of those transactions in bankruptcy. Current exposure is often also called replacement cost (see [Appendix C](#) for details).

<sup>57</sup> Banking book investments would not normally include investments in *listed* common shares or *listed* Islamic collective investment schemes, which would instead be held in the trading book.

<sup>58</sup> As mentioned in paragraphs 48 and 55 of IFSB-1, under both *Mushārah* and *Muḍārah* financings, the capital invested by the provider of finance is not guaranteed as it is not a debt, but is explicitly exposed to impairment in the event of losses – that is, to capital impairment risk. Also see footnote 47 of this standard above.

private equity investments). As an equity investor, the IIFS's rights and entitlements are subordinated to the claims of secured and unsecured creditors.

139. Capital impairment risk is the risk of losing the amount invested in an enterprise or in the ownership of an asset. Such impairments may arise for two kinds of reasons: (a) the investee may be unprofitable, so that the investor IIFS fails to recover its investment; and (b) the *Mushārah* partner or *Muḍārib* may fail either: (i) to pay the IIFS's share in the profit on a periodical basis, as contractually agreed; or (ii) to settle the IIFS's entitlement to its share of the capital and the profits at the time of redemption. The former kind of reason is an impairment of capital without any credit default being involved; whereas the latter, being a failure of the partner to meet its contractual obligations, is a type of credit default.

140. Bearing in mind the relatively risky nature of financing based on profit-sharing modes, supervisory authorities may set out some prudential conditions on IIFS that invest IAH funds in such financing either directly or by commingling the funds of IAH with those of shareholders in such financing. Unrestricted investment account holders (UIAH) typically have a small risk appetite and are content with an investment which has a relatively low risk and low returns.

141. The RW for such investments shall be calculated according to either of the following methods:

- (a) simple risk-weight method, treating the investment as an equity exposure held in the banking book; and
- (b) supervisory slotting method, considering the investment as a type of specialised financing.

#### *Simple risk-weight method*

142. For *Mushārah* or *Muḍārah* investments in commercial enterprises whose common shares are listed on a recognised security exchange, a 300% RW is to be applied. For *Mushārah* or *Muḍārah* investments in all other enterprises, a 400% RW will be applicable, subject to the following.

143. From a risk management perspective, a major distinction between *Muḍārah* and *Mushārah* financings relates to the IIFSs' involvement in the investments during the contract period. In *Muḍārah*, the IIFS invests as a silent partner and the management is the exclusive responsibility of the other party, namely the *Muḍārib*. In contrast, in *Mushārah* financing, the IIFS (and its partner or partners) invest their funds together, and the IIFS may be a silent partner, or may participate in management. Therefore, the supervisory authority may, at its discretion, allow application of a 300% RW for any such *Mushārah* financing. Further, in all cases where the IIFS can withdraw its financing at short notice (maximum five working days), the investment may be considered as being as liquid as publicly traded equity holdings. The applicable RW in such a case will be 300%.

144. As with other types of financing, an IIFS can use eligible *Sharīah*-compliant risk mitigation techniques in profit-sharing financing to reduce the credit exposure and risk of possible capital impairment. The use of such risk mitigation and subsequent reduction in credit exposure shall be taken into account when calculating the capital requirements of the IIFS.<sup>59</sup>

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<sup>59</sup> Some supervisory authorities apply a 150% RW on the *Muḍārah* and/or *Mushārah* investments of the IIFS in their jurisdictions, considering the exposure on such investments to be similar to that of a venture capital and/or a private equity investment. As per paragraph 22 of Basel II, Pillar 1, supervisory authorities have discretion to impose 150% or higher RWs on such exposures. Bearing in mind the features and operational mechanism of *Mushārah* and *Muḍārah* financing made by IIFS in private commercial enterprises to undertake business ventures, the Working Group considers that such exposures more closely resemble the nature of "equity exposure in the banking book", as mentioned in paragraph 344 of Basel II, Pillar 1. Any supervisory decision to suggest a lower RW than that suggested by the simple RW method should be subject to a robust supervisory review of the factors, including infrastructure and capacity of the IIFS to monitor the performance and operations of the financed entity, quality of collateral used, nature of business activities to be undertaken, legal and regulatory environment, adequacy of financial control and reporting system of the customer and the IIFS, information-sharing procedures, valuation methods and exit strategies. In appropriate cases, the supervisory slotting method provides a more risk-sensitive means of assigning a RW.



### Supervisory slotting method

145. In appropriate cases related mostly to the project finance or business ventures, the supervisor may permit an IIFS to employ an alternative approach, namely the supervisory slotting criteria. Under this method, an IIFS is required to map its internal risk grades into four supervisory categories for specialised financing, as set out in [Appendix E](#). Each of these categories will be associated with a specific RW, as given in the following. These RWs include an additional fixed factor of 20% RW to cater for the potential decline in the *Muḍārabah*'s or *Mushārah*'s net asset value.

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

#### 3.1.3.2 Diminishing *Mushārah*

146. This form of *Mushārah* is a mechanism whereby an IIFS can provide term financing to a customer on a profit-sharing basis. The IIFS enters into this type of *Mushārah* with the objective of transferring the ownership to the customer, where the IIFS acts initially as joint-owner of the asset, and the customer as its partner gives a binding promise in a separate document to buy out the IIFS's share by making payments on specified future dates in accordance with a separate contract of sale entered at that time. Diminishing *Mushārah* may relate to a specific fixed asset/real estate leased to the customer under an *Ijārah* contract or to the general working capital of the customer's business venture.

147. The IIFS's position in a diminishing *Mushārah* thus entails two kinds of exposures.

- a. The amounts due from the partner to buy out the agreed shares of the investment on the agreed dates are subject to credit risk in respect of the partner's ability and willingness to pay.<sup>60</sup> The IIFS's selling price for each share of ownership being transferred is based either on the fair value of that share at the date of the partial transfer of ownership (which exposes the IIFS to capital gains or losses and hence to capital impairment risk) or at a price agreed upon at the time of entering into the contract. The IIFS's credit risk exposure in respect of the *Mushārah* investment will be calculated based on the remaining balance of the amount invested (measured at historical cost, including any share of undistributed profits) less any specific provision for impairment. If there is a third-party guarantee to make good impairment losses, the RW of the guarantor shall be substituted for that of the outstanding balance of the *Mushārah* investment for the amount of any such guarantee.
- b. As a joint-owner, the IIFS is entitled to its share of income generated from its share of the underlying assets of the *Mushārah*, such as *Ijārah* lease rentals (e.g. when a home purchase plan is provided by an IIFS on the basis of diminishing *Mushārah*). The rental payable by the partner/customer as *Ijārah* lessee is adjusted periodically to reflect the IIFS's remaining ownership share in the asset. The IIFS is exposed to credit risk in respect of non-payment of the rentals receivable from the partner/customer.

148. Based on the above, when a diminishing *Mushārah* contract is related to a specific fixed asset/real estate leased to a customer under an *Ijārah* contract, the IIFS's credit exposure will be similar to an exposure under a *Mushārah* with an *Ijārah* sub-contract. In this case, the *Mushārah* investment shall be assigned a RW based on the credit standing of the counterparty/lessee, as rated by an ECAI that is approved by the supervisory authority, and 100% RW on residual value of an asset. In case the counterparty is unrated, a RW of 100% shall apply.

<sup>60</sup> Diminishing *Mushārah* contracts typically contain a clause whereby, in the event of a default by the partner in making a due payment, the IIFS has the right to terminate the contract and to exercise a put option requiring the partner to buy out the whole of the IIFS's remaining share of the investment. However, a financially distressed partner will most likely be unable to do so.

149. However, if the exposure under the diminishing *Mushārah* contract consists of working capital finance in the customer's business venture, the IIFS shall measure its credit risk similarly to an equity exposure held in the banking book, as set out in [section 3.1.3.1](#). This treatment will be, however, subject to the consideration of any third-party guarantee to make good impairment losses. In that case, the RW of the guarantor shall be substituted for that of the outstanding balance of the *Mushārah* investment for the amount of any such guarantee. Moreover, subject to obtaining prior approval from its supervisory authority, an IIFS can use the supervisory slotting method, based on the criteria set out in [Appendix F](#) (diminishing *Mushārah*).

### **3.1.3.3 Equity investments in a company or an Islamic collective investment scheme not held for short-term resale or trading purposes**

150. Such a holding is not a trading book exposure, and thus the "look-through" principle, whereby the RW of the exposure would be that of the underlying assets, does not apply and the exposure is that of an equity position in the banking book. Banking book investments would not normally include investments in common shares or Islamic collective investment schemes that are publicly listed. However, if such an investment is in an entity or Islamic collective investment scheme (consisting predominantly of equity instruments/stocks) that is publicly listed on a recognised securities exchange, the holding being not for short-term resale or trading purposes, a 300% RW shall be applied, consistent with the simple RW method. Likewise, a 400% RW shall be applied to all other equity holdings. The exposure in such investments shall be measured at the carrying values of the investments, according to the international financial reporting standards, or according to those in force in the relevant jurisdiction where different (such as historical cost less any provisions for impairment).

### **3.1.3.4 A specified project**

151. An IIFS can advance funds to a construction company which acts as *Muḍārib* in a construction contract for a third-party customer (ultimate customer). The ultimate customer will make progress payments to the *Muḍārib*, who in turn makes payments to the IIFS. The essential role of the IIFS in this structure is to provide bridging finance to the *Muḍārib* pending its receipt of the progress payments. In this *Muḍārah* structure, the IIFS as investor advances funds as *Rabb-al-Māl* to the construction company as *Mudārib* for the construction project, and is thus entitled to a share of the profit of the project but must bear 100% of any loss. In most cases, the IIFS has no direct or contractual relationship with the ultimate customer, but in such a structure the IIFS stipulates that payments by the ultimate customer to the *Muḍārib* be made to an account ("repayment account") with the IIFS which has been opened for the purpose of the *Muḍārah* and from which the *Muḍārib* may not make withdrawals without the IIFS's permission.

152. In such a case, the IIFS is exposed to the risk on the amounts advanced to the *Muḍārib* under the *Muḍārah* contract, but this risk would be mitigated by the amounts received from the ultimate customer into the "repayment account" which are effectively collateralised. Thus, while under the *Muḍārah* contract the amounts advanced by the IIFS to the *Muḍārib* would normally be treated under credit risk as "equity positions in the banking book", the use of the structure involving a "repayment account", whereby the ultimate customer makes payments into such an account with the IIFS instead of making payments directly to the *Muḍārib*, has the effect of substituting the credit risk of the ultimate customer for that of the *Muḍārib* to the extent of the collateralised balance of the "repayment account".

153. In addition to credit risk (i.e. in the absence of a repayment account, the risk that the *Muḍārib* has received payment from the ultimate customer but fails to pay the IIFS, or, if the repayment account is used, that the ultimate customer fails to pay), the IIFS is exposed to capital impairment in the event that the project results in a loss. The proposed RW and impact of credit risk mitigation are explained in [section 4.7](#).

### **3.1.3.5 *Mushārah* with *Ijārah* or *Murābahah* sub-contract**

154. An IIFS can establish joint ownership of tangible fixed assets (such as cars, machinery, etc.) with

a customer on a *Mushārah* basis, the assets being leased or sold on an *Ijārah* or a *Murābahah* basis, respectively. In these cases, the "look-through" principle (whereby the RW is that of the underlying contract) applies, as explained below.

155. In the case of *Ijārah*, ownership of such assets can produce rental income for the partnership, through leasing the assets to third parties by means of *Ijārah* contracts. In this case, the risk of the *Mushārah* investment is that of the underlying *Ijārah* contracts – that is, credit risk mitigated by the "quasi-collateral"<sup>61</sup> represented by the leased assets. In the event the asset is leased to the IIFS's partner as a customer instead of to a third party, the credit risk will relate to the partner's obligation to pay the lease rentals. This *Mushārah* investment shall be assigned a RW based on the credit standing of the counterparty/lessee, as rated by a supervisor-approved ECAI, and a 100% RW on the residual value of the *Ijārah* asset. In the event the counterparty is unrated, a RW of 100% shall apply.

156. In the case of *Murābahah*, the IIFS is entitled to its share of income (mark-up) generated from selling the assets to third parties. The IIFS as a capital contributor is exposed to credit risk in respect of the *Murābahah* receivables from the buyer/counterparty. This *Mushārah* investment shall be assigned a RW based on the credit standing of the counterparty/buyer, as rated by a supervisor-approved ECAI. In the event the counterparty is unrated, a RW of 100% shall apply.

### **3.1.4 Preferential Risk Weights Based on Underlying Assets**

157. The RW of a debtor, counterparty or other obligor shall be reduced and given preferential treatment if the underlying assets are financed under *Murābahah*, *Ijārah*, IMB, *Istisnā* or diminishing *Mushārah*, as set out below. Supervisory authorities may apply an appropriate RW that can be higher than as set out below based on the default experience for these types of exposures in their jurisdictions.

#### **3.1.4.1 Retail portfolios**

158. The RW shall be 75% on the credit exposure of the IIFS, provided:

- (a) the financing is provided to an individual person or persons or a small business;
- (b) the subject matter of the financing is pledged as collateral to the IIFS;
- (c) the aggregate receivables (accounts receivable in *Murābahah* and *Istisnā*, lease payments receivable in IMB, and share purchase plus lease receivables in diminishing *Mushārah*) due from a single counterparty or person(s) shall not exceed US\$500,000, subject to supervisory discretion; and
- (d) the regulatory retail portfolio is adequately diversified so that this reduces the risks in the portfolio. Supervisory authorities, at their discretion, may specify a numerical limit to ensure such diversification; for example, aggregate exposure (without taking any credit risk mitigation into account) to one counterpart cannot exceed 0.2% of the overall regulatory retail portfolio.

159. Any retail financing contract which is collateralised (or quasi-collateralised) by an asset other than the subject matter of the financing will not qualify for this preferential treatment unless the value of such collateral after adjustment for haircuts<sup>62</sup> is higher than the aggregate selling price of the financed asset throughout the tenure of the contract.

160. For any financing on the basis of the aforementioned contracts that is fully secured by real estate, the accounts or lease payments receivable can be excluded from this category and qualify for a lower RW as stated with respect to residential real estate (RRE) in the next sub-section.

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<sup>61</sup> Strictly speaking, *Ijārah* assets do not provide collateral to the lessor, as the latter owns the assets, but can repossess them in the event of default by the lessee. This provides what may be called "quasi-collateral", a term that is used in this and other IFSB standards.

<sup>62</sup> The term "haircut" in this context refers to a discount on the full value of an asset as collateral after taking into consideration some inherent risks that affect the volatility of the market price or value of the asset. It is commonly expressed in terms of a percentage by which an asset's value as collateral is reduced.

### 3.1.4.2 Residential real estate

161. The RW shall be 35% subject to meeting the prudential criteria imposed by the supervisory authorities, which include, *inter alia*:

- (a) the real estate is to be utilised for residential purposes only;
- (b) the subject matter of RRE must be pledged as collateral (or serve as quasi-collateral) to the IIFS in the case of *Murābahah*, IMB or diminishing *Mushārahah*;
- (c) the total accounts/lease receivables do not exceed 50% of the market value of the collateralised RRE subject to professional valuation of the RRE made within one year preceding the contract date, the 50% figure being subject to the supervisor's discretion; and
- (d) there exists a legal infrastructure whereby the IIFS can enforce the repossession and liquidation of the RRE.

162. The supervisory authorities have discretion to apply a higher RW if any of the above criteria are not met.

### 3.1.4.3 Commercial real estate

163. The RW is 100%. Subject to the supervisor's discretion, a preferential RW of 50% can be applied provided that, *inter alia*:

- (a) a well-developed and long-established commercial real estate (CRE) market is present in the jurisdiction;
- (b) financing is provided for office and/or multi-purpose premises and/or multi-tenanted premises;
- (c) the CRE is collateralised in case financing is provided on the basis of *Murābahah*, IMB or diminishing *Mushārahah*;
- (d) the tranche or outstanding balance of the financing does not exceed 50% of the market value of the collateralised CRE; and
- (e) total losses from CRE financing do not exceed 0.5% of the total amount due in respect of the outstanding balance of the financing in any given year.

### 3.1.5 Past Due Receivables

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

Type	RW	% of Specific Provisions for Past Due Receivables
Unsecured exposure (other than unsecured portion of receivable partly secured by RRE) that is past due more than 90 days, net of specific provisions	150%	Less than 20% of the outstanding receivables.
	100%	At least 20% of the outstanding receivables.
	100%	At least 50% of the outstanding receivables, but supervisory authorities have discretion to reduce RW to 50%.
Exposure fully secured by other than eligible collateral (as set out in section 3.1.8)	100%	At least 15% of the outstanding receivables.  Supervisory authorities are to set strict operational criteria to ensure the quality of collateral.

Type	RW	% of Specific Provisions for Past Due Receivables
Exposure secured by RRE	100%	For receivables that are past due for more than 90 days, net of specific provisions.
	50%	The RW can be reduced to 50% RW if specific provisions are at least 20% of the outstanding receivables at national discretion.

### 3.1.6 Other Assets

165. Other assets shall be risk-weighted at 100%. A RW of 20% shall be applicable on cash items under collection. Investments in regulatory capital instruments issued by banks or securities firms will have a RW of 100%, provided they are not deducted from the capital base, as per [section 2.1.5](#).

### 3.1.7 Credit Risk Mitigation

166. The exposure in respect of a debtor, counterparty or other obligor can be further adjusted or reduced by taking into account the credit risk mitigation (CRM) techniques employed by the IIFS. This section covers CRM used by IIFS in the standardised approach and outlines criteria, methodologies and specific requirements for using these techniques.

167. Double counting of CRM impacts shall not be permitted. Therefore, additional supervisory recognition of CRM will not be allowed on receivables for which an issue-specific rating is used that already reflects that CRM. IIFS should also take into account any residual risks arising out of use of CRM techniques such as market, operational, legal and liquidity risks. Therefore, an IIFS should have a strategy, policies and procedures to control and manage residual risks. Further, the impact of these risks on the overall credit profile and concentration risk of the IIFS should be monitored and controlled.

168. The collateral used as a part of CRM must be compliant with *Sharī'ah* requirements. The collateralisation<sup>63</sup> shall be properly documented in a security agreement or in the body of a contract to the extent permissible by *Sharī'ah*, and must be binding on all parties and legally enforceable in the relevant jurisdictions. The IIFS should ensure that the CRM documentation is legally enforceable and should carry out periodic reviews to confirm its enforceability at all times. The IIFS cannot recognise a commitment to provide collateral or a guarantee as an eligible CRM unless such a commitment is actually executed.

169. There should be a negligible positive correlation, if any, between the value of collateral and the credit quality of a counterparty. Consequently, securities issued by a counterparty or its related entities would not be eligible for collateral.

170. For a collateralised transaction – such as *Sharī'ah*-compliant alternatives to repo/reverse repo or borrowing/lending of *Sukūk* and Islamic securities – capital requirements shall be applicable on either side of the transaction.

171. Supervisory authorities can impose additional capital charges or take other supervisory steps under IFSB-5 (*Supervisory Review Process Standard*) if residual risks are not effectively controlled. Supervisory authorities should also specify requirements for relevant disclosure of CRM techniques by IIFS under IFSB-4 (*Disclosures to Promote Transparency and Market Discipline*).

172. The CRM techniques that are commonly employed by the IIFS are as follows:

<sup>63</sup> Generally, in IIFS such collateralisation takes place under the concept of "*Rahn*" or "*Kafālah*".

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

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

174. In the case of a non-binding PP/PL, the HJ is refundable in full to the client, and hence is not considered as an eligible CRM.

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

175. The *Urbūn* taken from a purchaser or lessee when a contract is established accrues to the benefit of the IIFS if the purchaser or lessee fails to execute the contract within the agreed term.

(c) *Guarantee from a third party (recourse or non-recourse guarantee)*

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

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

178. The supervisory authority may give capital relief for the use of a guarantee that meets the following conditions:

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

179. It is permitted to have a range of guarantors to cover the exposure. Guarantees issued by parties with a lower RW than the counterparty will result in a reduction of the capital charge because the credit exposure covered by the guarantee is assigned the RW of guarantor. The RW applicable to the uncovered portion will remain that of the underlying counterparty.

(d) *Pledge of assets as collateral*

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

181. The pledger can authorise the IIFS, as the pledgee, to sell the asset and to offset the amount due

against the sales proceeds without recourse to the courts. Alternatively, the IIFS can demand the sale of the pledged asset in order to recover the amount due. Any surplus from the sale proceeds is to be returned to the pledger, and any shortfall shall be treated as an unsecured exposure that ranks *pari passu* with other unsecured creditors when the debtor is declared insolvent.

182. In case an IIFS takes collateral of an asset pledged more than once, the collateral of the IIFS shall be ranked either *pari passu* to the collaterals of other earlier pledgees with their consent, or junior to the earlier pledgees, in which case the IIFS's claim shall be limited to the residual value of the pledged asset after payment is made to earlier pledgees. The IIFS shall take the residual value after deducting a haircut under the simple approach or the comprehensive approach (the standard supervisory haircuts or the internal haircuts) to offset its credit exposure but should first ascertain the recoverable value of the asset after taking into consideration the IIFS's position as a pledgee as to whether it ranks *pari passu* with the other pledgee(s) or ranks junior to a pledgee that is registered earlier than the IIFS.

(e) *Leased assets*

183. Assets leased under *Ijārah* or IMB contracts fulfil a function similar to that of collateral, in that they may be repossessed by the lessor in the event of default by the lessee (hence the term "quasi-collateral" used in this and other IFSB Standards).

(f) *On-balance sheet netting*

184. Subject to *Sharī'ah* approval, netting arrangements between financing assets and deposits/PSIA should be legally enforceable in order to be used as an eligible CRM technique. The net exposure will be used for capital adequacy purposes if the IIFS has a legally enforceable arrangement for netting or offsetting the financing assets and the deposits/PSIA, irrespective of whether the counterparty is insolvent or bankrupt. The IIFS should have a robust system of monitoring those financing assets and deposits/PSIA with the counterparty that is subject to the netting arrangements. In using the net exposure for the calculation of capital adequacy, financing assets shall be treated as exposures and deposits/PSIA as collateral in the comprehensive approach (as per the formula provided below). A zero haircut will be applicable, except in the case of a currency mismatch.

### **3.1.8 Types of Collateral**

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

- (a) *Hamish Jiddiyah* (security deposit) only for agreements to purchase or lease preceded by a binding promise.
- (b) *Urbūn*.
- (c) Unrestricted PSIA or cash on deposit<sup>64</sup> with the IIFS which is incurring the exposure.
- (d) *Sukūk* rated by an external rating agency which are issued by:
  - (i) sovereigns and PSEs (treated as sovereigns) with a minimum rating of BB-; or
  - (ii) issuers other than the above, with a minimum rating of BBB- (for long-term) or A-3/P-3 (for short-term).
- (e) *Sukūk* that are unrated by an ECAI but fulfil each of the following criteria:
  - (i) issued by an IIFS or a conventional bank (with Islamic windows or subsidiary operations) or a sovereign;
  - (ii) listed on a recognised exchange;
  - (iii) the IIFS which incurs the exposure or is holding the collateral has no information to suggest that the issue would justify a rating below BBB- or A-3/P-3;
  - (iv) the supervisory authorities are sufficiently confident about the market liquidity of the securities; and

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<sup>64</sup> Must be supported by an agreement or documentation that gives the IIFS the right of set-off against the amount of receivables due from the customer.

- (v) all rated issues by the issuing IIFS must be rated at least BBB- or A-3/P-3 by a recognised ECAI.
- (f) *Sharī'ah*-compliant equities and units in Islamic collective investment schemes.
- (g) Guarantees issued by third parties that fall within the following categories:
  - (i) sovereigns and central banks;
  - (ii) PSEs;
  - (iii) MDBs;
  - (iv) international organisations/official entities with a 0% RW;
  - (v) IIFS or conventional banks (with Islamic windows or subsidiary operations); and
  - (vi) corporate entities (including *Takāful*- and *Sharī'ah*-compliant securities firms) of a minimum rating of A-. This category includes guarantees issued by parent, subsidiary and affiliate companies when their RW is lower than the ultimate obligor.
- (h) Assets pledged as collateral, as stated in [section 3.1.7\(d\)](#), or fulfilling the function of collateral, as stated in [section 3.1.7\(e\)](#).

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

### **3.1.9 Risk Mitigation Approaches**

187. Capital relief against the collateral can be granted based on either the simple or the comprehensive approach as described below. However, IIFS are permitted to use either, but not both, of the approaches in reducing their risk exposures in the banking book. IIFS can use partial collateralisation in both approaches. Maturity mismatches between exposure and collateral will only be allowed under the comprehensive approach.

#### **3.1.9.1 Simple approach**

188. The IIFS can substitute the RW of the collateral for the RW of the counterparty for the collateralised portion of the exposure, subject to the collateral being pledged for at least the duration of the contract. The RW of that collateralised portion shall not be lower than 20%. The uncollateralised portion of the exposure will be assigned the RW of the counterparty. A 0% RW can be applied where the exposure and the collateral are denominated in the same currency, and the collateral consists of any of the following:

- (a) cash or cash equivalents;
- (b) a deposit with the IIFS; or
- (c) sovereign/PSE securities eligible for a 0% RW, and its market value has been discounted by 20%.

189. *Sharī'ah*-compliant hedging instruments which are normally traded OTC can be given a RW of 0% provided the conditions set out in the following are met. In case these conditions are not fulfilled, see [section 3.1.2](#) for calculating the credit equivalent using the Current Exposure Method.

- (a) The OTC *Sharī'ah*-compliant hedging instruments are subject to daily mark-to-market.
- (b) There is no currency mismatch.
- (c) The collateral is cash. In case the collateral is not cash, but consists of *Sukūk* issued by sovereigns/PSE that qualify for a 0% RW in the standardised approach, a minimum RW of 10% shall be applicable.

#### **3.1.9.2 Comprehensive approach**

190. In the comprehensive approach, the exposure to a counterparty shall be adjusted based on the



collateral used. The IIFS shall adjust *both* the amount of the exposure to the counterparty *and* the value of the collateral, using *haircuts* in order to reflect variations in the value of both the exposure and the collateral due to market movements. The resultant volatility-adjusted amount of exposure and collateral will be used for the calculation of capital requirements for the underlying risk exposure. In most cases, the adjusted exposure will be higher than the unadjusted exposure and adjusted collateral will be lower than the unadjusted collateral, unless either of them is cash. An additional downward adjustment for collateral shall be made if the underlying currencies of exposure and collateral are not similar, so as to take account of foreign exchange fluctuations in the future.

191. Risk-weighted assets shall be calculated by calculating the difference between the volatility-adjusted exposure and the volatility-adjusted collateral and multiplying this adjusted exposure by the RW of the counterparty.<sup>65</sup>

192. The formula for calculation of the adjusted exposure after incorporating risk mitigation using the comprehensive approach will be as follows:

$E^* = \max [0, \{E \times (1 + H_e) - C \times (1 - H_c - H_{fx})\}]$ , where:

$E^*$  = Adjusted exposure amount after risk mitigation

$E$  = Exposure amount

$H_e$  = Applicable haircut for exposure

$C$  = The current value of underlying collateral

$H_c$  = Applicable haircut for collateral

$H_{fx}$  = Applicable haircut for foreign exchange exposure, in case exposure and collateral have dissimilar currencies

193. If more than one asset is involved in a collateralised transaction, the haircut on the basket ( $H$ ) will be a weighted sum of applicable haircuts to each asset ( $H_i$ ), with asset weights ( $a_i$ ) measured by units of currency – that is,  $H = \sum a_i H_i$ .

194. For calculating haircuts, either of the two following methods may be used by IIFS: (a) standard supervisory haircuts; and (b) internal haircuts. The parameters for standard supervisory haircuts and features of qualitative and quantitative criteria for using internal haircuts are provided in the following paragraphs.

(a) *Standard supervisory haircuts*

195. Both the amount of exposure to a counterparty and the value of collateral received are adjusted by using standard supervisory haircuts, as set out below:

Types of Collateral*	Residual Maturity (yrs)	Haircuts	
		Sovereigns <sup>66</sup>	Others
Cash	All	0	0
<i>Sukūk</i> Long-term: AAA to AA- and Short-term: A-1	≤1	0.5	1
	>1 to ≤5	2	4
	>5	4	8
<i>Sukūk</i> Long-term: A+ to BBB- and Short-term: A-2 to A-3	≤1	1	2
	>1 to ≤5	3	6

<sup>65</sup> This calculation will be carried out when the volatility-adjusted exposure amount is greater than the volatility-adjusted collateral amount, including any additional adjustment for foreign exchange risk.

<sup>66</sup> Includes PSEs and MDBs.

Types of Collateral*	Residual Maturity (yrs)	Haircuts	
		Sovereigns <sup>66</sup>	Others
	>5	6	12
<i>Sukūk</i> Long-term: BB+ to BB-	All	15	25
<i>Sukūk</i> (unrated)	All	25	25
Equities (listed and included in main index)	All	15	15
Equities (listed but not included in main index)	All	25	25
Units in Islamic collective investment schemes	All	Depending on the underlying assets as above	Depending on the underlying assets as above
Physical assets pledged in accordance with section 3.1.7(d)	All	>=30	>=30

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

(b) *Internal haircuts*

196. Subject to obtaining the approval from its supervisory authority, an IIFS may use its own estimate of haircuts to measure market price and foreign exchange volatilities. Such approval will normally require the fulfilling of certain qualitative and quantitative<sup>67</sup> criteria set by the supervisory authority, *inter alia*:

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

### 3.1.10 Maturity Mismatch

197. A maturity mismatch is a situation where the residual maturity of the CRM is less than that of the underlying credit exposure. In the case of a maturity mismatch with the CRM having a maturity of less than one year, the CRM will not be recognised. This means that a CRM with a maturity mismatch will only be permitted where its maturity is at least one year. Only the comprehensive approach shall be used for CRM with maturity mismatches. In addition, a CRM having a residual maturity of three months or less, with a maturity mismatch, will not be recognised for capital adequacy purposes.

198. The following adjustment will be applied for a CRM with a maturity mismatch:

$P_a = P \times (t - 0.25) / (T - 0.25)$ , where:

$P_a$  = adjusted value of risk mitigation

$P$  = value of risk mitigation used (e.g. collateral or guarantee amount)

$T$  = min (5, residual maturity of the exposure) in years

$t$  = min (T, residual maturity of the risk mitigation) in years

### 3.1.11 Credit Risk Mitigation for *Muḍārabah* Classified as Equity Exposures

199. A placement of funds made under a *Muḍārabah* contract may be subject to a *Sharī'ah*-compliant guarantee from a third party. Such a guarantee relates only to the *Muḍārabah* capital, not to the return.

<sup>67</sup> For quantitative criteria, a 99<sup>th</sup> percentile, one-tailed confidence interval should be used, with a minimum one-year historical observation period. The minimum holding period will be dependent on the type of transaction and the frequency of marking to market. The holding period should also consider the illiquidity of the lower-quality assets. The haircuts must be computed at least every three months. In case of higher price volatility, supervisory authorities may require a shorter observation period.

In such cases, the capital should be treated as subject to credit risk with a risk-weighting equal to that of the guarantor provided that the RW of that guarantor is lower than the RW of the *Muḍārib* as a counterparty. Otherwise, the RW of the *Muḍārib* shall apply; that is, a RW for "equity exposure in banking book" shall apply, as per [section 3.1.3](#).

200. In a *Muḍārabah* investment in project finance, collateralisation of the progress payments made by the ultimate customers (e.g. by means of a "repayment account" – see [section 3.1.3.4](#)) can be used to mitigate the exposure to unsatisfactory performance by the *Muḍārib*.

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

### **3.1.12 Treatment of an Exposure Covered by Multiple CRM Techniques**

202. If an exposure is covered by multiple CRM techniques (e.g. an exposure partially covered by both collateral and a guarantee), the IIFS shall segregate the exposure into segments covered by each type of CRM technique. The calculation of risk-weighted assets will be made separately for each segment. Similarly, if a single CRM has differing maturities, they should also be segregated into separate segments.

### **3.1.13 Recognition of Ratings by ECAI**

203. IFSB GN-1 (*Guidance Note on Recognition of Ratings by ECAs on Sharī'ah-Compliant Financial Instruments*) outlined criteria recommended to national supervisors for consideration when approving ECAs for rating Sharī'ah-compliant financial instruments. These ratings are to be used by IIFS for calculating capital requirements under the standardised approach.

204. IFSB GN-1 asserts that rating analysis of Sharī'ah-compliant assets may differ from analysis of conventional assets, both in terms of the general principles that govern Sharī'ah-compliant finance (e.g. the concept of default) and of the features of specific financial instruments (e.g. the concept of DCR when dealing with returns on investment accounts that are based on a *Muḍārabah* contract). It notes that the principal areas where Sharī'ah-compliant finance may differ from conventional finance include, *inter alia*: (a) different meanings of ratings and the concept of default; (b) priority of claims; (c) corporate governance and the role of the Sharī'ah board; (d) risk mitigation techniques to cater for DCR; (e) definition of capital; (f) trading in *Sukūk* which in most jurisdictions does not involve trading in debt (unlike conventional bonds); (g) asset valuations; and (h) loss given default.

205. Supervisory authorities shall be responsible for recognising and determining on a continuous basis whether an ECAI meets the criteria for recognition as per IFSB GN-1. The assessments of ECAs may be recognised on a limited basis – for example, by type of claims or by jurisdiction. The supervisory process for recognising ECAs should be transparent, with requisite information about it being publicly available.

206. In addition to the guidance provided by IFSB GN-1, the following criteria should be considered by supervisory authorities for recognition of eligible ECAs in relation to Sharī'ah-compliant instruments and financial institutions.

(a) *Objectivity*: An ECAI should have a rigorous and systematic methodology for assessing credit exposure of the IIFS, with appropriate validation procedures. Such assessments should reflect related developments that can impact the underlying risk exposure and should be subject to review as and when necessary. The assessment methodology should have been established for more than one year, before being recognised by supervisory authorities.

(b) *Independence*: An ECAI should be independent and ensure that it is not influenced by any political, economic or regulatory considerations while performing the rating assignments. It must also avoid conflicts of interest with the board of directors, shareholders, senior management and other employees of the rated institution.

(c) *International access/transparency*: Apart from private assessments, an ECAI should make publicly available its procedures, methodologies, key assumptions and important elements used in the assessment process. It should publish its ratings in an accessible form.<sup>68</sup> In addition to the loss and cash-flow analysis, it should make publicly available the sensitivity of its ratings to changes in related assumptions.

(d) *Disclosure*: An ECAI should disclose the information related to: (i) its code of conduct; (ii) assessment methodologies; (iii) definition of default; (iv) priority of claims; (v) meaning of each rating; (vi) actual default rates experienced in each assessment category; (vii) transition trends; (viii) approach to incorporate DCR in assessment methodology; and (ix) considerations for *Sharī'ah* compliance. It should also disclose, where appropriate, the difference in methodology for assessing similar types of instruments and exposure in conventional financial institutions – for example, points of differentiation between ratings of conventional and Islamic securitisation, asset-based and asset-backed *Sukūk*, etc.

(e) *Resources*: An ECAI should demonstrate that they have sufficient resources to conduct high-quality analysis, both when assigning ratings for the first time and when maintaining ratings after they have been assigned. It should demonstrate that its analysts have expertise that is relevant to the sectors covered by the agency. It should establish that it has the financial resources to remain in business over the time horizon of its ratings.

(f) *Credibility*: Meeting the above criteria will help an ECAI to achieve credibility among the users of its ratings, including, *inter alia*, the investors, customers, supervisors, financial institutions and the media. An ECAI should have internal procedures that preclude the misuse of confidential information by its analysts and other staff. However, it is not essential for an ECAI to assess institutions in more than one jurisdiction to establish its credibility and be eligible for recognition by the supervisory authority.

207. IIFS should use the ratings provided by the selected ECAI on a consistent basis for the purpose of their risk management and capital adequacy (i.e. risk-weighting) calculations. IIFS shall not use the ratings provided by different ECAs on an arbitrary basis, and any use of ratings from more than one ECAI must receive the approval of the applicable supervisory authority. Normally, IIFS should use the ratings provided by the chosen ECAs at the request of the rated institution (i.e. solicited ratings). Supervisory authorities may allow, at their discretion, the use of an unsolicited rating from another ECAI, provided they are satisfied that the unsolicited rating is just as robust and reliable as the solicited rating. For guidance on ECAI ratings related to securitisation exposures of IIFS, see [section 5.8](#).

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<sup>68</sup> This means that ratings that are made available only to the parties to a transaction do not meet "transparency" requirements outlined in this Standard.

## 3.2 Market Risk

### 3.2.1 Introduction

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

- (a) equity position risk in the trading book;<sup>69</sup>
- (b) benchmark risk in trading positions in *Sukūk*;
- (c) foreign exchange risk; and
- (d) commodities and inventory risk.

209. The market risk capital charge on an equity position in the trading book and trading positions in *Sukūk* should be applied to trading book items based on the guidance provided in the paragraphs below. For the foreign exchange, commodities and inventories risks, market risk will apply to the trading book positions at IIFS level.

210. A trading book consists of positions in equity instruments, *Sukūk*, foreign exchange, as well as commodities and inventories held for the purpose of trading by an IIFS. It can also include exposures of an IIFS held to hedge its trading positions, on the basis of *Sharī'ah*-compliant contracts. Only those instruments which are free of any restrictions on their tradability will be eligible for trading book capital treatment. Further, the trading positions should be actively managed and a frequent and accurate valuation of the trading positions should be made.

211. Trading positions are defined as those positions of an IIFS that are held for short-term resale and/or with the intent of benefiting from actual or expected short-term price movements or to lock in arbitrage profits. An IIFS should have clearly outlined policies and procedures for including or not including any position in the trading book. Such policies should be commensurate with the IIFS's capabilities and capacities for risk management. The IIFS should have a well-documented procedure to comply with stated policies and procedures, which should be subject to periodic internal audit.

### 3.2.2 Policies and Procedures

212. The policies and procedures of the IIFS to include an instrument or position in the trading book should address the following considerations, at a minimum:

- (a) the types of activities the IIFS considers to be part of its trading book activities for capital adequacy purposes;
- (b) the extent to which an exposure can be marked-to-market on a daily basis;
- (c) if not marked-to-market, the extent to which an exposure can be marked-to-model, with clearly defined criteria (see [next section](#) for details);
- (d) how far the IIFS can have access to reliable valuations for the exposure that can be validated by external parties, in a coherent manner;
- (e) the legal, regulatory or operational restrictions on immediate liquidation of the exposure, if any;
- (f) the capacity and systems of the IIFS to manage its risk relating to trading positions; and
- (g) the criteria for and extent of transferring risk and exposures between the banking and trading positions of the IIFS.

213. In order for an IIFS to include any instrument or position in the trading book for capital treatment, some minimum requirements should be fulfilled. These requirements include: (a) a clearly documented trading strategy, approved by senior management, for relevant positions, instruments or portfolios; and (b) well-defined policies and procedures for the active management, reporting and monitoring of the trading positions.

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<sup>69</sup> An equity position treated under "equity exposures in the banking book" is dealt with under the credit risk, as set out in [section 3.1.3](#).

214. All other exposures that are not defined as trading book positions should be classified as banking book exposures. This will include both on- and off-balance sheet positions.

### **3.2.3 Guidance on Valuation Practices**

215. IIFS should have adequate systems and controls for carrying out the valuation of positions in the trading book. In view of the less liquid positions of many *Sukūk* and equity positions held by IIFS, adhering to prudent valuation practices as set out in this sub-section is of vital importance. Less liquid positions, however, are not to be excluded from the trading book solely on the basis of lesser liquidity.

216. IIFS should have robust systems and controls, with documented policies and procedures for the valuation process. These systems should be integrated with the IIFS's enterprise risk management processes and should have the ability to give confidence to the supervisory authorities and management regarding the reliability of the valuations. These policies and procedures should include: (a) clearly defined responsibilities of the personnel and departments involved in the valuation; (b) sources of market information, and review of their reliability; (c) frequency of independent valuations; (d) timing of closing prices; (e) procedures for adjusting valuations between periods; (f) ad-hoc verification procedures; and (g) reporting lines for the valuation department that should be independent of the front office. Such policies and procedures should also take into consideration compliance with the relevant accounting standards and supervisory requirements.

217. IIFS may use either of the two following valuation methodologies in order of preference: (a) mark-to-market; and (b) mark-to-model, subject to the approval of the supervisory authority. Mark-to-market valuation requires daily valuation of positions based on independently sourced current market prices.

218. In the case where an IIFS is unable to mark-to-market its positions as a result of certain limitations on the reliability of price estimates owing to low volume and number of transactions or in distressed market conditions, it can use mark-to-model for the valuation of its trading positions provided it is established that the market for an asset is inactive or that a transaction on which a valuation might have been based is a distressed transaction, so that no reliable fair value estimate is possible. In order to verify that the market for an asset is inactive, an IIFS should establish that there is a lack of recent transactions with sufficient frequency and volume, which could otherwise provide ongoing price information related to the assets to be valued (which may be *Sukūk* and/or other *Sharī'ah*-compliant instruments). The IIFS should also verify that price quotations available in the market are not up-to-date and have large variations over time. The prices should demonstrate a significant premium related to liquidity risk underlying the instruments. The IIFS should also confirm that the bid–ask spread has become abnormally wide or has been fluctuating over time, and that quoted prices available in the market are not related to any stressed market conditions.

219. After the verification of the aforementioned points, an IIFS may use the mark-to-model technique for estimating the value of assets. Mark-to-market valuation methodology is benchmarked, extrapolated or otherwise calculated from a market input. Such calculations should be performed while taking a conservative approach. Senior management should be aware of trading book exposures that are calculated using mark-to-model and should understand the impact of using this technique on reporting the risk and performance of the IIFS. To the extent possible, any market inputs used should reflect market prices. For particular products, generally accepted valuation methodologies should be used. Internally developed models should be subject to verification and testing of assumptions, calculation methods and software implementation by independent parties.<sup>70</sup> Those responsible for risk management should be aware of any weaknesses of the models used. The models should be reviewed periodically in order to verify the accuracy of their performance. To cover the uncertainties of mark-to-model valuation, valuation adjustments should be made as appropriate. IIFS should also have an arrangement for independent verification of market prices or model inputs for accuracy. Such verification should be made at least monthly. When pricing sources are few or limited, valuation adjustments or other appropriate measures may be used by IIFS.

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<sup>70</sup> Useful guidance on "mark-to-model" and associated valuation issues may be obtained from the International Accounting Standards Board's "Fair Value Hierarchy", as set out in International Financial Reporting Standard 13: *Fair Value Measurement*, paragraphs 72–90.

### 3.2.4 Measuring Market Risk

220. As mentioned above, market risk calculation includes: (a) equity position risk in the trading book; (b) benchmark risk on trading positions in *Sukūk*; (c) foreign exchange risk; and (d) commodities and inventory risk. The calculation methodology for these risks is provided below. The total market risk capital charge, summed arithmetically, will be the overall measure of the market risks from the aforementioned sources.

#### 3.2.4.1 Equity position risk

221. The market risk capital charge for equity securities (including common shares and investments in Islamic collective investment schemes) in an IIFS's trading book comprises two components that are calculated separately as specified below:

(a) *Specific risk*

222. The capital charge for specific risk is 8% on all long equity positions which must be calculated on a security-to-security basis (for each national market).

(b) *General market risk*

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

#### 3.2.4.2 Benchmark risk in trading positions in *Sukūk*

224. In the case of benchmark risk in trading positions in *Sukūk*,<sup>71</sup> the capital charge comprises two components that are calculated separately as specified below:

(a) *Specific risk*

225. The capital charge for specific risk covers against an adverse movement in the price of a *Sukūk* held for trading due to factors related to an individual issuer. Offsetting is restricted only to matched positions in the identical issues. No offsetting will be permitted between different issues even if the issuer is the same, since differences in features of *Sukūk* with respect to profit rates, liquidity and call features, etc. would imply that prices may diverge in the short run.

The capital charge for specific risk will depend on the RW of the issue and the term to maturity of the *Sukūk*, as follows:

Categories*		Capital Charge
Government	AAA to AA- A+ to BBB-	0%
		0.25% (residual term to final maturity <= 6 months )
		1.00% (residual term to final maturity >6 and <= 24 months)
		1.60% (residual term to final maturity >24 months)
	BB+ to B- Below B- Unrated	8%
		12%
8%		
Investment grade <sup>72</sup>	0.25% (residual term to final maturity <= 6 months )	
	1% (residual term to final maturity >6 and <= 24 months)	
	1.60% (residual term to final maturity >24 months)	
BB+ to BB-	8%	
Below B-	12%	

<sup>71</sup> For the purpose of this section, the term "*Sukūk*" includes various forms of *Shari'ah*-compliant securities/certificates issued by the government. *Sukūk* or *Shari'ah*-compliant securities/certificates issued by local and regional governments may be subject to a zero risk weight, depending on national discretion.

<sup>72</sup> For example, rated Baa or higher by Moody's and BBB or higher by Standard & Poor's.

\*The supervisory authority has the discretion to apply a different specific RW to Sukūk issued by certain foreign governments/issuers.

(b) *General market risk*<sup>73</sup>

226. Subject to supervisory approval, the capital charge for general market risk can be calculated by either the “maturity” or the “duration” method.

(i) Maturity method

227. The capital charge for general market risk will depend on the residual term to maturity or to the next repricing date, using a simplified form of the maturity method on the net positions in each time band in accordance with the table below:

Residual Term to Maturity	RW
1 month or less	0.00%
1–3 months	0.20%
3–6 months	0.40%
6–12 months	0.70%
1–2 years	1.25%
2–3 years	1.75%
3–4 years	2.25%
4–5 years	2.75%
5–7 years	3.25%
7–10 years	3.75%
10–15 years	4.50%
15–20 years	5.25%
>20 years	6.00%

(ii) Duration method

228. At the supervisor’s discretion, IIFS with the necessary capability may use the more accurate “duration” method. This method calculates the price sensitivity of each position of *Sukūk* held separately. This method should be used consistently by an IIFS, unless a change is approved by the supervisory authority. The steps involved in the calculation using this method are as follows:

1. Calculate the price sensitivity of each *Sukūk* position (called “weighted positions”) in terms of a change in profit rates between 0.6 and 1 percentage points depending on the maturity of the *Sukūk* and subject to supervisory guidance (see Table 1).
2. Slot the resulting sensitivity measures into a duration-based ladder with 13 time bands as set out in Table 1.
3. Subject long positions in each time band to a 5% *vertical disallowance* on the smaller of offsetting positions (i.e. a matched position) in each time band.
4. From the results of the above calculations, two sets of weighted positions – the net long position in each time band – will be produced. The maturity ladder is then divided into three zones, as follows: zone 1, 0–1 year; zone 2, >1–4 years; and zone 3, >4 years. IIFS will be required to conduct two further rounds of offsetting: (i) between the net time band positions in each of the three zones; and (ii) between the net positions across the three different zones (i.e. between adjacent zones and non-adjacent zones). The residual net positions are then carried forward and offset against opposite positions in other zones when calculating net positions between zones 2 and 3, and 1 and 3. The offsetting will be subject to a scale of disallowances (*horizontal disallowances*) expressed as a fraction of matched position, subject to a second set of disallowance factors (Table 2).
5. The general market risk capital charge will be the aggregation of three charges: net position, vertical disallowances and horizontal disallowances (Table 3).

<sup>73</sup> The capital charge for “general market risk” captures the risk of loss arising from changes in benchmark profit rates.



**Table 1 Duration Method: Time Bands and Assumed Changes in Yield**

Zone	Time Band (Expected profit rate $\geq 3\%$ )	Time Band (Expected profit rate $< 3\%$ )	Assumed Change in Expected Yield (%)
Zone 1	1 month or less	1 month or less	1.00
	>1–3 months	>1–3 months	1.00
	>3–6 months	>3–6 months	1.00
	>6–12 months	>6–12 months	1.00
Zone 2	>1–2 years	>1.0–1.9 years	0.90
	>2–3 years	>1.9–2.8 years	0.80
	>3–4 years	>2.8–3.6 years	0.75
Zone 3	>4–5 years	>3.6–4.3 years	0.75
	>5–7 years	>4.3–5.7 years	0.70
	>7–10 years	>5.7–7.3 years	0.65
	>10–15 years	>7.3–9.3 years	0.60
	>15–20 years	>9.3–10.6 years	0.60
	>20 years	>10.6–12 years	0.60
		>12–20 years	0.60
		>20 years	0.60

**Table 2 Duration Method: Horizontal Disallowances**

Zone	Time Band	Within the Zone	Between Adjacent Zones	Between Zones 1 and 3
Zone 1	$\leq 1$ month	40%	40%	100%
	>1–3 months			
	>3–6 months			
	>6–12 months			
Zone 2	>1–2 years	30%	40%	
	>2–3 years			
	>3–4 years			
Zone 3	>4–5 years	30%	40%	
	>5–7 years			
	>7–10 years			
	>10–15 years			
	>15–20 years			
	>20 years			

**Table 3 General Risk Capital Charge Calculation**

The sum of:		
Net position	Net long weighted position	x 100%
Vertical disallowances	Matched weighted positions (i.e. the smaller of the absolute value of the short and long positions with each time band) in all maturity bands	x 10%
Horizontal disallowances	Matched weighted positions within Zone 1	x 40%
	Matched weighted positions within Zone 2	x 30%
	Matched weighted positions within Zone 3	x 30%
	Matched weighted positions between Zones 1 and 2	x 40%
	Matched weighted positions between Zones 2 and 3	x 40%
	Matched weighted positions between Zones 1 and 3	x 100%

229. In the case of equity investments made by means of a *Mushārah* or a *Muḍārah* contract where the underlying assets are commodities, the market risk provisions for commodities, as described in section 3.2.4.4, will be applicable.

### 3.2.4.3 Foreign exchange risk

230. The capital charge to cover the risk of holding or taking long positions in foreign currencies, and in gold and silver,<sup>74</sup> is calculated in two steps by measuring:

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

*Measuring an exposure in a single currency and an open position in a unilateral binding promise to buy or sell gold and silver*

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

- (a) net spot position (total assets less total liabilities including accrued profit in the currency in question);
- (b) net position of a binding unilateral promise<sup>75</sup> by the IIFS to buy and/or sell currencies on a specified future date (that are not included in the spot position);
- (c) guarantees and similar off-balance sheet instruments that are likely to be called and irrecoverable; and
- (d) any other items representing an exposure to risk in foreign currencies – for example, a specific provision held in the currency in question but the underlying asset is held in a different currency.

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

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

<sup>74</sup> Gold, silver and currency fall under foreign exchange risk in accordance with the *Sharī'ah* rules and principles that require the exchange of currencies to be made in an equal amount and on a spot basis. On the other hand, the Basel 1996 Market Risk Amendment (section A3) treats gold as being under foreign exchange risk and silver as being under commodity risk.

<sup>75</sup> A binding bilateral promise in an exchange of currencies is equivalent to a forward contract, which is prohibited by *Sharī'ah* jurists in most (but not all) countries as the delivery of one or both countervalues is deferred.

positions are merely to protect the IIFS's capital ratio.

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

#### *Measuring the foreign exchange risk in a portfolio*

235. An IIFS is allowed to use either a shorthand method or an internal models approach in calculating the risks inherent in its mix of long and short positions in different currencies. However, the shorthand method, as stated below, is recommended.

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

236. The capital charge is 8% on the overall net position as calculated above in paragraph 235(c).

237. The use of an internal models approach by an IIFS is subject to the supervisory authority's explicit approval and fulfilment of qualitative standards, specifications of market risk factors being captured into the IIFS's risk management system, quantitative standards, comprehensive stress testing programme, and validation of the models by external auditors and/or supervisory authorities.

#### **3.2.4.4 Commodities and inventory risk**

238. This section sets out the minimum capital requirements to cover the risks of holding or taking long positions in commodities, including precious metals but excluding gold and silver (which falls under foreign exchange risk as set out in [section 3.2.4.3](#)), as well as the inventory risk which results from IIFS holding assets with a view to reselling or leasing them. A commodity is defined as a physical product which is and can be traded on a secondary market – for example, agricultural products, minerals (including oil) and precious metals. Inventory risk is defined as arising from holding items in inventory either for resale under a *Murābahah* contract, or with a view to leasing under an *Ijarah* contract. In the case of inventory risk, the simplified approach described in paragraph 243 below should be applied.

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

240. Positions in different groups of commodities<sup>76</sup> cannot be offset except in the following instances:

- (a) The sub-categories of commodities are deliverable against each other.
- (b) The commodities represent close substitutes for each other.
- (c) A minimum correlation of 0.9 between the price movements of the commodities can be clearly established over a minimum period of one year<sup>77</sup> to the satisfaction of the supervisory authority. Netting of positions for different commodities is subject to the supervisory authorities' approval. Under the maturity ladder approach, the net positions are entered into seven time bands as set out below:

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<sup>76</sup> Commodities can be grouped into clans, families, sub-groups and individual commodities; for example, a clan might be Energy Commodities, within which Hydro-carbons is a family, with Crude Oil being a sub-group, and West Texas Intermediate, Arabian Light and Brent being individual commodities.

<sup>77</sup> While this Standard stops short of suggesting any maximum period for reviewing the adequacy of the data and to compute the correlation for similar types of commodity products, supervisory authorities may suggest a maximum period at their discretion. A longer period of observations allows the correction to be more stable but it may not reflect the volatile spread between similar commodity products in a short period of time especially during the stressed period.

	<b>Time Band</b>
1	0–1 month
2	1–3 months
3	3–6 months
4	6–12 months
5	1–2 years
6	2–3 years
7	>3 years

241. A separate maturity ladder is used for each type of commodity, while the physical stocks are allocated to the first time band. The capital charge is calculated as follows:

- (a) The sum of short and long positions that are matched is multiplied by the spot price for the commodity and then by the appropriate spread rate of 1.5% for each time band.
- (b) The residual or unmatched net positions from nearer time bands may be carried forward to offset exposures in a more distant time band, subject to a surcharge of 0.6% of the net position carried forward in respect of each time band that the net position is carried forward.
- (c) Any net position at the end of the carrying forward and offsetting will attract a capital charge of 15%.

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

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

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

245. The funding of a commodities position that exposes the IIFS to foreign exchange exposure is also subject to a capital charge as measured under the foreign exchange risk (refer to [section 3.2.4.3](#)).

### 3.3 Operational Risk

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

247. Operational risk in IIFS can be broadly divided into three categories:

(a) *General risks*: Such risks are consequential upon various kinds of banking operations conducted by IIFS that are common to all financial intermediaries.<sup>78</sup> Nevertheless, the asset-based nature of financing products in IIFS such as *Murābahah*, *Salam*, *Istisnā'* and *Ijārah* may give rise to additional forms of operational risk in contract drafting and execution that are specific to such products.

(b) *Sharī'ah non-compliance risk*: This is the risk of non-compliance resulting from the failure of an IIFS's *Sharī'ah* governance mechanism (systems and personnel) to ensure its compliance with *Sharī'ah* rules and principles as determined by its *Sharī'ah* board or other relevant body in the related jurisdiction. This risk can lead to non-recognition of an IIFS's income and resultant losses. The risk can take two broad forms in IIFS: (i) risks relating to potential non-compliance with *Sharī'ah* rules and principles in the IIFS' operations, including the risk of non-permissible income being recognised, when there is a failure in *Sharī'ah* compliance; and (ii) the risk associated with the IIFS's fiduciary responsibilities as *Mudārib* towards fund providers under the *Muḍārabah* form of contract, according to which, in the case of misconduct or negligence by the *Muḍārib*, the funds provided by the fund providers become a liability of the *Muḍārib*. *Sukūk* structures may also be exposed to *Sharī'ah* non-compliance risk which may adversely affect the marketability, and hence the value, of the *Sukūk*.

(c) *Legal risks*: Legal risk includes, but is not limited to, exposures to fines, penalties or punitive damages resulting from supervisory actions as well as private settlements. Such risk can arise from either: (i) the IIFS's operations – that is, from legal risks common to all financial intermediaries; or (ii) problems of legal uncertainty in interpreting and enforcing contracts based on *Sharī'ah* rules and principles. Legal risks also include the risk that a *Sukūk* structure in which an IIFS is originator, sponsor, manager or investor fails to perform as intended because of some legal deficiency. The current section is concerned, not with exposures to legal risk as a *Sukūk* investor, but with potential losses due to exposures to legal risk as originator, sponsor or manager.

248. The proposed measurement of capital to cater for operational risk in IIFS may be based on the following two approaches, which are in a continuum of increasing sophistication and risk sensitivity:

- (a) the basic indicator approach (BIA); and
- (b) (i) the standardised approach (TSA); or (ii) the alternative standardised approach (ASA).

As the point of entry for capital calculation, IIFS adopting the BIA are required to adopt international best practices on the management of operational risk.<sup>79</sup> However, to adopt TSA/ASA, an IIFS will be required to satisfy the supervisory authority that it has achieved sound implementation of operational risk and *Sharī'ah* non-compliance risk management framework and processes, and has adhered to the business line mapping principles, *inter alia*. Supervisory authorities may specify detailed qualifying criteria for TSA/ASA.

249. IIFS that adopt standardised approaches (TSA or ASA) will not be allowed to revert to the simpler approach (BIA) without the prior approval of their supervisory authority. However, supervisory authorities, at their discretion, may require an IIFS to use a simpler approach for some or all of the operations in

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<sup>78</sup> Though operational risk related to the banking operations of IIFS can be considered similar to that of conventional banks in many respects, the characteristics of such risk may be different in IIFS in certain cases – for example: (i) *Sharī'ah*-compliant products may involve processing steps distinct from those of their conventional counterparts; (ii) IIFS typically hold different types of assets on their balance sheets compared to conventional banks – for example, physical assets or real estate; and (iii) IIFS may encounter varied risk related to information technology products and systems due to the requirements of *Sharī'ah* compliance.

<sup>79</sup> Among others, the IIFS can refer to the Principles for the Sound Management of Operational Risk, issued by the BCBS in June 2011.

case they are not satisfied with an IIFS as regards meeting the criteria for a more sophisticated approach. Afterwards, the IIFS shall not be allowed to revert to the more advanced approach without the prior approval of their supervisory authority.

250. A financial institution with Islamic banking operations in the form of Islamic windows shall be required to calculate the operational risk capital charge for its conventional and Islamic banking operations separately. Thus the total operational risk capital charge of such an institution will be the sum of the operational risk capital charges for its conventional and Islamic banking operations.

### 3.3.1 The Basic Indicator Approach

251. The BIA uses gross income as a proxy measure of exposure for operation risk of the IIFS. Under this approach, the capital charge of an IIFS is equal to the average of a fixed percentage of 15% of positive annual gross income over the previous three years.

252. For calculation of gross income, figures are categorised into 12 quarters – that is, equivalent to three years. Recent annual gross income is calculated by aggregating the gross income of the last four financial quarters. In a similar manner, aggregation will take place for the next two years, preceding the most recent year. If the annual gross income for any given year is negative or zero, the figure is excluded from both the numerator and the denominator when calculating the three-year average.<sup>80</sup> For the calculation of the operational capital charge under the BIA, the charge may be expressed as the following formula:

$$K_{BIA} = [\sum (GI_{1...n} \times \alpha)] / n$$

Where:

$K_{BIA}$  = the capital charge under the BIA

GI = annual gross income, where positive, over the previous three years

N = number of the previous three years for which gross income is positive

$\alpha$  = a fixed percentage of 15% of required capital

253. Gross income is defined as:

(a) *Net income from financing activities*, which is gross of:

- any provisions;
- any operating expenses; and
- depreciation of *Ijārah* assets.

(b) *Net income from investment activities*. This includes the IIFS's share of profit from *Mushārah* and *Muḍārah* financing activities.

(c) *Fee income (e.g. commission and agency fee)*.

Less:

(d) Share of income attributable to investment account holders and other account holders.

254. The gross income includes income attributable to restricted and unrestricted PSIA funds, but excludes extraordinary or exceptional income from *Takāful* activities, and realised profits/losses from the sale of *Sukūk* in the banking book.

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<sup>80</sup> For newly established IIFS with less than three years of data, the new entity shall use any actual gross income earned to date for the purpose of deriving the average gross income, while leaving the gross income for any remaining quarters as zero.

### 3.3.2 The Standardised Approach

255. Under TSA, the activities of an IIFS are divided into eight lines of business (LOBs). Within each LOB, gross income serves as a proxy for the likely operational risk exposure attributable to that particular business line. The total operational risk capital charge is calculated as the three-year average of the simple addition of the capital charges across the eight LOBs in each year. The capital charge for each LOB is calculated by multiplying the annual gross income by the applicable percentage factor assigned to that business line. This percentage factor varies, according to the LOB, from 12% to 18%, being 18% for corporate finance, trading and sales, and payment and settlement, to 15% for commercial banking and agency services, and 12% for retail banking, asset management and retail brokerage. A negative capital charge in any year (resulting from negative gross income) for one LOB is offset against the positive capital charges for the other LOBs in that year. However, in case the aggregate operational risk capital charge across the eight business lines results in a negative figure, the operational risk capital charge for that year (i.e. the input for the year to the three-year calculation) is set at zero. The total capital charge under TSA may be expressed as the following formula:

$$K_{TSA} = \{\sum_{\text{years } 1-3} \max [\sum GI_{1-8} \times \beta_{1-8}, 0]\} / 3$$

Where:

$K_{TSA}$  = the capital charge under TSA

$GI_{1-8}$  = annual gross income in a given year, as defined in paragraph 252 in the BIA, for each of the eight business lines

$\beta_{1-8}$  = a fixed percentage, relating the level of required capital to the level of the gross income from each of the eight business lines.

256. IFSB studies have shown that in most IIFS, common LOBs for calculation of operational risk capital charges are retail banking, commercial banking, corporate finance, trading and sales, and asset management.<sup>81</sup> Although supervisory authorities in most jurisdictions have generally stipulated the same percentage factors for various LOBs as mentioned in the previous paragraph, they may, at their discretion, lay down different *percentage factors* based on the operational risk loss data<sup>82</sup> available for IIFS in their jurisdictions. Further, taking account of the nature of the business operations of the IIFS in their jurisdictions, supervisory authorities may define additional business lines and associated percentage factors for application to these IIFS.

### 3.3.3 The Alternative Standardised Approach

257. IIFS may use ASA as an alternative to TSA, subject to supervisory approval. Before granting such approval, supervisory authorities should be satisfied that ASA provides an improved operational risk measure over TSA. Once the IIFS is allowed to adopt ASA, it is not allowed to revert to TSA without the approval of its supervisory authority.

258. Under ASA, the operational risk capital charge is calculated in the same way as under TSA, except for two business lines – that is, retail banking and commercial banking. For these two business lines, instead of using relevant gross income, the amount of financing in each LOB is multiplied by a fixed factor of 0.035 to obtain the indicator of exposure. The resultant figures for these two business lines and gross income for other six business lines are then multiplied by the same *percentage factors* mentioned in section 3.3.2. As with TSA, the total capital charge for the ASA is calculated as the aggregate of the regulatory capital charges across the eight LOBs. Capital charge for retail banking (with similar formula for commercial banking) under the ASA may be expressed as the following formula:

$$K_{RB} = \beta_{RB} \times m \times F_{RB}$$

<sup>81</sup> Business lines such as payment and settlement, agency services and retail brokerage are present in a relatively smaller number of IIFS.

<sup>82</sup> Supervisory authorities should encourage IIFS to collect operational risk loss data so that it can enable the IIFS's management to identify potential areas of vulnerability and improve the risk profile in various LOBs.

Where:

$K_{RB}$  = capital charge for the retail banking business line

$\beta_{RB}$  = the beta for the retail banking business line (12%)

$F_{RB}$  = total outstanding retail financing (non-risk-weighted and gross of provisions) averaged over the past three years

$m$  = as mentioned in paragraph 258,  $m$  is a fixed factor = 0.035

259. The total financing in the retail banking business consists of the total drawn amounts in the following financing portfolios: retail and small and medium enterprises (SMEs) treated as retail, including non-performing financing (NPF). The total financing in the commercial banking business consists of the total drawn amounts in the following financing portfolios: corporate, sovereign, IIFS, specialised financing, and SMEs treated as corporate, including NPF. The total of commercial financing should also include the book value of *Sukūk* held in the banking book. The outstanding amounts of both retail and commercial financing portfolios should be non-risk-weighted and gross of both general and specific provisions. These amounts should be averaged over the past three years – that is, over the 12 most recent quarters.

260. IIFS are also allowed to aggregate retail and commercial banking under the ASA. In that case, the applicable *percentage factor* of 15% shall be used (instead of 12% for retail banking and 15% for commercial banking, as specified in [section 3.3.2](#)). Similarly, IIFS are allowed to aggregate the total gross income for the other six business lines, in case they are unable to compute separately the gross income for these business lines. The applicable *percentage factor* for this aggregation shall be 18%. Negative gross income shall be treated as explained in [section 3.3.2](#).

### 3.3.3.1 Mapping of business lines under the standardised approach

261. IIFS which have separately identifiable business activities of material size should use the following principles for mapping these activities into some or all of the eight business lines mentioned above.

- (a) The IIFS should map all their activities into the eight business lines in a mutually exclusive manner, without leaving any significant activity.
- (b) Any ancillary function of the IIFS, which represents its banking or non-banking activity but cannot be readily mapped into a unique business line, should be assigned to the business line it supports. If the ancillary function supports more than one business line, the IIFS should define objective criteria to carry out the mapping.
- (c) When mapping gross income, if an activity cannot be mapped into a particular business line then the business line yielding the highest charge must be used. The same business line equally applies to any associated ancillary activity.
- (d) Banks may use internal pricing methods to allocate gross income between business lines provided that total gross income for the bank (as would be recorded under the BIA) still equals the sum of gross income for the eight business lines.
- (e) The mapping of activities into business lines for operational risk capital purposes must be consistent with the definitions of business lines used for regulatory capital calculations in other risk categories – that is, credit and market risk. Any deviations from this principle must be clearly motivated and documented.
- (f) The mapping process used must be clearly documented. In particular, written business line definitions must be clear and detailed enough to allow third parties to replicate the business line



mapping. Documentation must, among other things, clearly motivate any exceptions or overrides and be kept on record.

- (g) Processes must be in place to define the mapping of any new activities or products.
- (h) Senior management is responsible for the mapping policy (which is subject to the approval by the board of directors).
- (i) The mapping process to business lines must be subject to independent review.

### 3.3.3.2 Qualifying criteria

262. Use of the standardised approaches is subject to the qualifying criteria set out in IFSB Revised Standard on Supervisory Review Process.

### 3.3.4 *Sharī'ah* Non-compliance Risk

263. In line with paragraph 247(b), set out below are examples of *Sharī'ah* requirements that are to be complied with by IIFS in respect of their financing contracts. The list is not conclusive and may vary according to the views of different *Sharī'ah* boards:

#### (a) *Murābahah and Ijārah contracts*

- (i) The asset is in existence at the time of sale or lease or, in the case of *Ijārah*, the lease contract should be preceded by acquisition of the usufruct of that asset, except if the asset was agreed upon based on a general specification.
- (ii) The asset is in the legal and constructive possession of the IIFS when it is offered for sale or lease.
- (iii) The asset is intended to be used by the buyer/lessee for activities or businesses permissible by *Sharī'ah*; if the asset is leased back to its owner in the first lease period, it should not lead to a contract of *'inah*.
- (iv) There is no late payment penalty fee or increase in price in exchange for extending or rescheduling the date of payment of accounts receivable or lease receivable, irrespective of whether the debtor is solvent or insolvent.

#### (b) *Salam and Istisnā' contracts*

- (i) Sale and purchase contracts cannot be interdependent and interconditional on each other, such as *Salam* and parallel *Salam*, or *Istisnā'* and parallel *Istisnā'*.
- (ii) It is not permitted to stipulate a penalty clause in respect of delay in delivery of a commodity that is purchased under a *Salam* contract; however, it is allowed under *Istisnā'* or parallel *Istisnā'*.
- (iii) As with *Salam*, an essential characteristic of an *Istisnā'* contract is that the subject matter does not, and is not required to, exist physically when the parties enter into the contract.

#### (c) *Mushārahah and Muḍārahah contracts*

- (i) The capital of the IIFS is to be invested in *Sharī'ah*-compliant investments or business activities.
- (ii) A partner in *Mushārahah* cannot guarantee the capital of another partner, nor may a *Muḍārib* guarantee the capital of the *Muḍārahah*.
- (iii) The purchase price of another partner's share in a *Mushārahah* with a binding promise to purchase can only be set as per the market value or as per an agreement entered into at the date of contracting. It is not permissible, however, to stipulate that the share be acquired at its nominal value based on the capital originally contributed.

### 3.3.5 Operational Risk Features of Sharī'ah-Compliant Modes of Financing and Investment

264. As explained in paragraph 247, operational risk in IIFS may be classified into various categories including general operational risk, *Sharī'ah* non-compliance risk and legal risk. In the previous paragraph, certain minimum *Sharī'ah* requirements for various modes of financing are set out, non-compliance with which can lead to operational risk for IIFS. In the following paragraphs, an explanation of unique operational risks faced by IIFS in commonly used *Sharī'ah*-compliant modes of financing and investment is provided, in addition to the points mentioned in earlier paragraphs. It must be emphasised that any lack of precision in contract documentation entails operational risk.

265. *Murābahah*: In addition to credit risk exposures, IIFS can face the following types of operational risk relating to *Murābahah* financing:

- (a) At the time of signing the *Murābahah* contract, it is required that an IIFS should purchase the asset and have it in its legal or constructive possession before selling it to the customer. Therefore, the IIFS needs to ensure that the legal characteristics of the contract properly match the commercial intent of the transactions.
- (b) If the *Murābahah* customer acts as the agent of the IIFS for purchasing the underlying asset, title of the asset must first pass to the IIFS and not directly to the customer.

266. *Salam*: When an IIFS purchases the commodity from the customer against advanced payment, the following type of operational risks may arise:

- (a) If the underlying goods are agricultural commodities, and the goods delivered are of an inferior quality to that specified in the contract, the IIFS as a buyer must either reject the goods, or accept them at the originally agreed price. In the latter case, the IIFS would have to sell the goods at a lower price than would have been obtained for those specified in the contract. [In case of a parallel *Salam*, however, the buyer of the commodity from the IIFS may (but is not obliged to) agree to accept the goods at the contract price. In such a case, IIFS does not suffer any loss of profit.]
- (b) The underlying goods may be delivered early by the customer, before the agreed date. If the goods delivered meet the contract specifications, the IIFS as buyer normally has to accept the goods before the agreed delivery date. This may result in additional cost for the IIFS, such as storage, *Takāful* cover, or even deterioration of the goods if they are perishable in nature, before the goods are resold.
- (c) In the case of parallel *Salam*, if the goods cannot be delivered to the parallel *Salam* buyer – due to either late delivery by the *Salam* seller (the customer) or delay by the IIFS itself – the IIFS may face legal risk, unless the parallel *Salam* buyer agrees to modify the delivery date of the goods involved.

267. *Istisnā*: In the case of *Istisnā* with parallel *Istisnā*, the IIFS contracts to deliver a constructed or manufactured asset and enters into a contract with a sub-contractor in order to get the asset constructed or manufactured. The reliance of the IIFS on the sub-contractor exposes it to various operational risks. These risks need to be managed by a combination of legal precautions, due diligence in choosing sub-contractors, and selection of suitably qualified consultants and staff for the execution of contract by the sub-contractor and, ultimately, delivery by the IIFS to the customer. Some operational risks related to *Istisnā* may include:

- (a) In case of late delivery by the sub-contractor, the IIFS may be unable to deliver the asset to the ultimate customer on the agreed date, and thus can be subject to payment of penalties for late delivery.
- (b) In case of cost overruns during the construction or manufacturing process (due to either increases in the prices of raw materials and manufacturing/production costs or delays by the sub-contractor, resulting in higher costs), additional costs may have to be absorbed wholly or partly by the IIFS, in the absence of an agreement in advance with the ultimate customer. If the sub-contractor fails to meet quality standards or other specifications agreed with the ultimate customer, the IIFS may face legal risk if no agreement is reached with the sub-contractor and the ultimate customer, either for remedying the defects or for reducing the contract price.

- (c) If the sub-contractor fails to complete the asset on time, the IIFS may have to find a replacement from the market. This is likely to result in additional costs for the IIFS.

268. *Ijārah and IMB*: In an operating *Ijārah* or an IMB contract, an IIFS as lessor may face the following types of operational risks during the period of lease:

- (a) The ultimate utilisation of the *Ijārah* asset should be *Shari-ah* compliant. Otherwise, the IIFS will be exposed to non-recognition of the *Ijārah* income as non-permissible. Further, the IIFS will be required to repossess the asset and find a new lessee.
- (b) If the lessee damages the assets in its possession, but refuses to pay for the damage, the IIFS will have to repossess the asset and take legal action to cover damages. This might involve operational and litigation costs.
- (c) In the event of severe damage or destruction of the asset, without any fault of the lessee, the IIFS as lessor is required to provide an alternative asset to the customer. If the asset is not insured, the IIFS will have to bear the cost of buying the new asset. Further, if the IIFS fails to provide the lessee with an alternative asset, the customer may terminate the *Ijārah* contract without paying the rental for the remaining duration of the contract.
- (d) In the event of any default or misconduct by the lessee, the IIFS may face legal risk in relation to the enforcement of its contractual right to repossess the asset.

269. *Mushārah*: In a *Mushārah* contract, the IIFS provides financing on the basis of profit- and loss-sharing. In such a contract, the following types of operational risk may arise:

- (a) The IIFS may fail to perform adequate due diligence on the customer or the financed venture.
- (b) During the period of investment, the IIFS may fail to monitor adequately the financial performance of the venture or may not be able to receive the required information from the customer.

270. *Muḍārah*: In a *Muḍārah* contract, the IIFS provides financing on the basis of a profit-sharing and loss-bearing contract. In such a contract, the following types of operational risk may arise:

- (a) In this contract, the IIFS's customer as *Muḍārib* is not required to bear any losses, in the absence of any negligence or misconduct on its part.<sup>83</sup> The customer is only required to act in a fiduciary capacity as the manager of the IIFS's funds. In the absence of the IIFS's right to control the management of the enterprise as provider of funds (*Rabb al-Māl*), the situation gives rise to moral hazard. Information asymmetry may exist due to the failure of the customer to provide regular, adequate and reliable information about the financial performance of the venture to the IIFS.
- (b) The IIFS may fail to perform adequate due diligence on the customer or the underlying venture.

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<sup>83</sup> A *Muḍārah* contract is a "partnership between work and capital". Therefore, the *Muḍārib*, who invests work but not capital, is exposed only to the loss of (fruitless) work.

### 3.4 Profit-Sharing Investment Accounts

271. This section deals with the capital requirement for assets financed by profit-sharing investment accounts, a pool of investment funds placed with an IIFS on the basis of *Muḍārabah*.

272. Based on the practices prevalent in the various jurisdictions, this section could equally be applicable to other forms of investment contracts, such as *Wakālah* or *Mushārah*. Where investment accounts are managed under a *Wakālah* contract, the relationship between the IIFS and the investors is a simple agency one, with the IIFS earning a flat fee (plus, in some cases, a performance-related component) rather than a share of profit. Supervisory authorities should use stringent eligibility criteria for including *Wakālah*- or *Mushārah*-based accounts in the definition of PSIA, based on the features and specificities of PSIA mentioned in this section. Supervisory authorities should also ensure that the provisions of this section are applied to *Wakālah*-<sup>84</sup> or *Mushārah*-based accounts in cases where there is no element of actual or constructive capital guarantee or promised returns given by the IIFS to the fund providers.

#### 3.4.1 Types and Nature of PSIA

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

- (a) unrestricted PSIA (UPSIA); and
- (b) restricted PSIA (RPSIA).

274. For UPSIA, IIFS have full discretionary power in making investment decisions, as such funds are provided by unrestricted investment account holders without specifying any restrictions as to where, how or for what purpose the funds should be invested, provided that they are *Sharī'ah* compliant. More often than not, the UIAH funds are “commingled” in an asset pool in which shareholders’ and current account holders’ funds (which are guaranteed by the IIFS) are also invested. UPSIA are expected to share in the overall risks of the jointly funded investments made by the IIFS. For RPSIA, on the other hand, the usage of funds by the IIFS is either subject to pre-specified investment criteria or is as agreed upon between the restricted investment account holders (RIAH) and the IIFS at the time of contracting. The RIAH share in the returns and bear the risks of an identified class of assets or a specified type of asset portfolio. Typically, IIFS do not commingle the shareholders’ funds or other funds at their disposal with those of RIAH funds.

275. In the case of both unrestricted and restricted PSIA, the IIFS assumes the role of economic agent or *Muḍārib* in placing such funds in income-producing assets or economic activities, and as such is entitled to a share (the *Muḍārib* share) in the profits (but not losses) earned on funds managed by it on behalf of the IAH, according to a pre-agreed ratio specified in the *Muḍārabah* contract. An important implication of the profit-sharing and loss-bearing nature of a *Muḍārabah* contract is that UPSIA, while normally appearing on the IIFS’s balance sheet, are not treated as liabilities of the IIFS. Accordingly, in the case of liquidation, UIAH have no claim as creditors over the assets of the IIFS (as do conventional depositors). Instead, they have a claim to the assets financed by their funds (together with their share of any undistributed profits, less any losses), including their proportionate share of assets financed by commingled funds.<sup>85</sup>

#### 3.4.2 Adjustment to the Capital Ratio Denominator

276. The capital amount of PSIA is not guaranteed by the IIFS due to the profit-sharing nature of the underlying *Muḍārabah* contract (or other similar contracts as per paragraph 272). Therefore, any losses

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<sup>84</sup> An IFSB survey has shown that, in certain cases, a *Wakālah*-based contract is constructed such that it has an element of fixed return and/or capital guarantee, which makes it closer to a deposit account than a PSIA.

<sup>85</sup> The UPSIA holders have an ownership claim as *Rabb al-Māl* to the net asset value of their funds, and in this respect do not rank *pari passu* with shareholders. Shareholders are, on the other hand, liable up to the amount of their capital in the IIFS for amounts deposited by current account holders and other creditors of the IIFS.

arising from investments or assets financed by PSIA are to be borne by the IAH. Nevertheless, IAH are not liable for any losses arising from the IIFS's negligence, misconduct, fraud or breach of its investment mandate, which is characterised as a fiduciary risk and considered part of the IIFS's operational risk.

277. In principle, assets financed by unrestricted or restricted PSIA do not represent risks for the IIFS's own (shareholders') capital and thus would not entail a regulatory capital requirement for the IIFS. This implies that assets funded by PSIA would be excluded from the calculation of the denominator of the capital adequacy ratio; that is, IIFS would not be required to hold regulatory capital in respect of risk arising from PSIA-funded assets.

278. In practice, however, an IIFS may be constructively obliged to smooth the profits payout to UIAH (and, where applicable, to RIAH) due to commercial pressure,<sup>86</sup> regulatory requirements<sup>87</sup> or management strategy<sup>88</sup> using various smoothing techniques (mentioned in [section 3.4.3](#)). A necessary consequence of some of these smoothing practices adopted by IIFS is that a portion of risk (i.e. volatility of the stream of profits) arising from assets managed on behalf of UIAH is effectively transferred to the IIFS's own capital, a phenomenon known as "displaced commercial risk". As a result of DCR (see [section 3.4.4](#) for an explanation), commercial risks of assets financed by UPSIA are considered to be borne proportionately by both the UIAH and the IIFS. Hence, instead of excluding all the assets funded by PSIA from the denominator of the CAR discussed in the previous paragraph to reflect DCR, a proportion of the RWA funded by UPSIA is required to be included in the denominator of the CAR. This portion of RWA is denoted by the Greek letter "alpha". The quantification and use of this alpha parameter in the CAR calculation are subject to supervisory discretion. (See [section 3.4.6](#) for a discussion of the calculation of alpha.)

### 3.4.3 Smoothing Practices

279. In order to mitigate withdrawal risk, IIFS resort to various smoothing techniques, depending upon various internal and regulatory considerations mentioned earlier. IIFS use these techniques alternatively to, and/or in combination with, other techniques listed below. These techniques may or may not transfer the risk of assets financed by PSIA funds to shareholders, as explained in the following:

- (a) *Adjusting the Muḍārib share:* An IIFS can smooth returns paid to IAH by temporarily reducing its *Muḍārib* share below the contractual share (which tends, in practice, to be set at a maximum level) and/or by otherwise assigning a lower profit share to shareholders, even if the IIFS is not contractually obliged to do so. However, this mechanism can only be used for income smoothing in the absence of losses, as investment losses on PSIA funds are to be borne by the IAH themselves, while the IIFS merely receives no share of profit as *Muḍārib*.
- (b) *Transferring from shareholders' funds:* IIFS management may (with the shareholders' approval) donate some portion of the shareholders' income to IAH on the basis of *Hibah*, so as to offer the latter a level of return close to the market benchmark level, when the overall investment returns of the IIFS are lower than the benchmark.
- (c) *Maintaining a profit equalisation reserve:* An IIFS may establish PER by setting aside amounts from the investment profits before allocation between the shareholders and the UIAH<sup>89</sup> and the calculation of the IIFS's *Muḍārib* share of profits. The components of the accumulated PER that are owned pro-rata by UIAH and the shareholders can be drawn down to smooth the profit payouts attributable to UIAH when investment returns decline.
- (d) *Establishing an investment risk reserve:* An IIFS may also maintain a reserve called IRR by setting aside amounts from the investment profits attributable to the UIAH, after deducting the IIFS's *Muḍārib* share of profits. The accumulated IRR, which belongs entirely to UIAH, can be used only

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<sup>86</sup> IIFS may face competitive pressures to pay IAH a market-related return to prevent withdrawal of funds by IAH.

<sup>87</sup> A supervisory authority may require the IIFS to maintain smoothing reserves and/or use other techniques to pay returns to IAH that take into account prevailing market rates. Supervisory authorities normally take these steps in order to reduce withdrawal risk by IAH in response to poorer-than-expected returns by IIFS, which, if unmitigated, can reach systemic proportions and be a cause of concern from a financial stability perspective.

<sup>88</sup> IIFS management may manage investment risks as well as expectations of IAH so that the extent of risk (i.e. the volatility of returns) that is retained by shareholders, and the amount of risk that is borne by IAH, is managed through a set of smoothing techniques, thereby maintaining the capital requirements of IIFS.

<sup>89</sup> In some countries, the appropriation of income is to be made after taking into consideration the tax effect.

to cushion any losses (negative asset returns) attributable to UIAH that might arise from time to time.

#### **3.4.4 Displaced Commercial Risk**

280. The term “displaced commercial risk” refers to the extent of additional risk borne by an IIFS’s shareholders (i.e its own capital) in comparison to the situation where the IAH assume all commercial risks associated with the assets financed by their funds. While in principle the IIFS has full discretion as to whether it performs this displacement of commercial risk, in practice it may find itself virtually obliged to do so due to various reasons mentioned in paragraph 278. The rate of return paid to the IAH (especially UIAH) is thus “smoothed” at the expense of the profits attributable to the IIFS’s shareholders. Such a situation would most often arise:

- (a) as a result of rate of return risk (otherwise referred to as "profit rate risk"), where the IAH’s funds are invested in assets such as *Murābahah* or *Ijārah* with a relatively long maturity and at a rate of return which no longer meets current market expectations. A lower rate of return on assets than that currently expected by the UIAH could result in the withdrawal of funds by them, exposing the IIFS to liquidity risk. In its efforts to limit these risks, an IIFS can employ smoothing techniques; or
- (b) in respect of other market risks (such as price risk) or credit risk when an IIFS wishes to protect its IAH from the effects of the poor overall performance of a portfolio of assets under its management (subject to the *Sharī’ah* prohibition of the *Muḍārib* making good an overall loss to the investor).

281. By using the PER, IIFS may maintain the profit payouts to UIAH at market-related levels when the actual asset returns are higher, by making appropriations to the PER. These appropriations may be reversed when actual asset returns are lower than market-related levels. In addition, appropriations to IRR can be made from the IAH share of profit, to be reversed when asset returns are negative. In case IIFS are able to manage the distribution of returns on UPSIA entirely through adjustments in PER without adjusting the *Muḍārib* share of profits and/or having any recourse to income transfer from shareholders (explained in section 3.4.3(a) and (b)), there will be no DCR, and no consequent requirement for the IIFS to support an additional capital charge.

282. The formulation of prudential reserves may not, however, entirely mitigate DCR. This is because of the limitations of PER and IRR themselves. Apart from corporate governance restraints on the setting up of these reserves, mentioned in detail in section 4.2 of IFSB GN-3, excess accumulation of PER and IRR may be constrained by supervisory authorities.<sup>90</sup> Further, the required magnitude of the displacement of risk from UIAH to shareholders by adjusting the *Muḍārib* share of profits and/or income transfer from shareholders to achieve a desired rate of return to UIAH depends upon the available level of PER, the market benchmark return, and the actual investment return of the IIFS. The relationship between the IIFS’s investment returns and the risk transfer to UIAH is expected to be negative, since the larger the investment return, the less is the need for transfer of risks from shareholders. The larger the negative correlation between these two, the greater is the DCR to which shareholders are exposed, and hence the larger is the capital requirement.

283. It should be noted that DCR does not relate to covering an overall loss attributable to UIAH by reallocating profit from shareholders, as *Sharī’ah* rules and principles do not permit this. IIFS should cover such losses by maintaining an IRR, and if the IRR balance is insufficient to cover the loss entirely, no further amounts may be transferred from the PER in order to made a profit payout to the IAH. However, if the balances of the PER and IRR are sufficient, this may permit the payment of targeted levels of return to UIAH even when actual asset returns are negative.

#### **3.4.5 Calculation of CAR**

284. It follows from the above that it may be appropriate for an IIFS to use either of the following formulas for calculation of its CAR, depending on the circumstances:

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<sup>90</sup> See paragraph 63 of IFSB GN-3.

- (a) *The standard formula:* In the absence of any smoothing of the profit payouts to IAH by an IIFS, the IIFS is not required to hold regulatory capital in respect of commercial (i.e. credit or market) risks arising from assets funded by PSIA. This implies that the RWAs funded by such accounts are excluded in respect of commercial risks in calculating the denominator of the CAR, leaving only operational risk. This is called the "standard formula" and is calculated as follows:

$$\frac{\text{Eligible Capital}}{\left\{ \begin{array}{l} \text{Total risk-weighted assets}^{91} (\text{Credit}^{92} + \text{Market}^{92} \text{ risks}) \text{ Plus: Operational risks} \\ \\ \text{Less:} \\ \\ \text{Risk-weighted assets funded by PSIA}^{93} (\text{Credit}^{92} + \text{Market}^{92} \text{ risks}) \end{array} \right\}}$$

- (b) *The supervisory discretion formula:* In jurisdictions where IIFS practise the type of income smoothing for IAH (mainly UIAH) that gives rise to DCR, the supervisory authority should require regulatory capital to be held to cater for DCR. In this approach, commercial risks of assets financed by UPSIA (i.e. the volatility of the returns excluding overall losses) are considered to be borne proportionately by both the UIAH and the IIFS. Hence, a proportion of the RWAs funded by UPSIA, denoted by the Greek letter "alpha", is required to be included in the denominator of the CAR, the permissible value of alpha being subject to supervisory discretion. A supervisory authority may also decide to extend this treatment to RPSIA. Such risk-sharing between PSIA and IIFS gives rise to a *supervisory discretion formula* that is applicable in jurisdictions where the supervisory authority takes the view that, in order to mitigate withdrawal risk and the attendant systemic risk, IIFS in the jurisdiction are permitted (or in some jurisdictions required) to smooth income to the IAHS. The CAR under this formula is calculated as follows:

$$\frac{\text{Eligible Capital}}{\left\{ \begin{array}{l} \text{Total risk-weighted assets (Credit}^{92} + \text{Market}^{92} \text{ risks) Plus: Operational risks} \\ \\ \text{Less:} \\ \\ \text{Risk-weighted assets funded by restricted PSIA}^{93} (\text{Credit}^{92} + \text{Market}^{92} \text{ risks) Less:} \\ (1 - \alpha)^{94} [\text{Risk-weighted assets funded by unrestricted PSIA}^{93} (\text{Credit}^{92} + \text{Market}^{92} \text{ risks) Less:} \\ \alpha [\text{Risk-weighted assets funded by PER and IRR of unrestricted PSIA}^{95} (\text{Credit}^{92} + \text{Market}^{92} \\ \text{risks)]] \end{array} \right\}}$$

<sup>91</sup> Total RWAs include those financed by both restricted and unrestricted PSIA.

<sup>92</sup> Credit and market risks for on- and off-balance sheet exposures.

<sup>93</sup> Where the funds are commingled, the RWAs funded by PSIA are calculated based on their pro-rata share of the relevant assets. PSIA balances include PER and IRR, or equivalent reserves.

<sup>94</sup> "Alpha ( $\alpha$ )" refers to the proportion of assets funded by unrestricted PSIA which is to be determined by the supervisory authorities. The value of  $\alpha$  would therefore vary, based on the supervisory authorities' discretion on a case-by-case basis.

<sup>95</sup> The relevant proportion of RWAs funded by the PSIA's share of PER and by IRR is deducted from the denominator. The PER has the effect of reducing the displaced commercial risk, and the IRR has the effect of reducing any future losses on the investment financed by the PSIA.

### 3.4.6 Determination of Alpha ( $\alpha$ )

285. Supervisory authorities should assess the extent of risks borne by PSIA and reflect these assessments in the computation of capital adequacy for IIFS in their jurisdiction. The main challenge facing IIFS and their supervisors in this connection is to assess the risk-sharing level between IIFS' own capital (shareholders' funds) and that of the IAH. As mentioned above, the proportion of RWAs that needs to be included in the CAR to cater for the transfer of risk from IAH to IIFS is denoted by "alpha". The supervisory assessment of how an IIFS manages the risk–return mix of PSIA would determine the alpha factor, with a value of alpha near zero reflecting an investment-like product with the investor bearing the commercial risk, while a value of alpha close to 1 would reflect a deposit-like product with the depositor effectively bearing virtually no commercial risk. PSIA could also be positioned anywhere along a continuum between these two cases, depending upon the extent of investment risks actually borne by the IAH.

286. The IFSB issued GN-4 (*Guidance Note on the Determination of Alpha in the CAR for IIFS*) in March 2011 which outlines a methodology to estimate the value of alpha to be used in the supervisory discretion formula in calculating the CAR of IIFS. It has also demonstrated how to measure the DCR – that is, the additional risk that IIFS shareholders may assume in order to cushion the returns payable to IAH against variations in asset returns. This GN has also endeavoured to provide an algebraic approach to the determination of DCR and alpha that can be used by supervisory authorities to decide the appropriate level of alpha for all or some of the IIFS in the jurisdiction. It has, however, cautioned that supervisory authorities need to require additional data in order to estimate the level of exposure to DCR and thereby arrive at reasonably accurate estimates of alpha. In this context, supervisory and regulatory authorities will need, in the first place, to determine data requirements for the calculation of DCR and alpha. This, in turn, may require assessing the existing accounting frameworks, and requirements in their jurisdictions for reporting and disclosure to the supervisor.

287. IFSB GN-4 provided guidance on a number of supervisory discretion issues when estimating the value of alpha for IIFS, looking at the DCR risk profile of the latter, at both institution and jurisdiction levels. It further cautioned that higher values of alpha may be applicable in jurisdictions where IAH tend to be highly protected by the governments and central banks for strategic reasons. In this context, it has been recommended that supervisory authorities should base their judgements on the actual legal status of PSIA in their jurisdictions (i.e. whether PSIA are *de jure* or *de facto* capital certain because of legal or regulatory/supervisory requirements, or are led to expect market-related returns, or are protected by *Shari'ah*-compliant deposit insurance in the jurisdiction).



## SECTION IV: CAPITAL REQUIREMENTS FOR ISLAMIC FINANCING AND INVESTMENT ASSETS

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

### 4.1 *Murābahah* and *Murābahah* for the Purchase Orderer

#### 4.1.1 Introduction

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

290. In *Murābahah* and MPO, the capital requirement for credit risk refers to the risk of a counterparty not paying the purchase price of an asset to the IIFS. In the case of market (price) risk, the capital requirement is applicable with respect to: (a) assets in the IIFS's possession which are available for sale either on the basis of *Murābahah* or MPO; and (b) assets which are in its possession due to the customer's non-performance of a promise to purchase (PP) in either non-binding or binding MPO.

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

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

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

#### 4.1.2 *Murābahah* and Non-binding MPO

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

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

#### 4.1.3 Binding MPO

296. In a binding MPO, the IIFS has no "long" position in the asset that is the subject of the transaction, as there is a binding obligation on the customer to take delivery of the asset at a pre-determined price. The IIFS is exposed to counterparty risk in the event that the orderer in a binding MPO does not honour his/her obligations under the PP, resulting in the IIFS having to dispose of the asset to a third party at a selling price which may be lower than the cost to the IIFS. Depending on the *Shari'ah* rulings that are applicable, the risk of selling at a loss may be mitigated by requiring the customer to deposit a *Hamish Jiddiyah* upon executing the PP, as commonly practised in the case of a binding MPO. The IIFS would have recourse to the customer for any shortfall in the HJ to compensate for the loss, and would be

obliged to refund to the customer any amount of the HJ in excess of the loss. The HJ may be treated, after the conclusion of *Murābahah*, as part of the payment of the agreed selling price under the *Murābahah* contract. Alternatively, the IIFS may take a down-payment (*Urbūn*) from the purchase orderer when signing the contract. This payment is retained by the IIFS if the purchase orderer fails to execute the contract, whereas on the execution of the contract the *Urbūn* is treated as a payment in advance.

#### **4.1.4 Collateralisation**

297. As one of the CRM techniques, the IIFS may secure a pledge of the sold asset or another tangible asset as collateral for the *Murābahah* receivable (“collateralised *Murābahah*”). Collateralisation is not automatically provided in a *Murābahah* contract but must be explicitly stated or must be documented in a separate security agreement at or before the time of signing the *Murābahah* contract.<sup>96</sup> The IIFS may employ other techniques such as pledge of deposits or PSIA or a third-party financial guarantee. The RW of a financial guarantor may be substituted for the RW of the purchaser provided that the guarantor has a better credit rating than the purchaser and that the guarantee is legally enforceable.

#### **4.1.5 Credit Risk**

##### **4.1.5.1 *Murābahah* and non-binding MPO**

298. The credit exposure of a *Murābahah* or MPO consists of the balance of the account receivable under the contract which is recorded at its cash-equivalent value – that is, the amount due from the customer at the end of the financial period less any provision for doubtful debts.

299. The account receivable (net of specific provisions) arising from a *Murābahah* sale shall be assigned a RW based on the credit standing of the obligor (purchaser or guarantor) as rated by an ECAI that is approved by the supervisory authority. In cases where the obligor is unrated, a RW of 100% shall apply.

##### **4.1.5.2 Binding MPO**

300. In a binding MPO, an IIFS is exposed to default on the purchase orderer’s obligation to purchase the asset in its possession. In the event of the orderer defaulting on its PP, the IIFS will dispose of the asset to a third party. The IIFS will have recourse to any HJ<sup>97</sup> paid by the orderer, and (a) may have a legal right to recoup from the orderer any loss on disposing of the asset, after taking account of the HJ; or (b) may have no such legal right. In both cases, this risk is mitigated by the asset in possession as well as any HJ paid by the purchase orderer.

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

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

303. In applying the treatment as set out in the previous paragraph, the IIFS shall ensure that the PP is properly documented and legally enforceable. In the absence of proper documentation and legal enforceability, the asset is to be treated as similar to a non-binding MPO which is exposed to price risk, where the measurement approach is as set out in [section 4.1.6.1](#).

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<sup>96</sup> In some jurisdictions, on foreclosure the obligations are deemed to be fully discharged, while in other jurisdictions the customer remains liable for any amount of the financing that is not repaid by the realisation of the pledged asset. This is true of collateralised financing generally, not just of collateralised *Murābahah* obligations. These differences affect the amount of the “loss given default”.

<sup>97</sup> The IIFS’s recourse to HJ should be within the limits of the actual loss, which is the difference between the actual cost and the sale price of the asset.

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

#### **4.1.5.3 Exclusions**

305. The capital requirement is to be calculated on the receivable amount, net of specific provisions, any amount that is secured by eligible collateral as defined in [section 3.1.8](#), and/or any amount that is past due by more than 90 days. The portions that are collateralised and past due are subject to the relevant RW as set out in [sections 3.1.9](#) and [3.1.5](#), respectively.

#### **4.1.5.4 Preferential RW**

306. Subject to meeting the minimum requirements as set out in [section 3.1.4](#), the RW of collateralised *Murābahah* may be given preferential RW as set out below for the following types of collateralised asset (see [section 3.1.4](#) for the eligibility criteria):

- (a) 75% for eligible retail customers or small businesses;
- (b) 35% for a *Murābahah* contract secured by eligible residential real estate unless otherwise determined by the supervisory authorities; or
- (c) 100% for a *Murābahah* contract secured by commercial real estate, or 50% in "exceptional circumstances" subject to eligibility criteria.

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

#### **4.1.6 Market Risk**

##### **4.1.6.1 *Murābahah* and non-binding MPO**

308. In the case of an asset in possession in a *Murābahah* transaction and an asset acquired specifically for resale to a customer in a non-binding MPO transaction, the asset would be treated as inventory of the IIFS and, using the simplified approach, the capital charge for such a market risk exposure would be 15% of the amount of the position (carrying value), which equates to a RW of 187.5% if the minimum capital requirement is 8%. The 15% capital charge is also applicable to assets held by an IIFS in respect of incomplete non-binding MPO transactions at the end of a financial period.

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

##### **4.1.6.2 Binding MPO**

310. In a binding MPO, the orderer has the obligation to purchase the asset at the agreed price, and the IIFS as the seller is not exposed to market risk in respect of the asset, but only to credit risk, as indicated in [section 4.1.5.2](#).

#### *Foreign exchange risk*

311. The funding of an asset purchase or the selling of an asset may well expose an IIFS to foreign exchange risk; therefore, the relevant positions should be included in the measures of foreign exchange risk described in [section 3.2.4.3](#).

#### 4.1.7 Summary of Capital Requirement at Various Stages of the Contract

312. The following tables set out the applicable stages of the contract and the applicable capital charges.

##### 4.1.7.1 *Murābahah* and non-binding MPO

Applicable Stage of the Contract		Credit RW	Market Risk Capital Charge
1	Asset available for sale (asset on balance sheet)*	Not applicable	15% capital charge (187.5% RW)
2	Asset is sold and title is transferred to a customer, and the selling price (accounts receivable) is due from the customer	Based on customer's rating or 100% RW for unrated customer (see <a href="#">section 4.1.5.1</a> )	Not applicable
3	Maturity of contract term or upon full settlement of the purchase price, whichever is earlier	Not applicable	Not applicable

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

##### 4.1.7.2 Binding MPO

Applicable Stage of the Contract		Credit RW**	Market Risk Capital Charge
1	Asset available for sale (asset on balance sheet)*	Asset acquisition cost less market value of asset as collateral (net of any haircut) less any HJ x 100% RW (see <a href="#">section 4.1.5.2</a> )	Not applicable
2	Asset is sold and delivered to a customer (accounts receivable is due from a customer)	Based on customer's rating or 100% RW for unrated customer (see <a href="#">section 4.1.5.2</a> , last paragraph)	Not applicable
3	Maturity of contract term or upon full settlement of the selling price, whichever is earlier	Not applicable	Not applicable

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

\*\*This credit RW is applicable only when IIFS will have recourse to any HJ or Urbūn paid by the customer, and (depending on the legal situation) in the case of HJ may have a right to recoup from the customer any loss on disposing of the asset, after taking account of the HJ. (This right does not exist in the case of Urbūn.)

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

## 4.2 Commodity *Murābahah* Transactions

### 4.2.1 Introduction

313. This section sets out the minimum capital requirements to cover the credit and market risks arising from financing contracts that are based on the *Sharī'ah* rules and principles of commodity *Murābahah* transactions, either in the interbank market or to other customers.

314. IIFS can be involved in CMT-based financing in the following forms:<sup>98</sup>

- (a) CMT for interbank operations for managing short-term liquidity surplus (i.e. selling and buying of *Sharī'ah*-compliant commodities through *Murābahah* transactions, which is commonly termed “placement” in conventional institutions) or where the counterparty is the central bank or monetary authority offering a *Sharī'ah*-compliant lender of last resort and/or a standing facility for effective liquidity management. Such placement/financing is referred to as “commodity *Murābahah* for liquid funds (CMLF)”.<sup>99</sup>
- (b) CMT for providing financing to a counterparty by a longer-term commodity *Murābahah* where the counterparty immediately sells the commodities on the spot market is referred to as “commodity *Murābahah* financing (CMF)”.

315. CMLF is a tool for liquidity management for IIFS in order for them to invest their surplus liquid funds on a short-term basis with other market players, within or outside the jurisdiction. In this type of transaction, the RW will be influenced by the credit standing of the counterparty receiving the funds and the duration of the placement.

### 4.2.2 Capital Requirements

316. Based on the general CMT structures, the transactions can pass through several important phases, each of which has different risk implications. Thus, an IIFS is exposed to different risks in different phases of the CMT. Consequently, it is crucial for IIFS to recognise and evaluate the overlapping nature and transformation of risks that exist between various types of risk. Since the dynamism of risk exposure through the phases of CMT is unique, IIFS should break down the contractual timeline for CMT while managing the risks in each phase.

317. An IIFS may be exposed to market risk through any fluctuation in the price of the underlying commodity that comes into its possession for a longer duration than normal – for example, when a customer refuses to honour his commitment to buy or when the agreement is non-binding. With CMLF and CMF on the asset side, market risk transforms into credit risk; that is, market risk is applicable before selling the commodities to the counterparty, while upon their being sold to the counterparty on deferred payment terms the market risk converts into credit risk. In view of the market practice relating to CMT whereby the commodities are sold instantaneously after being bought on the basis of a binding promise, there would be no market risk. On the other hand, if an IIFS holds title to the commodities for any length of time in the CMT transaction, a market risk exposure will be present. Placement of funds in currencies other than the local currency will also expose the IIFS to foreign exchange risk.

#### 4.2.2.1 Credit risk

318. As in both CMLF and CMF, a binding promise from the customer exists to purchase the commodity; an IIFS will be exposed to default on the customer's obligation to purchase. In the event of default by the customer, the IIFS will dispose of the asset to a third party; that is, the credit risk will be

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<sup>98</sup> Please see IFSB GN-2 (*Guidance Note on CMT*, issued in December 2010) for details on various risk management and capital adequacy aspects of CMT that can be conducted on both sides of the balance sheet.

<sup>99</sup> CMLF is also referred to as “commodity *Murābahah* investment” by some IIFS in the industry. Strictly speaking, *Murābahah* should not be classified as an investment, since in fact it is a type of receivable.

mitigated by the asset in possession as collateral, net of any haircut. The exposure shall be measured as the amount of the total acquisition cost to the IIFS for the purchase of commodities, less the market value of the commodities as collateral, subject to any haircut and specific provisions, if any. The RW of the counterparty shall be applicable to the resultant receivables,<sup>100</sup> and would be based on credit ratings issued by a recognised ECAI.<sup>101</sup> In the case of an unrated counterparty, the applicable RW will be 100%.

319. In applying the RWs outlined above, an IIFS should ensure that the contracts for the transactions are properly documented and legally enforceable in a court of law. In the absence of these features, the commodities will be exposed to market risk as set out in the following paragraph.

#### 4.2.2.2 Market risk

320. In the presence of a binding promise to purchase from the counterparty (section 4.2.2, paragraph 294) and legally enforceable contract documentation (above paragraph), no capital charge will be applicable for market risk. Otherwise, a capital charge for commodities risk will be applicable, and will be measured by using either the maturity ladder approach or the simplified approach as set out in sub-section 3.2.4.4.

321. In case the exposure is denominated in a foreign currency, a capital charge on the foreign currency exposure will be calculated as outlined in section 3.2.4.3.

#### 4.2.3 Summary of Capital Requirement

322. The following table delineates the applicable stage of the CMLF and CMF on the asset side and associated capital charges.

Applicable Stage of the Contract		Credit RW	Market Risk Capital Charge
1	Commodities on IIFS balance sheet for sale	Total acquisition cost to the IIFS for the purchase of commodities, less the market value of the commodities as collateral, subject to any haircut and specific provisions.	Not applicable*
2	Commodities sold and delivered to the customer	Based on counterparty's rating or 100% RW for unrated customer.	Not applicable

\*In the presence of a binding promise from the counterparty to purchase, and legally enforceable contract documentation, there will be no capital charge.

<sup>100</sup> In CMLF and CMF on the asset side, the IIFS will be exposed to market risk in the interval before it sells the commodities to the counterparty, and subsequently to credit risk (accounts receivable risk), which will be applicable after the IIFS sells those commodities to the counterparty.

<sup>101</sup> If the credit exposure is funded and denominated in local currency and the counterparty is a domestic sovereign, a 0% risk weight shall be applied. Otherwise, a higher risk weight as suggested by the credit rating of the foreign sovereign shall be applicable.

## 4.3 Salam

### 4.3.1 Introduction

323. This section sets out the minimum capital requirement to cover credit and market (price) risks arising from entering into contracts or transactions that are based on the *Shari'ah* rules and principles of *Salam*. The IIFS is exposed to: (a) the credit (counterparty) risk of not receiving the purchased commodity after disbursing the purchase price to the seller; and (b) the price risk that the IIFS incurs from the date of execution of a *Salam* contract, which is applicable throughout the period of the contract and beyond the maturity date of the contract as long as the commodity remains in the ownership of the IIFS, in the absence of a hedge in the form of a parallel *Salam* contract covering the subject matter. (A parallel contract may also be used to hedge part of the exposure.)

324. This section is applicable to: (a) *Salam* contracts that are executed without any parallel *Salam* contracts; and (b) *Salam* contracts that are hedged by independently executed parallel *Salam* contracts.

325. A *Salam* contract is a contract to purchase, at a pre-determined price, a specified kind of commodity<sup>102</sup> which is to be delivered on a specified future date in a specified quantity and quality. The IIFS as the buyer makes full payment of the purchase price upon execution of a *Salam* contract or within a subsequent period not exceeding two or three days as deemed permissible by its SSB.

326. In certain cases, an IIFS enters into a separate back-to-back contract, namely a parallel *Salam*, to sell a commodity with the same specification as the purchased commodity under a *Salam* contract to a party other than the original seller. The parallel *Salam* allows the IIFS to sell the commodity for future delivery at a pre-determined price (thus hedging the price risk on the original *Salam* contract) and prevents the IIFS from having to take delivery of and to warehouse the commodity. As noted above, such a parallel contract may also be used as a partial hedge.

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

328. The obligations of an IIFS under *Salam* and parallel *Salam* are not interconditional or interdependent, which implies that there is no legal basis for offsetting credit exposures between the contracts.

329. In the absence of a parallel *Salam* contract, an IIFS may sell the subject matter of the original *Salam* contract in the spot market upon receipt, or, alternatively, the IIFS may hold the commodity in anticipation of selling it at a higher price. In the latter case, the IIFS is exposed to price risk on its position in the commodity until the latter is sold.<sup>103</sup>

### 4.3.2 Credit Risk

330. The receivable amount generated from the purchase of a commodity based on a *Salam* contract shall, in appropriate cases, be assigned a RW based on the credit standing of a supplier/counterparty as rated by an ECAI that is approved by the supervisory authority. If the supplier/counterparty is unrated (which will normally be the case), a RW of 100% shall apply.

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<sup>102</sup> A commodity is defined as a fungible physical product which is and can be traded on a secondary market – for example, agricultural products, minerals (including oil) and precious metals (excluding gold and silver). The commodity may or may not be traded on an organised exchange.

<sup>103</sup> If the *Salam* counterparty (supplier) defaults by failing to deliver the subject matter, the IIFS as buyer has *de facto* no long position in the subject matter. If there is a parallel *Salam* contract, the IIFS is obliged to procure the commodity in the spot market to honour the parallel contract. In the absence of a parallel *Salam*, however, it is arguably excessive to require an IIFS to make capital charges for both credit risk and market risk on a *Salam* contract. Following this logic, only a market risk capital charge (the larger of the two) may be required. This is a matter for supervisory discretion.

#### **4.3.2.1 Exclusions**

331. The capital requirement is to be calculated on the receivable amount, net of specific provisions, of any amount that is secured by eligible collateral as defined in [section 3.1.8](#) and/or any amount which is past due by more than 90 days. The portions that are collateralised and past due are subject to the relevant RW as set out in [sections 3.1.9](#) and [3.1.5](#), respectively.

#### **4.3.2.2 Applicable period**

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

#### **4.3.2.3 No offsetting arrangement between credit exposures of *Salam* and parallel *Salam***

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

#### **4.3.3 Market Risk**

334. The price risk on the commodity exposure in *Salam* can be measured using either: (a) the maturity ladder approach; or (b) the simplified approach (see [section 3.2.4.4](#)). Under the simplified approach, the capital charge will be equal to 15% of the net position in each commodity, plus an additional charge equivalent to 3% of the gross positions, long plus short, to cover basis risk and forward gap risk. The 3% capital charge is also intended to cater for potential losses in parallel *Salam* when the seller in the original *Salam* contract fails to deliver and the IIFS has to purchase an appropriate commodity in the spot market to honour its obligation.

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

#### *Foreign exchange risk*

336. The funding of a commodity purchase or selling of a commodity may well leave an IIFS open to foreign exchange exposures, and in that case the relevant positions should be included in the measures of foreign exchange risk described in [section 3.2.4.3](#).

#### *Supervisory discretion*

337. Under the maturity ladder approach for market risk, the supervisory authority has discretion to allow netting between different categories of commodities where the commodities are deliverable against each other or represent close substitutes for each other (provided the exchange of similar commodities would not result in *Riba*) and have a minimum correlation of 0.9 between the price movements that can be established over a minimum period of one year (see [section 3.2.4.4](#)).

#### **4.3.4 Summary of Capital Requirement at Various Stages of the Contract**

338. The following tables set out the applicable stage of the contract that attracts capital charges.



(a) *Salam* with parallel *Salam*

Applicable Stage of the Contract		Credit RW	Market Risk Capital Charge
1	Payment of purchase price by the IIFS to a <i>Salam</i> customer/seller	Based on customer's rating or 100% RW for unrated customer  No netting of <i>Salam</i> exposures against parallel <i>Salam</i> exposures See <a href="#">section 4.3.2</a>	Two approaches are applicable:  <u>Maturity ladder approach</u> See <a href="#">section 3.2.4.4</a>  <u>Simplified approach</u> 15% capital charge (187.5% RW equivalent) on net position (i.e. netting of <i>Salam</i> exposures against parallel <i>Salam</i> exposures)  Plus:  3% capital charge (37.5% RW equivalent) on gross positions (i.e. <i>Salam</i> exposures plus parallel <i>Salam</i> exposures)
2	Receipt of the purchased commodity by the IIFS	Not applicable	See <a href="#">section 4.3.3</a>
3	The purchased commodity is sold and delivered to a buyer	Not applicable	Not applicable

(b) *Salam* without parallel *Salam*

Applicable Stage of the Contract		Credit RW	Market Risk Capital Charge
1	Payment of purchase price by the IIFS to a <i>Salam</i> customer (seller)	Based on customer's rating or 100% RW for unrated customer (but see footnote 103)  See <a href="#">section 4.3.2</a>	<u>Simplified approach</u> 15% capital charge (187.5% RW equivalent) on long position of <i>Salam</i> exposures
2	Receipt of the purchased commodity by the IIFS	Not applicable	See <a href="#">section 4.3.3</a>
3	The purchased commodity is sold and delivered to a buyer	Not applicable	Not applicable

## 4.4 *Istisnā`*

### 4.4.1 Introduction

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

### 4.4.2 Principles of *Istisnā`*

340. An *Istisnā`* contract is a contract between a seller (*al-sani`*) and the buyer (*al-mustasni`*) to manufacture or construct 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 pre-determined selling price. In an *Istisnā`* contract, price and other necessary specifications must also be fixed and fully settled between the buyer and manufacturer/builder. The payments by the buyer in *Istisnā`* may be made in advance, during the period of construction reflecting stages of completion, or deferred to a specified future date. The contract of *Istisnā`* is a binding contract that cannot be cancelled unilaterally by either party once the manufacturing work starts. If the subject matter does not conform to the specification agreed upon, the buyer has the option to accept or to refuse the subject matter.

341. The subject matter on which transaction of *Istisnā`* is based is always an item which needs to be manufactured or constructed, such as a ship, an aircraft or a building, and it cannot be an existing and designated asset. *Istisnā`* may also be used for similar projects such as installation of an air-conditioner plant in the customer's factory, or building a bridge or a highway.

342. The price of an asset under this contract is agreed or determined on the contractual date, and such a contract is binding. The price cannot be increased or decreased on account of an increase or decrease in commodity prices or labour cost. The price can be changed subject to the mutual consent of the contracting parties, which is a matter for the commercial decision of the IIFS and can result in a lower profit margin.

### 4.4.3 Roles and Exposure of IIFS in *Istisnā`* Contract

343. In practice, an IIFS can play different roles while engaging in the contract of *Istisnā`*, as follows:

#### (a) *IIFS as a seller (al-sani`) in Istisnā` contract*

In many cases, an IIFS acts as a "seller" in the *Istisnā`* contract and engages the services of a contractor (other than the client) by entering into another *Istisnā`* contract as buyer<sup>104</sup> or using some other *Shar`ah*-compliant contract such as *Murābahah*.

If a parallel *Istisnā`* contract is used for manufacturing the asset, the IIFS acts as a buyer in the parallel contract. The IIFS as an intermediary calculates its cost in the parallel contract and fixes the price of *Istisnā`* with its client that allows it to make a reasonable profit over his cost. The two contracts, however, need to be totally independent of each other. In order to secure the payment from the ultimate buyer (i.e the customer), the title deeds of the underlying asset, or any other collateral, may be required by the IIFS as a security until the complete payment is made by the ultimate buyer.

#### (b) *IIFS as a buyer (al-mustasni`) in Istisnā` contract*

In some cases, an IIFS can act as a "buyer" in an *Istisnā`* contract where it can have an asset constructed by a contractor: (i) for its own account (which can be, for example, subsequently sold or leased on a *Murābahah* or *Ijārah* basis, respectively); or (ii) on the basis of the ultimate customer's specifications.

If the parallel *Istisnā`* contract is used in this scenario with the ultimate customer, the IIFS acts a seller in the parallel contract.

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<sup>104</sup> Where two such parallel *Istisnā`* contracts exist, it is customary to refer to one of the contracts as a "parallel *Istisnā`*". Typically, it is the contract which is entered into second which is referred to as the "parallel *Istisnā`*".

344. This section makes distinctions between two types of exposures in *Istisnā`* financing, as follows:

(a) *Exposure to customer*

The receipt of the selling price by the IIFS is dependent on the financial strength or payment capability of the ultimate customer or the contractor (cases (a) and (b), respectively, as discussed in the previous paragraph), where the source of payment is derived from the various other activities of the ultimate customer or contractor and is not solely dependent on the cash flows from the underlying asset/project.

(b) *Exposure to asset (i.e. exposure to the cash flows from the completed asset)*

The receipt of the selling price by the IIFS is dependent partially or primarily on the amount of revenue generated by the asset being manufactured or constructed by selling its output or services to contractual or potential third-party buyers. This form of *Istisnā`* faces "revenue risk" arising from the asset's ability to generate cash flows, instead of the creditworthiness of the ultimate customer or project sponsor (cases (a) and (b), respectively, as discussed in the previous paragraph). Such exposure normally arises when an *Istisnā`* contract is used in project finance and BOT (build, operate, transfer) transactions.

345. In the *Istisnā`* contract, the IIFS assumes the completion risk<sup>105</sup> that is associated with the failure to complete the project at all, delay in completion, cost overruns, occurrence of a *force majeure* event, and unavailability of qualified personnel and reliable seller(s) or sub-contractors, including any late completion penalty<sup>106</sup> payable to the ultimate customer due to non-fulfilment of required specifications.

#### **4.4.4 Capital Adequacy Requirements**

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

347. There is a capital requirement to cater for the credit (counterparty) risk of the IIFS not receiving the selling price of the asset from the ultimate customer or contractor, either in pre-agreed stages of completion and/or upon full completion of the manufacturing or construction process. (The risk of a customer failing to complete such a transaction in project finance is referred to as "off-take risk" – see [Appendix E.](#))

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

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

350. Keeping in view the different risk and capital adequacy implications for an IIFS performing different roles (as seller or as buyer) in an *Istisnā`* contract, as highlighted in [section 4.4.3](#), both scenarios will be discussed separately in the following.

##### **4.4.4.1 IIFS as a seller (*al-sani`*) in *Istisnā`* contract**

###### *Istisnā` with parallel Istisnā`*

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<sup>105</sup> In conventional project financing, the completion risk is normally borne by the project sponsor/contractor, and not by the bank, because the project sponsor/contractor has most often been asked to provide an undertaking to cover cost overruns.

<sup>106</sup> Normally, the contract between the IIFS and the contractor will specify in a penalty clause the latter's liability for penalties in case of delays for which it is responsible.

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

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

353. The obligations of an IIFS under *Istisnā`* and parallel *Istisnā`* contracts are not interconditional or interdependent, which implies that there is no legal basis for offsetting credit exposures between the contracts.

### **Credit risk**

(a) *Exposure to customer*

354. The receivable amount generated from selling of an asset based on an *Istisnā`* contract with full exposure to the customer (ultimate buyer) shall be assigned a RW based on the credit standing of the customer as rated by an ECAI that is approved by the supervisory authority. Please refer to [section 3.1.1](#) for the RW. In cases where the ultimate buyer is unrated, a RW of 100% shall apply.

(b) *Exposure to asset*

355. When the project is rated by an ECAI, the RW based on the credit rating of the ultimate buyer is applied to calculate the capital adequacy requirement. Otherwise, the RW shall be based on the "supervisory slotting criteria" approach for specialised financing (project finance), as set out in [Appendix E](#), which carries RWs as given below:

<b>Supervisory Categories</b>	<b>Strong</b>	<b>Good</b>	<b>Satisfactory</b>	<b>Weak</b>
External credit assessments	BBB- or better	BB+ or BB	BB- to B+	B to C-
Risk weights	70%	90%	115%	250%

356. *Istisnā`* financing with an "Exposure to Asset" structure is required to meet the characteristics as set out below in order to qualify for the above RW:

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

(c) *Exclusions*

357. The capital requirement is to be calculated on the receivable amount, net of specific provisions, any amount that is secured by eligible collateral as defined in [section 3.1.8](#), and/or any amount which is past

due by more than 90 days. The portions that are collateralised and past due are subject to the relevant RW as set out in sections 3.1.9 and 3.1.5, respectively.

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

(d) *Applicable period*

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

(e) *Offsetting arrangement between credit exposures of Istisnā` and parallel Istisnā`*

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

## **Market risk**

### *Exposure to customer*

(a) *Istisnā` with parallel Istisnā`*

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

(b) *Istisnā` without parallel Istisnā`*

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

363. This inventory is held subject to the binding order of the *Istisnā`* ultimate buyer and is thus not subject to inventory price as described in section 3.2.4.4. However, this inventory is exposed to the price risk as described in paragraph 342.

### *Foreign exchange risk*

364. Any foreign exchange exposures arising from the purchasing of input materials, or from parallel *Istisnā`* contracts made, or the selling of a completed asset in foreign currency, should be included in the measures of foreign exchange risk described in section 3.2.4.3.

## **4.4.4.2 IIFS as a buyer (*al-Mustasni`*) in *Istisnā`* contract**

### *Istisnā` with parallel Istisnā`*

365. In cases where an IIFS enters into parallel *Istisnā`* to sell an asset to an ultimate customer, its price risk relating to input materials is mitigated. The IIFS remains exposed to the counterparty risk of the *Istisnā`* supplier in delivering the asset on time and in accordance with the parallel *Istisnā`* ultimate buyer's specifications. This is the risk of not being able to recover damages from the *Istisnā`* supplier for the losses resulting from the breach of contract.

366. The failure of the *Istisnā`* supplier to deliver a completed asset which meets the ultimate buyer's specifications does not discharge the IIFS's obligations to deliver the asset ordered under a parallel

*Istisnā`* contract, and thus exposes the IIFS to potential loss in making good the shortcomings or obtaining the supply elsewhere.

367. The obligations of an IIFS under *Istisnā`* and parallel *Istisnā`* contracts are not interconditional or interdependent, which implies that there is no legal basis for offsetting credit exposures between the contracts.

**Credit risk**

(a) *Exposure to customer*

368. The receivable amount generated from selling of an asset based on a parallel *Istisnā`* contract with full exposure to the ultimate customer shall be assigned a RW based on the credit standing of the customer as rated by an ECAI that is approved by the supervisory authority. Please refer to section 3.1.1 for the RW. In cases where the ultimate buyer is unrated, a RW of 100% shall apply.

(b) *Exposure to asset*

369. When the project is rated by an ECAI, the RW based on the credit rating of the "off-taker" (third-party buyer) is applied to calculate the capital adequacy requirement. Otherwise, the RW shall be based on the "supervisory slotting criteria" approach for specialised financing (project finance) as set out in Appendix E, which carries RWs as given below:

<b>Supervisory Categories</b>	<b>Strong</b>	<b>Good</b>	<b>Satisfactory</b>	<b>Weak</b>
External credit assessments	BBB- or better	BB+ or BB	BB- to B+	B to C-
Risk weights	70%	90%	115%	250%

370. The "Exposure to Asset" *Istisnā`* structure is required to meet the characteristics as set out in paragraph 362.

(c) *Exclusions*

371. The capital requirement is to be calculated on the receivable amount, net of specific provisions, any amount that is secured by eligible collateral as defined in section 3.1.8 and/or any amount which is past due by more than 90 days. The portions that are collateralised and past due are subject to the relevant RW as set out in sections 3.1.9 and 3.1.5, respectively.

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

(d) *Applicable period*

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

(e) *Offsetting arrangement between credit exposures of Istisnā` and parallel Istisnā`*

374. The credit exposure amount of a parallel *Istisnā`* contract is not to be offset against the credit exposure amount of an *Istisnā`* contract (or vice versa) because an obligation under one contract does not discharge an obligation to perform under the other contract.

**Market risk**

*Exposure to customer*

(a) *Istisnā` with parallel Istisnā`*

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

(b) *Istisnā` without parallel Istisnā`*

376. In this case, the IIFS is making progress payments to the *Istisnā`* supplier, thereby acquiring title to WIP inventory. This WIP inventory is exposed to price risk. As there is no parallel *Istisnā`* sale to an ultimate customer, there is no credit risk.

377. The WIP should receive a capital charge appropriate to inventory – that is, 15% (equivalent to a RW of 187.5% if the minimum capital requirement is 8%).

**Foreign exchange risk**

378. Any foreign exchange exposures arising from the purchasing of input materials, or from parallel *Istisnā`* contracts made, or the selling of a completed asset in foreign currency should be included in the measures of foreign exchange risk described in section 3.2.4.3.

**4.4.5 Summary of Capital Requirement at Various Stages of the Contract**

379. The following tables set out the applicable stage of the contract that attracts capital charges.

**4.4.5.1 IIFS as a seller (*al-Sani`*) in *Istisnā`* contract**

(a) *Exposure to customer*

(i) *Istisnā` with parallel Istisnā`*

<b>Applicable Stage of the Contract</b>	<b>Credit RW</b>	<b>Market Risk Capital Charge</b>
Unbilled WIP inventory	Based on ultimate buyer's rating or 100% RW for unrated buyer	Nil, provided that there is no provision in the parallel <i>Istisnā`</i> contract that allows the seller to increase or vary the selling price
Amounts receivable after contract billings	No netting of <i>Istisnā`</i> exposures against parallel <i>Istisnā`</i> exposures  See credit risk under <u>section 4.4.4.1</u>	See market risk under <u>section 4.4.4.1</u>
Maturity of contract term or upon full settlement of the purchased price by an <i>Istisnā`</i> buyer, whichever is the earlier	Not applicable	Not applicable

(ii) *Istisnā` without parallel Istisnā`*

Applicable Stage of the Contract	Credit RW	Market Risk Capital Charge
Unbilled WIP inventory	Based on ultimate buyer's rating or 100% RW for unrated buyer	1.6% capital charge (equivalent to 20% RW) on WIP inventory See market risk under <a href="#">section 4.4.4.1</a>
Progress billing to customer	Based on ultimate buyer's rating or 100% RW for unrated buyer  See credit risk under <a href="#">section 4.4.4.1</a>	Not applicable
Maturity of contract term or upon full settlement of the purchased price by an <i>Istisnā`</i> buyer, whichever is the earlier	Not applicable	Not applicable

(b) *Exposure to asset*

(i) *Istisnā` with parallel Istisnā` (for project finance)*

Applicable Stage of the Contract	Credit RW	Market Risk Capital Charge
Unbilled WIP inventory	Based on buyer's ECAI rating, if available, or supervisory slotting criteria that ranges from 70% to 250% RW	Not applicable
Amounts receivable after contract billings	No netting of <i>Istisnā`</i> exposures against parallel <i>Istisnā`</i> exposures  See credit risk under <a href="#">section 4.4.4.1</a>	
Maturity of contract term or upon full settlement of the purchased price by an <i>Istisnā`</i> customer, whichever is the earlier	Not applicable	Not applicable



#### 4.4.5.2 IIFS as a buyer (*al-Mustasni*) in *Istisnā`* contract

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

- (a) *Exposure to customer*  
 (i) *Istisnā` with parallel Istisnā`*

Applicable Stage of the Contract	Credit RW	Market Risk Capital Charge
Unbilled WIP inventory	Based on ultimate buyer's rating or 100% RW for unrated buyer	Nil, provided that there is no provision in the parallel <i>Istisnā`</i> contract that allows the seller to increase or vary the selling price
Amounts receivable after contract billings	No netting of <i>Istisnā`</i> exposures against parallel <i>Istisnā`</i> exposures  See credit risk under <a href="#">section 4.4.4.2</a>	
Maturity of contract term or upon full settlement of the purchased price by an <i>Istisnā`</i> buyer, whichever is the earlier	Not applicable	Not applicable

- (ii) *Istisnā` without parallel Istisnā`*

Applicable Stage of the Contract	Credit RW	Market Risk Capital Charge
Amounts of progress payments to supplier for WIP inventory	None (no ultimate <i>Istisnā`</i> customer)  See credit risk under <a href="#">section 4.4.4.2</a>	15% (equivalent to 187.5% RW) for WIP inventory  See market risk under <a href="#">section 4.4.4.1</a>

- (b) *Exposure to asset*
- (ii) *Istisnā` with parallel Istisnā` (for project finance)*

Applicable Stage of the Contract	Credit RW	Market Risk Capital Charge
Unbilled WIP inventory	Based on buyer's ECAI rating, if available, or supervisory slotting criteria that ranges from 70% to 250% RW	Not applicable
Amounts receivable after contract billings	No netting of <i>Istisnā`</i> exposures against parallel <i>Istisnā`</i> exposures  See credit risk under <u>section 4.4.4.2</u>	
Maturity of contract term or upon full settlement of the purchased price by an <i>Istisnā`</i> customer, whichever is the earlier	Not applicable	Not applicable

## **4.5 *Ijārah* and *Ijārah Muntahia Bittamlīk***

### **4.5.1 Introduction**

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

382. In an *Ijārah* contract (either operating or IMB), the IIFS as the lessor maintains its ownership of the leased asset while transferring the right to use the asset, or usufruct, to a customer as the lessee, for an agreed period at an agreed consideration. All liabilities and risks pertaining to the leased asset are to be borne by the IIFS as lessor, including obligations to restore any impairment and damage to the leased asset arising from wear and tear and natural causes which are not due to the lessee's misconduct or negligence. Thus, in both *Ijārah* and IMB, the risks and rewards (and obligations and rights) of ownership remain with the lessor, except for the residual value risk at the term of an IMB which is borne by the lessee. The lessor is exposed to price risk on the asset while it is in the lessor's possession prior to the signature of the lease contract, except where the asset is acquired following a binding promise to lease (PL) as described in paragraph 390.

383. In an IMB contract, the lessor promises to transfer to the lessee its ownership in the leased asset at the end of the contract as a gift or as a sale for a specified consideration, provided that: (a) the promise is separately expressed and independent of the underlying *Ijārah* and the lessor concludes the contract of gift or sale while still completely owning the asset; or (b) a gift contract is entered into that is dependent upon the fulfilment of all the *Ijārah* obligations, whereupon ownership shall be automatically transferred to the lessee.

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

### **4.5.2 Operating *Ijārah***

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

### **4.5.3 IMB**

386. In IMB, once the lease contract is signed, the lessor is exposed to credit risk in respect of the lease payments receivable from the lessee (a credit risk mitigated by the asset's value as collateral<sup>107</sup>) and to a type of operational risk in respect of the need to compensate the lessee if the asset is permanently impaired through no fault of the latter. If the leased asset is permanently impaired and is uninsured, the IIFS suffers a loss equal to the carrying value of the leased asset, just as it would if any of its fixed assets were permanently impaired. In the event that the lessee exercises its right to cancel the lease, the lessor is exposed to the residual value of the leased asset being less than the refund of payments due to the lessee. In such a case, the price risk, if any, is already reflected in a "haircut" to be

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<sup>107</sup> The collateral (or "quasi-collateral") used in the context of IMB is of the usufruct, or use value, of the asset, as the IIFS is the owner of the asset.

applied to the value of the leased asset as collateral. Therefore, the price risk, if any, is not applicable in the context of the IMB.

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

388. The IIFS may be exposed to losses in cases where a lessee acquiring an asset under IMB decides not to continue with the contract. The lease contract may give the lessee this right subject to certain conditions (such as a minimum period of notice). In such a case, if these conditions are satisfied, the lessor is required to refund to the lessee the capital payments (instalments of the purchase price) that were included in the periodic lease rentals (subject to deduction of any amounts due for unpaid rentals). If the value of the repossessed asset is less than the amount to be refunded (before any such deduction), the difference constitutes a loss to the lessor. This exposes the IIFS as lessor to a form of market risk.<sup>108</sup>

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

#### **4.5.4 Credit Risk**

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

391. In applying the treatment as set out in the above paragraph, the IIFS must ensure that the PL is properly documented and legally enforceable. In the absence of a proper documentation and legal enforceability, the asset is to be treated similarly to one in a non-binding PL which is exposed to market (price) risk, using the measurement approach as set out in [section 4.5.5](#) on non-binding PL.

##### **4.5.4.1 Operating *Ijārah***

392. In addition to credit risk, mentioned in [section 4.5.4](#), the lessor is exposed to credit risk in respect of the estimated value of the lease payments for the remaining period of the *Ijārah*. This exposure is mitigated by the market value of the leased asset which may be repossessed. The net credit risk exposure shall be assigned a RW based on the credit standing of the lessee/counterparty as rated by an ECAI that is approved by the supervisory authority. In cases where the lessee is unrated, a RW of 100% shall apply.

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<sup>108</sup> The contract should include clauses that cover the treatment of destruction or loss of the property without any fault of the tenant. The contract should also elaborate how the IIFS as a lessor will cover itself in the absence of any *Takāful*.

#### 4.5.4.2 IMB

393. In addition to section 4.5.4, the capital requirement for IMB is based on the following two components:

- (a) *Total estimated future Ijārah receivable amount over the duration of the lease contract*: This exposure is mitigated by the market value of the leased asset which may be repossessed. The net credit risk exposure shall be assigned a RW based on the credit standing of the lessee/counterparty as rated by an ECAI that is approved by the supervisory authority. In cases where the lessee is unrated, a RW of 100% shall apply.
- (b) *Price risk attached to the expected residual fair value of a leased asset*: This exposure is treated under section 4.5.5.1.

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

#### 4.5.4.3 Exclusions

395. The capital requirement is to be calculated on the receivable amount, net of specific provisions, of any amount that is secured by eligible collateral as defined in section 3.1.8 and/or any amount which is past due by more than 90 days. The portions that are collateralised and past due are subject to the relevant RW, as set out in sections 3.1.9 and 3.1.5, respectively.

#### 4.5.4.4 Preferential RW

396. Subject to meeting the minimum requirements as set out in section 3.1.4, a preferential RW can be assigned for certain types of leased asset, such as real estate. The supervisory authorities have discretion to apply RW appropriate for their circumstances.

#### 4.5.5 Market Risk

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

##### (a) *Non-binding PL*

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

##### (b) *Binding PL*

In a binding PL, an IIFS is exposed to default on the lease orderer's obligation to lease the asset in its possession. In the event of the lease orderer defaulting on its PL, the IIFS will either lease or dispose of the asset to a third party. The IIFS will have recourse to any HJ paid by the customer,<sup>109</sup> and (i) may have a right to recoup from the customer any loss on leasing or disposing of the asset after taking account of the HJ, or (ii) may have no such right, depending on the legal situation. In both cases, this risk is mitigated by the asset in possession as well as any HJ paid by the lease orderer.

In case (i), if the down-payment was made as HJ, the IIFS has the right to recoup any loss (as indicated in the previous paragraph) from the customer; that right constitutes a claim receivable which is exposed

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<sup>109</sup> In the case of HJ, the amount can only be deducted for damages – that is, the difference between the asset acquisition cost and the total of lease rentals (when the asset is leased to a third party) or selling price (when the asset is sold to a third party), whichever is applicable.

to credit risk, and the exposure shall be measured as the amount of the asset's total acquisition cost to the IIFS, less the market value of the asset as collateral subject to any haircut, and less the amount of any HJ. The applicable RW shall be based on the standing of the customer as rated by an ECAI that is approved by the supervisory authority. In cases where the obligor is unrated, a RW of 100% shall apply.

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

#### 4.5.5.1 Operating *Ijārah*

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

#### 4.5.5.2 IMB

399. In the event that the lessee exercises its right to cancel the lease, the lessor is exposed to the residual value of the leased asset being less than the refund of payments due to the lessee. In such a case, the price risk, if any, is already reflected in a haircut to be applied to the value of the leased asset as collateral in credit risk. Therefore, the price risk, if any, is not applicable in the context of the IMB.

#### 4.5.6 Summary of Capital Requirement at Various Stages of the Contract

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

##### 4.5.6.1 Operating *Ijārah*

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

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

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

**4.5.6.2 IMB**

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

*\*This credit RW is applicable only when IIFS will have recourse to any HJ paid by the customer. In the case of HJ (depending on the legal situation), the IIFS may have a right to recoup from the customer any loss on leasing or disposing of the asset to a third party, after taking account of the HJ, while any excess HJ must be refunded.*

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

## 4.6 *Mushārah* and Diminishing *Mushārah*

### 4.6.1 Introduction

401. This section sets out the minimum capital adequacy requirement to cover the risk of losing invested capital arising from entering into financing contracts or transactions that are based on the *Sharī'ah* rules and principles of *Mushārah* and diminishing *Mushārah* where the IIFS and its customers/partner(s) contribute to the capital of the partnership and share its profits or losses.

402. This section is applicable to both (a) *Mushārah*, in which all the partners' shares remain constant throughout the contract period; and (b) diminishing *Mushārah*, in which the share of the IIFS is gradually reduced during the tenure of the contract until all of it has been sold to the other partner(s).

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

### 4.6.2 *Mushārah*

404. This section sets out the minimum capital adequacy requirement to cater for "capital impairment risk", the risk of losing the amount contributed to an enterprise or joint ownership of an asset. An IIFS acts as a partner in a *Mushārah* contract and is exposed to the risk of losing its capital upon making payment of its share of capital. A *Mushārah* can expose the IIFS to capital impairment risk and/or to normal credit risk, depending on the structure and purpose of the *Mushārah* and the types of asset in which the funds are invested (see [section 3.1.3](#)). The invested capital is redeemable either by liquidation of the *Mushārah* assets at the end of a contract which has a fixed tenure or as mutually agreed by the partners, or upon divestment of partnership in an ongoing *Mushārah* subject to giving notice to other partners. The amount of capital redemption is represented by the value of a share of capital, which is dependent on the quality of the underlying investments or assets, and their ability to generate profits and cash flows from the *Mushārah*.

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

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

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

This type of *Mushārah* exposes the IIFS to the risk of underlying activities, namely foreign exchange, equities or commodities.

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

This type of *Mushārah* exposes the IIFS to the risk as an equity holder, which is similar to the risk assumed by a partner in venture capital or a joint venture, but not to market risk. As an equity investor, the IIFS serves as the first loss position and its rights and entitlements are subordinated to the claims of secured and unsecured creditors. For further explanation of the nature of risk in such ventures, see paragraphs 138–140 ([section 3.1.3.1](#)).



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

(i) *Mushārahah in Ijārah contract*

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

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

(ii) *Mushārahah in Murābahah contract*

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

#### **4.6.3 Diminishing Mushārahah**

407. The IIFS's position in a diminishing *Mushārahah* is set out in [section 3.1.3.2](#).

#### **4.6.4 Equity Position Risk**

##### *Mushārahah*

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

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

409. The *Mushārahah* exposures, net of specific provisions, shall be measured as follows:

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

The RW shall be based on the applicable underlying assets as set out in the market risk section in [section 3.2](#).

The investment in foreign exchange and trading in gold/silver shall be measured according to the treatment as set out in [section 3.2.4.3](#), which requires 8% capital charge on the greater of either net long or net short positions in foreign exchange and 8% capital charge on the net long position of gold/silver.

The RW of a *Mushārahah* that invests in quoted shares shall be measured according to the equity position risk approach, where positions in assets tradable in markets will qualify for treatment as equity position risk in the trading book, which would incur a total capital charge of 16% (equivalent to 200% RW) as set out in [section 3.2.4.1](#).

Investment in commodities shall be measured according to either the maturity ladder approach or the simplified approach as set out in [section 3.2.4.4](#).

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

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

- (i) *Simple risk-weight method*: The RW shall be applied to the exposures (net of specific provisions) based on equity exposures in the banking book. The RW under the simple RW method for equity position risk in respect of an equity exposure in a business venture shall entail a 400% RW for shares that are not publicly traded less any specific provisions for impairment. If there is a third-

party guarantee to make good impairment losses, the RW of the guarantor shall be substituted for that of the assets for the amount of any such guarantee.

- (ii) *Supervisory slotting method*: An IIFS is required to map its RW into four supervisory categories as set out in Appendix E (specialised financing) where the RW of each category is as follows:

<b>Supervisory Categories</b>	<b>Strong</b>	<b>Good</b>	<b>Satisfactory</b>	<b>Weak</b>
Risk weights	90%	110%	135%	270%

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

For further explanation, also see paragraphs 141–145 (section 3.1.3.1).

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

*Mushārahah in Ijārah contract*

Income-producing *Mushārahah* through leasing to third parties by means of *Ijārah* contracts exposes the capital contributor to the risk of that underlying *Ijārah* contract – that is, counterparty risk mitigated by the value of leased assets.

This *Mushārahah* investment shall be assigned a RW based on the credit standing of the counterparty/lessee, as rated by an ECAI that is approved by the supervisory authority, and a 100% RW on the residual value of an *Ijārah* asset (operating lease). In cases where the counterparty is unrated, a RW of 100% shall apply. (Please refer to the treatment for *Ijārah* as set out in section 4.5.6.)

*Mushārahah in Murābahah contract*

Income-producing *Mushārahah* through selling to third parties by means of *Murābahah* contracts exposes the capital contributor to the risk of that counterparty/buyer.

This *Mushārahah* investment shall be assigned a RW based on the credit standing of the counterparty/buyer, as rated by an ECAI that is approved by the supervisory authority. In cases where the counterparty is unrated, a RW of 100% shall apply. (Please refer to the treatment for *Murābahah* as set out in section 4.1.)

*Diminishing Mushārahah*

410. The equity exposure in a diminishing *Mushārahah* contract, where the IIFS has provided funds for the working capital of the partnership and intends to transfer its full ownership in the partnership to the other partner over the life of the contract, is calculated based on the remaining balance of the amount invested (measured at historical cost, including any share of undistributed profits) less any specific provision for impairment. This exposure shall be risk-weighted according to the nature of the underlying assets as set out in section 3.1.3.2. If there is a third-party guarantee to make good impairment losses, the RW of the guarantor shall be substituted for that of the assets for the amount of any such guarantee. Moreover, IIFS can use the slotting method after necessary supervisory approval, based on the criteria set out in Appendix F (diminishing *Mushārahah*).

#### 4.6.5 Summary of Capital Requirements for Mushārakah Categories

411. The following table sets out the *Mushārakah* categories that attract capital charges.

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

\*In the case of diminishing *Mushārakah*, the contributed amount is based on the remaining balance of the invested amount.

## 4.7 *Muḍārabah*

### 4.7.1 *Introduction*

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

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

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

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

415. As the fund provider, the IIFS is exposed to the risk of losing its capital investment, or "capital impairment risk", upon making payment of the capital to the *Muḍārib*. Any loss on the investment is to be borne solely by the capital provider, but is limited to the amount of his/her capital.<sup>110</sup> Losses that are due to misconduct, negligence or breach of contractual terms are to be borne by the *Muḍārib*.

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

417. Apart from such placements, *Muḍārabah* contracts are commonly used for the investment purposes mentioned in paragraph 419.

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

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

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

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<sup>110</sup> Unless the capital provider has authorised the borrowing and investment in the *Muḍārabah* of a sum in addition to the amount of its own capital that it has provided, in which case the capital provider is also responsible for this additional amount.

*commodities*

This type of *Muḍārabah* exposes the IIFS to the risk of the underlying activities, namely foreign exchange, equity or commodities.

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

This type of *Muḍārabah* exposes the IIFS to risk as an equity holder, which is similar to the risk assumed by a partner in venture capital or a joint venture, but not to market risk. As an equity investor, the IIFS serves as the first loss position and its rights and entitlements are subordinated to the claims of secured and unsecured creditors. For further explanation of the nature of risk in such ventures, see paragraphs 138–140 ([section 3.1.3.1](#)).

(c) *Muḍārabah investments in project finance*

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

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

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

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

Direct payment by ultimate customer into a “repayment account” opened with the IIFS and effectively pledged to the IIFS

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

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

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

#### **4.7.2 Equity Position Risk**

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

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

421. The *Muḍārabah* exposures, net of specific provisions, shall be measured as discussed below.

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

The RW shall be based on the applicable underlying assets as set out in the market risk section in section 3.2.

An investment in foreign exchange and trading in gold/silver shall be measured according to the treatment set out in section 3.2.4.3, which requires an 8% capital charge on the greater of either net long or net short positions and an 8% capital charge on the net position of gold/silver.

The RW of a *Muḍārabah* that invests in quoted shares shall be measured according to the equity position risk approach where positions in assets tradable in markets will qualify for treatment as equity position risk in the trading book, which would incur a total capital charge of 16% (equivalent to 200% RW) as set out in section 3.2.4.1.

Investment in commodities shall be measured according to either the maturity ladder approach or the simplified approach, as set out in section 4.1.

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

There are two possible methods used to calculate the equity exposures in this type of investment – that is: (i) the simple risk-weight method; and (ii) the slotting method. The calculation details are set out in paragraphs 141–145 (section 3.1.3.1).

- (c) *Muḍārabah investment in project finance*

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

- (i) the amount receivable by the IIFS from the *Muḍārib* in respect of progress payments due to the *Muḍārib* from the ultimate customer for work certified as having reached a certain stage of completion: If a binding agreement exists as described in paragraph 421(c), whereby the amount will be paid by the ultimate customer into a “repayment account” with the IIFS, a RW will reflect the credit standing of the ultimate customer. In the absence of such an agreement, the RW would reflect the credit standing of the *Muḍārib* (or 100% RW for unrated customer);
- (ii) the amount held in the “repayment account” with the IIFS, which would have a risk-weighting of 0%; and
- (iii) for any remaining balance of the funds advanced by the IIFS to the *Muḍārib*, which would incur a RW of between 300% and 400% under the simple RW method, or between 90% and 270% under the slotting method, unless otherwise rated, the treatment as set out in

paragraph 421(b) applies.

#### 4.7.3 Summary of Capital Requirements for Muḍārabah Categories

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

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

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

#### *Muḍārabah investment in project finance*

<b>Applicable Stages in a Contract</b>		<b>Credit RW</b>	<b>Market Risk Capital Charge</b>
1	<u>Prior to certification</u> , where funds are already advanced by the IIFS to the <i>Muḍārib</i>	Risk weight is based on the rating of either the ultimate customer or the <i>Muḍārib</i> (see paragraph 421(c)). Otherwise, 400% RW is applied to an unrated <i>Muḍārib</i> .	Not applicable
2	<u>After certification</u> , where the amount is receivable by the IIFS from the <i>Muḍārib</i> in respect of progress payment to the <i>Muḍārib</i> from the ultimate customer	If a "repayment account" or similar mitigation structure is used, RW is based on the credit standing of the ultimate customer on the amounts receivable by the IIFS from the <i>Muḍārib</i> (or 100% RW for unrated customer).	Not applicable

## 4.8 *Qarḍ*

### 4.8.1 *Introduction*

423. This section sets out the minimum capital requirement to cover the risk of losing capital arising from entering into contracts or transactions that are based on the *Sharī'ah* rules and principles of *Qarḍ*.

424. *Qarḍ* is a loan given by an IIFS, where the borrower is contractually obliged to repay only the principal amount borrowed.<sup>111</sup> In the contract of *Qarḍ*, no additional payment in addition to the principal amount lent may be required, as that would be a form of *Riba*.

425. If a fixed period of repayment is stipulated in the contract, the borrower is liable to pay back the principal amount to the IIFS on or before the agreed date of payment. On the other hand, if no period is stipulated in the contract, it is binding upon the borrower to make a repayment of the loaned amount to the lender on demand.

### 4.8.2 *Collateralisation*

426. As one of the CRM techniques, IIFS can secure a pledge of a tangible asset. The collateralisation is not automatically provided in a *Qarḍ* contract but must be explicitly stated or must be documented in a separate security agreement at or before the time of signing of the *Qarḍ* contract. The IIFS may employ other techniques such as pledge of deposits/PSIA or a third-party financial guarantee.

### 4.8.3 *Credit Risk*

427. IIFS are exposed to credit risk in the event that the borrower fails to repay the principal amount in accordance with the agreed terms of the contract. In a fixed-period *Qarḍ* contract, credit risk exposure commences upon the execution of the contract until the full repayment by the borrower.

428. The credit exposure shall be measured based on account receivable in *Qarḍ* – that is, the amount due from the customer at the end of the financial period less any provision for doubtful debts.

429. The account receivable amount (net of specific provisions) arising from the *Qarḍ* contract shall be assigned a RW based on the credit standing of the borrower, as rated by an ECAI that is approved by the supervisory authority (see [section 3.1.1](#)). In cases where the borrower is unrated, a RW of 100% shall apply. The RW of a financial guarantor can be substituted for the RW of the borrower provided that the guarantor has a better credit rating than the borrower and that the guarantee is legally enforceable. If an exposure is covered by multiple CRM techniques, the exposure will be segregated into segments covered by each type of CRM technique as specified in [section 3.1.12](#). For any uncovered exposure, the RW of the underlying counterparty shall apply.

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<sup>111</sup> As a business entity, IIFS provide financing to their customers to perform their role as financial intermediary and seek an opportunity to earn profits for their enterprise and for distribution to their shareholders and fund providers. Therefore, most IIFS will not be providing any significant amount of lending on the basis of *Qarḍ*, as *Sharī'ah* rules and principles require the borrower to pay only the principal amount in that case. Nonetheless, an IFSB survey has shown that, in several jurisdictions, some IIFS do provide *Qarḍ*-based lending for different reasons. These vary widely among IIFS and may include: (a) lending to some specific type of clients such as the poor, needy or widows, etc. as a part of Corporate Social Responsibility practice; (b) lending out of their Charity Account (built out of their non-permissible income) to small entrepreneurs and new businesses that do not have access to sufficient assets that can be used as collateral; (c) lending as a part of their business product – that is, not out of the Charity Account; (d) providing funding to various microfinance institutions or customers; and (e) lending mainly for marketing or public acceptance purposes, where a small portion of the overall financing portfolio is allocated to support certain activities of underprivileged sections of the population, etc.



#### 4.8.4 Market Risk

430. In the case where a cash loan is provided by the IIFS, there is no element of market risk. If, however, a loan is provided in a currency other than the local currency or in the form of a commodity, the related market risk will be applicable, as mentioned in section 3.2 of this Standard.

#### 4.8.5 Summary of Capital Requirement for Qarđ-based Lending

431. The following table sets out capital charges for lending on the basis of *Qarđ*.

Exposure		Credit RW	Market Risk Capital Charge
1	Accounts receivable from customer	Exposure is equal to the amount of loan (less specific provisions) X customer's rating (or 100% RW for unrated customer).	Not applicable*

\*Applicable only if *Qarđ*-based lending is made in the foreign currency or in commodities.

## 4.9 *Wakālah*

### 4.9.1 *Introduction*

432. This section sets out the minimum capital adequacy requirement to cover the risk of losing invested capital arising from an IIFS entering into asset-side financing contracts or transactions that are based on the *Sharī'ah* rules and principles of *Wakālah*.

433. An IIFS assumes the role of a principal (*Muwakkil*) and appoints the customer as agent (*Wakīl*) to carry out a specified set of services or act on its behalf. This section is applicable to both restricted and unrestricted *Wakālah* financing.

434. *Wakālah* is a contract of agency whereby one person contracts to perform any work or provide any service on behalf of another person. Businesses rely on a range of individuals to act on their behalf; these include employees, directors, partners, and a range of professional agents. An action performed by an agent on behalf of the principal will be deemed to be an action by the principal. An agent will obtain a payment wage for services rendered according to the contractual reward structure offered by the principal which may incorporate a performance-related element.

435. A *Wakālah*<sup>112</sup> is thus an agreement in which one party (*Muwakkil*) appoints the other (*Wakīl*) to act on its behalf to accomplish certain specified services or activities. Profits generated by any such activity are distributed to the *Muwakkil* less the *Wakīl* fee, in accordance with the terms of the *Wakālah* agreement. In case the contract includes some “indicative” or “expected” profit rate on the investment, the *Wakālah* contract can include a clause stipulating that the *Wakīl*'s remuneration may be: (a) any gain in excess of the “expected” profit rate; or (b) a certain share of profit added to a pre-agreed flat fee, subject to approval from the relevant *Sharī'ah* board.

436. A *Wakālah* financing can be carried out on either:

- (a) a restricted basis, where the capital provider allows the *Wakīl* to make investments subject to specified investment criteria or certain restrictions such as types of instrument, sector or country exposures; or
- (b) an unrestricted basis, where the capital provider allows the *Wakīl* to invest funds freely based on the latter's skills and expertise. For interbank *Wakālah*, the *Wakīl* is permitted by the *Muwakkil* to invest the investment amount on a discretionary basis, but only in *Sharī'ah*-compliant transactions.

437. As the *Muwakkil*, the IIFS is exposed to the risk of losing its invested capital – that is, capital impairment risk. Any loss on the investment is to be borne solely by the *Muwakkil*, but is limited to the amount of its capital. Losses that are due to fraud, misconduct, negligence or breach of contractual terms are to be borne by the *Wakīl*. The *Wakīl* shall be entitled to any pre-agreed flat *Wakīl* fee irrespective of whether the actual profit is less than, equal to or greater than any expected profit, and also in the event of a loss.

438. However, while it is not permissible for a *Wakīl* to give a guarantee against losses or for any indicative or expected profits, such a guarantee may be given by a third party on the basis of *tabarru'* (donation). In such a case, the amount of the *Wakālah* capital so guaranteed may be considered as

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<sup>112</sup> Another term used by IIFS for investment of funds on a *Wakālah* basis is *Wakālah al-Istismār*. In a *Wakālah al-Istismār* contract (meaning agency services for management of funds), an IIFS can manage the funds of other investors (which can be individuals, corporate entities, institutions or IIFS) against a pre-agreed flat fee irrespective of the profit or loss on the relevant investment. This fee may be paid in one lump sum or as periodic (e.g. monthly or annual) remuneration as a percentage of the amount invested or the net asset value of the fund. Any one of the aforesaid bases should be agreed before the launch of any fund or other financial product by an IIFS that is working as *Wakīl*.

subject to credit risk with a risk-weighting equal to that of the guarantor. In particular, such guarantees may be given when liquid funds are placed in an Islamic interbank market under a *Wakālah* contract.

439. In the absence of any fraud, misconduct, negligence or breach of contractual terms on the part of *Wakīl*, all the risk of loss on the investment is to be borne by the *Muwakkil*. Therefore, the IIFS is exposed to the skills of the *Wakīl* that manages the investments on behalf of the IIFS, as well as to business risks associated with the underlying activities and types of investments or assets of the *Wakālah* agreement.

#### **4.9.2 Capital Requirements**

440. For the purpose of determining the minimum capital requirements, this section makes distinctions between the following main categories of *Wakālah*:

- (a) *Wakālah* investments to undertake trading activities in foreign exchange, shares and/or commodities, including CMT;
- (b) *Wakālah* investments with a private commercial enterprise to undertake business activities (other than (a)); and
- (c) *Wakālah* placement in the interbank market.

441. The *Wakālah* exposures, net of specific provisions, shall be measured as set out below.

- (a) *Wakālah investments to undertake trading activities in foreign exchange, shares and/or commodities, including CMT*

The RW shall be based on the applicable underlying assets as set out in the market risk section in [section 3.2](#).

An investment in foreign exchange and trading in gold or silver shall be measured according to the treatment as set out in [section 3.2.4.3](#), which requires an 8% capital charge on the greater of either net long or net short positions and an 8% capital charge on the net position of gold/silver.

The RW of a *Wakālah* for funds that are invested in quoted shares shall be measured according to the equity position risk approach, where positions in assets tradable in markets will qualify for treatment as equity position risk in the trading book, which would incur a total capital charge of 16% (equivalent to 200% RW) as set out in [section 3.2.4.1](#).

Investment in commodities shall be measured according to either the maturity ladder approach or the simplified approach as set out in [section 3.2.4.4](#).

If the *Wakālah* investment is to be utilised by the *Wakīl* (another IIFS) for conducting CMT to earn a (fixed rate of) profit, the investing IIFS is primarily exposed to the counterparty risk. In that case, the invested amount (net of specific provisions) shall be assigned a RW based on the credit standing of the counterparty as rated by an approved ECAI. In cases where the counterparty is unrated, a RW of 100% shall apply (see [section 4.2](#)).

- (b) *Wakālah investments with private commercial enterprise to undertake business activities (other than (a))*

This type of *Wakālah* investment exposes the IIFS to capital impairment risk, as explained above. Due to this downside risk, the RW shall be measured according to equity position in the banking book approach.

The RW shall be applied to the exposures net of specific provision, if any.

As explained in sections 4.6 and 4.7, there are two possible methods used to calculate the equity exposures – that is: (i) the simple risk-weight method; and (ii) the slotting method.

- (i) The RW under the simple risk-weighting method shall entail a RW of 300–400%.
- (ii) Under supervisory slotting criteria, an IIFS is required to map its RW into four supervisory categories as set out in Appendix E (specialised financing) where the RWs of each category are as follows:

<b>Supervisory Categories</b>	<b>Strong</b>	<b>Good</b>	<b>Satisfactory</b>	<b>Weak</b>
Risk weights	90%	110%	135%	270%

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

For further explanation, also see paragraphs 141–145 (section 3.1.3.1).

(c) *Wakālah placement in the interbank market*

An IIFS may place liquid funds with a central bank or another IIFS on a *Wakālah* basis in order to obtain a return on those funds. Such placements are considered to be more secure than those mentioned in category (a) above, owing to the available credit standing of, and the established relationship with, the counterparty in the interbank market.

442. As mentioned above, a placement of funds made by an IIFS with another IIFS under a *Wakālah* agreement (whether on a restricted or unrestricted basis) may be subject to a *Sharī'ah*-compliant guarantee from a third party. Such a guarantee can be related to the amount of principal invested, as well as the expected return. In such cases, the capital should be treated as subject to credit risk, with a risk-weighting equal to that of the guarantor provided that the RW of that guarantor is lower than the RW of the *Wakīl* as counterparty. Otherwise, the RW of the *Wakīl* shall apply. As explained in section 3.1.11 related to *Muḍārabah* interbank placement, interbank placement received on a *Wakālah* basis can also be effectively treated as a liability by the IIFS receiving the funds. In the absence of any guarantee mentioned earlier, the risk-weighting can be applied based on the credit standing of the counterparty as rated by an approved ECAI, or a RW of 100% for an unrated counterparty.

443. If the funds placed under a *Wakālah* arrangement are placed in a foreign currency, in addition to the above treatment, capital charge related to foreign exchange risk will be applicable as outlined in section 3.2.4.3.

### 4.9.3 Summary of Capital Requirements for Wakālah Categories

444. The following table sets out the *Wakālah* categories that attract capital charges.

<b>Wakālah Category</b>	<b>Credit RW</b>	<b>Market Risk Capital Charge</b>
<i>Wakālah</i> investments to undertake trading activities in foreign exchange, shares and/or commodities, including CMT	Not applicable	Depends on the underlying asset as set out in the applicable market risk section  See <a href="#">section 3.2.4.3</a> for <i>Wakālah</i> investments in foreign exchange  See <a href="#">section 3.2.4.1</a> for <i>Wakālah</i> investments in shares  See <a href="#">section 3.2.4.4</a> for <i>Wakālah</i> investments in commodities  See <a href="#">section 4.2</a> for <i>Wakālah</i> investments in CMT
<i>Wakālah</i> investments with private commercial enterprise to undertake business activities, other than above categories	(a) <u>Simple risk-weight method</u> 300–400% RW of the placed amount less any specific provisions  Or: (b) <u>Slotting method</u> Between 90% and 270% RW of the contributed amount to the business venture based on the four categories	Not applicable
<i>Wakālah</i> placement in the interbank market	Risk-weighting can be applied based on the credit standing of the counterparty* as rated by the approved ECAI, or a RW of 100% for an unrated counterparty.	Not applicable <sup>c</sup>

\*In the case of a third-party guarantee, the capital should be treated as subject to credit risk with a risk-weighting equal to that of the guarantor provided that the RW of that guarantor is lower than the RW of the *Wakīl* as counterparty. Otherwise, the RW of the *Wakīl* shall apply.

<sup>c</sup>If funds are invested in foreign exchange, foreign exchange risk will also be applicable as per [section 3.2.4.3](#).

## SECTION V: SUKŪK AND SECURITISATION

### 5.1 Introduction

445. This section deals with minimum capital adequacy requirements in relation to (i) IIFS holdings of *Sukūk*; and (ii) the exposures of an IIFS where it is, or acts in a capacity such that it is considered to be, (a) the *originator* of a *Sukūk* issue, (b) an issuer of *Sukūk*, (c) a servicer of a *Sukūk* issuance, or (d) a provider of credit enhancement to a *Sukūk* issuance.

446. *Sukūk* (plural of *Sakk*) are certificates, with each *Sakk* representing a proportional undivided ownership right in tangible and intangible assets, monetary assets, usufructs, services, debts<sup>113</sup> or a pool of these assets, or a business venture (such as a *Muḍārabah* or *Mushārah*). These assets, which must be clearly identifiable,<sup>114</sup> may be in a specific project or investment activity in accordance with *Sharī'ah* rules and principles. Issuance of *Sukūk*, including the utilisation of funds raised through such issuance, should not involve any elements of *riba*, *gharar* and activities prohibited by *Sharī'ah*. The ownership right on *Sukūk* assets may be either a right of legal ownership (commonly referred to in the market as “asset-backed *Sukūk*”) or a right of beneficial ownership through a trust which holds the assets for the benefit of the *Sukūk* holders (commonly referred to in the market as “asset-based *Sukūk*”).

447. *Sukūk* differ from conventional interest-based securities or bonds in a number of ways. Please refer to [Appendix D](#) for a comparison between *Sukūk*, conventional bonds and shares.

### 5.2 Features of Securitisation in *Sukūk*

448. *Sukūk* are based on securitisation structures which, in the case of asset-backed *Sukūk*, insulate the *Sukūk* holders from exposure to any financial problems of the originator and, due to the ownership of underlying assets, expose them to losses in the event of impairment of the securitised assets. The applicable risks are thus those of the underlying assets, and these will in principle be reflected in any credit rating issued by a recognised ECAI. For such *Sukūk*, it is necessary that the key securitisation elements are in place to ensure that *Sukūk* holders have legal title and realisable security over the assets (see [section 5.2.1](#)). It follows from this characterisation of asset-backed *Sukūk* that the underlying (securitised) assets must be transferred to the *Sukūk* investors (or to an SPE for their benefit) by a “true sale”, thus conferring on them true and effective rights of ownership. The underlying assets are de-recognised from the balance sheet of the originator, who has no financial liability to the *Sukūk* investors. The assets are “bankruptcy-remote” from the originator in case the latter becomes insolvent. In case of a default of the *Sukūk* (e.g. because *Ijārah* lessees of the assets fail to pay what is due), the investors have recourse to the assets (physical assets or the usufruct thereof), not to the originator.

449. However, in some issuances the investors’ ownership is of a beneficial nature (through a trust over the securitised assets). Such issuances may be made, for example, because of legal impediments to the transfer of legal ownership of sovereign assets or for other reasons that make the transfer of true and effective rights of ownership problematic (see paragraph 452).<sup>115</sup> Since the *Sukūk* investors in such cases

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<sup>113</sup> It is not considered permissible in most jurisdictions to securitise debt claims or other receivables for the purpose of issuing *tradable Sukūk*. In most jurisdictions, *Sharī'ah* scholars require that, to be tradable, *Sukūk* must not solely represent receivables or debts, except in the case of a trading or financial entity selling all its assets, or a portfolio with a standing financial obligation, in which some debts, incidental to physical assets or usufruct, were included unavoidably.

<sup>114</sup> See [section 5.5](#) (assets in securitisations) for details.

<sup>115</sup> According to the *Sharī'ah* Board of the IDB, *Sukūk* assets must be undividedly owned by the *Sukūk* holders either directly or through their agent (SPE). This ownership should be valid from both the legal and *Sharī'ah* perspectives, in the sense that the *Sukūk* holders (whether as individuals or through their agent – that is, an SPE) have the ownership of the underlying assets. The ownership of the underlying assets should be transferred to the *Sukūk* holders and registered in their names with legal authorities. (These *Sukūk* may be known, rather incongruously, in the market as “asset-backed”). However, in jurisdictions where there is a prohibition on transferring legal titles to such assets, in this case only the beneficial ownership is permitted to be transferred to the *Sukūk* holders (such *Sukūk* may be known, rather incongruously, in the market as “asset-based”) based on the following conditions: (a) The definition of beneficial ownership must be stated clearly in the *Sukūk* document. The beneficial ownership of *Sukūk* assets

have beneficial rather than legal ownership of the underlying assets, in case of default the investors have recourse to the originator. This Standard deals with the prudential issues raised for IIFS by their involvement in the issuance and holding of *Sukūk*, whether asset-backed or asset-based, from the perspective of capital adequacy.

### 5.2.1 Securitisation Process for *Sukūk* Structuring

450. Securitisation for *Sukūk* is the financial engineering process for the creation and issuance of *Sukūk*, where:

- (a) payment of face value and income is derived from the cash flows generated by the securitised assets, or by the pool of assets that underlie the issuance of the *Sukūk*;<sup>116</sup> and
- (b) legal or beneficial ownership of the underlying assets is transferred to the investors in the form of *Sukūk*.

Contrary to the conventional securitisation where receivables and associated “collateral rights”<sup>117</sup> are transferred to the bondholders, *Shari’ah*-compliant securitisation involves legal or beneficial ownership rights in the underlying assets being transferred to *Sukūk* holders.

451. The ownership of assets, or a pool of assets, to be securitised is transferred to an SPE which is set up to manage the assets on behalf of the *Sukūk* holders and to issue the *Sukūk*. (See [section 5.2.5](#) for details on SPE.) The contractual terms of the *Sukūk* issuance determine the rights of the investors in the *Sukūk* to the securitised assets.

452. In many jurisdictions, including some in which *Sukūk* issuances may take place, there may be legal obstacles to setting up an appropriate type of SPE which can meet the conditions for the fiduciary responsibilities on behalf of *Sukūk* investors. In such legal environments, it may not be possible to transfer legal title in the underlying assets to the investors, or to ensure that the investors are able to exercise these rights (e.g. to repossess *Ijārah* assets) in the event of default. In these circumstances, a right of beneficial ownership through a trust over the assets is typically created. Such cases can arise, among others, in the *Sukūk* issued by some sovereigns and national monetary authorities where the laws applicable in the jurisdiction restrict the legal transfer of national assets to certain types of investors – for example, those based in other jurisdictions. In some common law jurisdictions, the transfer of legal ownership is not a regulatory requirement given that such jurisdictions recognise the transfer of beneficial ownership.<sup>118</sup> These asset-based *Sukūk* commonly involve a repurchase undertaking<sup>119</sup> from the obligor,

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refers to valid ownership with all the rights and obligations, but excluding the right of registration in the legal authorities. (b) There must be a statement by the transferor (by the way of trust certificate) in order to confirm that indeed the valid ownership has been transferred to the *Sukūk* holders along with associated rights and obligations. The SPE does not have any right to utilise these assets without prior permission from the *Sukūk* holders to the fact that the assets have been registered under the SPE’s name as a fiduciary only. (c) The trust certificate, as mentioned above, can be enforced in the official authorities that prohibit the legal transfer of the underlying assets to the *Sukūk* holders.

In case of breach of, or not being able to take into consideration, any of these conditions, the *Sukūk* is not permitted to be issued legitimately from a *Shari’ah* perspective on the basis of such assets.

<sup>116</sup> Basel II defines a traditional securitisation (in conventional finance) as a structure where the cash flow from an underlying pool of exposures is used to service at least two different stratified risk positions or tranches reflecting different degrees of credit risk. Payments to the investors depend upon the performance of the specified underlying exposures, as opposed to being derived from an obligation of the entity originating those exposures. In contrast, *Sukūk* securitisation may or may not involve issuance of various tranches of *Sukūk*.

<sup>117</sup> In the case of conventional securitisation, the receivables sold to the SPV will usually arise from loans, leases, rentals, trade or credit card debts and any associated collateral rights – for example, personal and proprietary security such as guarantees, mortgages and pledges. The purpose of the SPV is to acquire receivables and any associated collateral rights from an originating institution.

<sup>118</sup> In cases where there is no transfer of legal title of the assets to the *Sukūk* holders, there should be a sale contract that fulfils all the *Shari’ah* conditions and requirements, such as identification of securitised assets. Likewise, the effects of a valid sale contract should be reflected, such as recognition/recording of profits and losses related to the sale of assets. The SPE should also be able to protect the rights of the *Sukūk* holders. In this case, in order to mitigate the risk of the originator’s sale of securitised assets to a third party, the *Sukūk* issuer may request the originator to pledge the securitised assets for its benefit.

<sup>119</sup> A repurchase undertaking (unilateral binding promise to buy the assets) is issued by the originator to the issuer/trustee that it will purchase the *Sukūk* assets at a future date or on the occurrence of certain events such as maturity of the *Sukūk* or the exercise of

due to non-transferability of legal title. In such a case, the credit risk of the *Sukūk* is that of the originator, subject to any *Sharī'ah*-compliant credit enhancement.

453. *Sukūk* securitisation involves the following steps:

- (a) origination of assets (in conventional finance, these are normally loans or other receivables, while in Islamic finance they are *Sharī'ah*-compliant assets such as the subject matter of *Ijārah* or partnership interests in *Mushārah* or *Muḍārah*);
- (b) transfer of the assets to an SPE, which acts as the issuer by packaging them into securities (*Sukūk*); and
- (c) issuance of the securities to investors.

454. Asset-based *Sukūk* can also be issued by a separate issuing entity that purchases the underlying assets from the originator, packages them into a pool and acts as the issuer of the *Sukūk*. This issuing entity may require the originator to give the holders recourse that should comply with *Sharī'ah* rules and principles. The issuing entity can, however, provide *Sharī'ah*-compliant credit enhancement by repayment undertaking, in the event of default by the originator, through a *Sharī'ah*-compliant financing mechanism to *Sukūk* holders. This credit enhancement provides the *Sukūk* issuance with the credit rating of the (high-rated) issuer and thus enables it to achieve an investment-grade credit rating.

## 5.2.2 Parties in a Securitisation Structure

455. From a capital adequacy perspective, the parties in a securitisation structure include the originator, the issuer and the investors, in addition to which the following may be involved: an institution that acts as manager of the issuance, a servicer to service the underlying assets,<sup>120</sup> one or more credit rating agencies to rate the securities (*Sukūk*), an investment banker to act as an adviser or to place the securities with investors, and (in some *Sukūk* securitisations) an institution that acts as a provider of credit enhancement.<sup>121</sup>

456. An IIFS may act as *originator* of *Sukūk* issues in any of the following cases:

- (a) The ownership of assets held by the IIFS is transferred to holders of *Sukūk* by means of a securitisation. Such a securitisation may offer the IIFS one or more of the following benefits:
  - (i) increased liquidity, since a relatively illiquid asset (such as an asset held as lessor in an *Ijārah* or *Ijārah Muntahia Bittamlik*) is converted into cash paid by the investors in the *Sukūk* subscription; and
  - (ii) reduced capital requirements, insofar as the securitisation may permit the IIFS to exclude the assets from the calculation of its RWAs.

The achievement of the second of these benefits will depend on the way in which the securitisation is structured. For this, the IIFS must be able to derecognise all or most of the exposures relating to the assets from its balance sheet, according to the criteria for derecognition set out in [section 5.6](#).

(b) An IIFS may act as *sponsor* of a *Sukūk* issuance or similar programme involving assets of a customer in which the IIFS manages or acts as adviser to the programme, places the *Sukūk* into the market, or provides liquidity and/or credit enhancements. In this case, the benefit to the IIFS would be the earning of fees for the services provided.

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an early redemption right by the *Sukūk* holders. Where a repurchase undertaking exists, investors have a credit exposure to the corporate or sovereign entity providing the undertaking. This gives rise to the risks of (a) the enforceability or strength of the repurchase undertaking in the jurisdiction, and (b) the priority of the *Sukūk* in the capital structure of the originator. Also see [section 5.2.4](#) for *Sharī'ah* requirements on repurchase undertaking.

<sup>120</sup> Depending on the structure of the *Sukūk* securitisation, a servicer may perform different functions for management of the underlying assets in the *Sukūk* – for example, to collect payment, handle related taxes, manage escrow accounts and/or remit payments.

<sup>121</sup> See [section 5.3](#) for details.



457. In a securitisation structure, the role of servicer consists of, *inter alia*, collecting payments on behalf of the investors and passing them on to the latter, when this function is not carried out by the issuer. In the case of *Ijārah* or IMB assets, the lessor is legally responsible for maintaining the assets in such condition that the lessee is not deprived of the full usufruct of the assets, which involves responsibility for basic maintenance, *Takāful*, and so forth. This function is performed on behalf of the *Sukūk* holders by the servicer, but the originator may act as servicer.

### 5.2.3 Collateral Security Structure

458. Consideration of the collateral security structure<sup>122</sup> is a critical factor; it needs to be the subject of legal opinions and is subject to *Sharī'ah* permissibility (in the case of perfectibility<sup>123</sup>). Those security interests must be the first priority (there can be no prior or subsequent claims) and be perfected (or perfectible).

459. The legal opinions must address the nature of the security interest, the enforceability of the security interest against third parties, and perfection requirements (such as notices, registration and recordation). The effects of bankruptcy on perfection must also be considered and opined upon. Major issues related to *Sukūk* based on collateral security interest and related perfection include the following:

- (a) *Rahn* (mortgage or other pledge of assets) concepts in certain jurisdictions are possessory in nature. This makes perfection a particularly difficult opinion issue in these jurisdictions.
- (b) In many jurisdictions, and without regard to *rahn* concepts, perfection and priority regimes are not well developed.
- (c) Bankruptcy laws and regimes may also not be well developed in some jurisdictions.

### 5.2.4 Characteristics of True Sale and Repurchase of Assets

460. *Sukūk* are issued based on securitisation of assets where the originator "transfers" the assets via an SPE to *Sukūk* investors and the latter have a legally recognised asset ownership interest. For such transfer of assets to hold legally, there must be an agreement that is evidence of a binding sale transaction from the originator to the *Sukūk* investors; that is, such a contract must be valid, binding and legally enforceable on all parties involved. With this sale transaction, the investors will become legal owner of the assets underlying the *Sukūk* transaction, with all of the rights and obligations that accompany actual ownership. The SPE must be "bankruptcy remote" from the originator. Thus, upon the insolvency of a *Sukūk* originator, the underlying assets cannot be clawed back into the bankruptcy estate of the originator. In such *Sukūk*, *Sukūk* holders have no recourse to the originator; their only recourse is to the underlying assets.

461. From a juristic perspective, subject to jurists' interpretations in the jurisdiction, there are four key criteria for a transaction to be considered as a "true sale" that transfers legal title to the SPE for the benefit of the *Sukūk* investors:

- (a) The transfer must be such that it cannot be recharacterised by a court or other body as a secured loan, or otherwise be avoided in a bankruptcy or insolvency proceeding involving the originator of the assets (such as pursuant to a fraudulent transfer in anticipation of bankruptcy or a preference payment).
- (b) The bankruptcy or insolvency of the originator should not affect the assets that have been transferred to the issuer/SPE. This, in turn, means that the issuer will be able to enforce collection and other rights against the source of the income (the payer) without hindrances resulting from the bankruptcy or insolvency of the originator.

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<sup>122</sup> Collateral security structure is mainly used in *Sukūk* based on *Sharī'ah*-compliant project financing.

<sup>123</sup> In legal terminology, perfection relates to the additional steps required to be taken in relation to a security interest in order to make it effective against third parties and/or to retain its effectiveness in the event of default by the grantor of the security interest. Depending on the legal system in the jurisdiction, collateral security may be perfected by some kind of notice, registration or filing.

- (c) The transfer must then be perfectible at the election of the issuer.
- (d) The sale must be free and clear of all prior overriding liens.

462. In the case of *Sukūk* meeting the criteria for "true sale" to the SPE, the risk of principal repayment depends on the performance of the underlying assets and not on any other mechanism that ensures principal or profit repayment, such as a "repurchase undertaking" provided by the originator to the investors. Similarly, the payment of income to the investors depends on the asset performance instead of any obligation of the originator. Effectively, this means that in the event of the originator's insolvency, the *Sukūk* holders continue to retain the ownership of the underlying assets, and cash flows continue to be paid to the investors.

463. According to *Sharī'ah* rules and principles as generally understood, it is not permissible for the *Muḍārib* (investment manager), *Sharik* (partner) or *Wakīl* (agent) to undertake in advance to repurchase the assets at maturity from *Sukūk* holders or from one who holds them, for their nominal or par value. It is, however, permissible to undertake the purchase on the basis of the net value of assets, their market value, fair value or a price to be agreed at the time of purchase. In the event of negligence or misconduct by the *Sukūk* manager (i.e. *Muḍārib*, *Sharik* or *Wakīl*), it is required that the *Sukūk* manager be liable to guarantee the payment of capital to *Sukūk* holders, at the nominal or par value. It is also permissible for a lessee (i.e. the originator) in an *Ijārah Sukūk* to undertake to purchase the leased assets at maturity for their nominal value, provided the lessee is not also a *Sharik*, *Muḍārib* or *Wakīl*.

464. A *Mushārahah* structure may be used to acquire asset ownership by setting up a venture (*Mushārahah*) jointly owned by the *Sukūk* investors and the originator/issuer. Thus, it represents the direct proportionate ownership shares of the holders in the assets of a private commercial enterprise or a project. The investor's subscription money may be used to purchase non-liquid or fixed assets such as real estate or movable assets, whereas the originator/issuer can contribute specific assets or management skills. In order to cover risks related to the *Mushārahah* venture, this structure may use repurchase undertaking subject to meeting the criteria mentioned in the previous paragraph.

### 5.2.5 Special-Purpose Entity

465. A special-purpose entity is a legal entity that is created solely for a particular financial transaction or series of transactions. The SPE may take the form of a limited partnership, limited liability company, trust, corporation or collective investment fund, or be established under a special law if such a law is SPE-enabling. The establishment of an SPE vehicle or conduit is required to house the assets transferred by the originator and issue *Sukūk* based on such assets.<sup>124</sup> The SPE then serves as an intermediary between the originator and the *Sukūk* investors.

466. In *Sukūk* structures, the SPE is established as a "bankruptcy-remote" independent entity, company or trust so that following a "true sale" of the securitised assets to the SPE, the assets cannot be clawed back by the liquidator of the originator in the event of its liquidation.

467. In conventional securitisations, the SPE is a company or trust or other legal entity having no other business. In a *Sukūk* securitisation, the SPE can be organised, for example, as a *Mushārahah*, *Muḍārabah* or *Wakālah*, where, nonetheless, the requirement of SPE having no other business continues to apply. In the former two cases, there is a partnership contract with financial participation by the *Sukūk* investors. In the case of a *Muḍārabah* structure, only the *Sukūk* investors participate with money as *Rabb al-Māl*, while the other party (i.e. the SPE) acts as the manager (as *Muḍārib*) of the securitised assets. In the case of *Wakālah*, the SPE as an agent (*Wakīl*) acts as the manager of assets on behalf of the *Sukūk* investors.

468. A general-purpose or operating company (as opposed to an SPE) is not appropriate for holding the securitised assets, as such a company might have other assets and other liabilities, each of which would be likely to interfere with the exclusivity of the *Sukūk* investors' rights over the securitised assets.

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<sup>124</sup> As mentioned in section 5.2.1, there may be some obstacles to setting up an appropriate type of SPE in certain jurisdictions, which can meet the conditions for the fiduciary responsibilities. In that case, the *Sukūk* structure would not involve an SPE.

The SPE is a legal entity which has a legal status that makes it bankruptcy-remote from the originator. By its very nature, it is a legal shell with only the specific assets transferred by the originator, and those assets are effectively owned by the *Sukūk* investors, legally or via a trust, there being nothing else in the vehicle in which any other party could have an interest. Such an SPE cannot be consolidated with the originator for tax, accounting or legal purposes, as that would affect its bankruptcy-remote position.

### **5.3 Credit Enhancement**

469. *Sukūk* can be "credit enhanced" to raise their credit quality above that of the underlying asset pool. Credit enhancement is therefore intended to reduce the credit risk to the *Sukūk* investors and reduce the funding cost of the originator. It also results in the *Sukūk* having an enhanced credit rating by the ECAI. Subject to *Sharī'ah* permissibility, the mechanisms used in credit enhancement may include, *inter alia*, those discussed below.

#### **5.3.1 Over-collateralisation**

470. Subject to *Sharī'ah* approval of the structure, an originator may retain a small equity share in a pool of securitised assets in order to provide over-collateralisation. For example, the originator of a securitisation of a pool of *Ijārah* lease assets might securitise 90% of the pool and retain 10% as an equity position (first loss position) – that is, a residual claim. The *Sukūk* holders would be entitled to income based on 90%, and the originator, based on the remaining 10%, of the rental income from the pool.

#### **5.3.2 Excess Spread**

471. Excess spread is the difference between (a) the expected periodic net income from the securitised assets (i.e. the income after expenses such as servicing fees and operating fees have been paid) and (b) the periodic amounts payable to the *Sukūk* investors. Subject to *Sharī'ah* approval, excess spread may be built into a *Sukūk* structure such that the issuer/SPE retains a certain percentage of the periodic net income if this is in excess of the target level of the periodic payments to the *Sukūk* holders, and holds this amount in an excess spread reserve. If the net income falls below the level required to meet the target level of the payments to the *Sukūk* holders, the issuer/SPE may release an amount from the excess spread reserve in order to make good the shortfall in whole or in part.<sup>125</sup>

#### **5.3.3 Cash Collateral**

472. Cash collateral is a segregated trust account, funded at the time when a new series of *Sukūk* is issued, that can be used to cover shortfalls in payment of coupons, principal or servicing expenses if the excess spread falls below zero. The account can be funded by the issuer, but is most often generated by a *Qard* from the originator or another third party. Commonly, the pooling and servicing agreements dictate the amount of the cash collateral, which is typically based on a specified percentage of the *Sukūk* issued. The amount in the cash collateral account can be invested in the high-rated *Sukūk* to generate profits during the period.

#### **5.3.4 Takāful Protection**

473. It is possible that *Takāful* cover may be provided by a third-party *Takāful* undertaking against losses due to defaults (i.e. in *Ijārah Sukūk*, non-payment of rentals or redemption price by the

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<sup>125</sup> This mechanism is comparable to the "profit equalisation reserve" commonly used by IIFS to "smooth" the profit payouts to investment account holders.

originator/lessee) or ratings downgrades of *Sukūk*.<sup>126</sup>

### 5.3.5 Classification of Credit Enhancement

474. The credit enhancement in a *Sukūk* structure can be provided by an "internal" mechanism such as by the issuer of the *Sukūk* structure or by an "external" arrangement such as a third-party guarantee. These credit enhancement structures are explained in the following:

(a) *Issuer-provided credit enhancement structure (the SPE)*

This structure comprises credit support where a part of the credit risk of the asset pool is assumed by the issuer.

(b) *Third-party guarantee credit enhancement structure*

This structure comprises the assumption of credit risk by parties other than the issuer. The guarantor does not have the right of recourse to the originator, and the guarantee can be for a fixed period and for a limited amount, without any consideration being received by the guarantor. However, a claim should first be made against the underlying assets, and then against the guarantor, unless an option is provided to make the claim otherwise.

### 5.4 Credit Rating

475. Under securitisation, the *Sukūk* investors are not concerned with the credit strength of the issuing entity or the originator except for the quality of the originated portfolio. Essentially, the ECAI are concerned with the quality of the underlying pool of assets and the robustness of the structure. The most important concerns of an ECAI while assigning a rating are the quality of the asset portfolio, solvency of the issuer or the originator, perfection of the legal structure, tax risks, clean and prior title to the securitised portfolio, risks of set-off and prepayment, etc. A change in the rating for a *Sukūk* issue may be due to deterioration in the performance of the collateral, heavy utilisation of credit enhancement or downgrade of a supporting rating – for example, a *Takāful* company that was underwriting *Takāful* on the pool of the assets. In those *Sukūk* structures where legal transfer of assets has not taken place due to the reasons mentioned in [section 5.2.1](#), the rating will depend on a composite view of the strength of the rating of the issuer or the originator and the quality of the asset pool.

### 5.5 Assets in Securitisations

476. The assets in a *Sukūk* securitisation have to be in compliance with *Sharī`ah* rules and principles. Islamic finance typically relates finance to assets or equity interests, and the concept of payments of income and nominal value being derived from *Sharī`ah*-compliant sources (non-financial assets or equity interests) is prevalent in Islamic structured transactions. All *Sukūk* returns and cash flows should be linked to assets purchased or (in the case of project finance) those generated from an asset once constructed. Therefore, originators wishing to raise financing through *Sukūk* are required to utilise *Sharī`ah*-compliant assets in the structure.

477. For an IIFS, the underlying assets to be securitised may include, *inter alia*, *Ijārah* leased assets, *Murābahah* or *Salam* receivables, *Istisnā`* assets or equity ownership (*Mushārahah* or *Muḍārahah*) according to *Sharī`ah* rules and principles. In certain jurisdictions, the *Sukūk* may also be based on a portfolio of underlying assets comprising different categories. Use of such a portfolio allows for a greater mobilisation of funds, as a certain proportion of *Murābahah* or *Salam* assets that do not meet *Sharī`ah* criteria for tradability (being classed as receivables) can be combined in a portfolio with *Ijārah* assets and/or with *Mushārahah* or *Muḍārahah* assets that are classed as non-financial.

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<sup>126</sup> Such *Takāful* protection would not resemble credit default swaps in any way. The *Takāful* participants would be required to have the credit exposures being covered (an "insurable interest").

478. Thus, while *Sukūk* based on financial assets are not tradable, the latter may be combined in a pool with non-financial assets that can act as a basis for tradable *Sukūk*,<sup>127</sup> provided the proportion of non-financial assets (neither debt nor cash) in the pool is not less than a certain acceptable minimum ratio, in accordance with *Sharī'ah* rules and principles.

479. Business ventures organised as *Mushārahah* or *Muḍārabah* partnerships may also be securitised, and the resultant *Sukūk* are tradable. Where such *Sukūk* are held by an IIFS until maturity and are unrated, the provisions of "equity position risk in the banking book" are applicable.

## 5.6 Recognition of Risk Transference (Asset Derecognition Criteria)

480. An originating IIFS may exclude securitised exposures from the calculation of its assets for capital adequacy purposes only if all of the following conditions have been met. IIFS meeting these conditions must still hold regulatory capital against any exposures that they retain in respect of the securitisation (such as credit enhancements).

(a) Substantially all credit risks (and price risk, where applicable) associated with the securitised assets have been transferred to third parties.

(b) The transferor (i.e. originator) does not maintain effective or indirect control over the transferred assets. The assets are legally isolated from the transferor in such a way that the exposures are put beyond the reach of the transferor and its creditors, even in bankruptcy or receivership. These conditions must be supported by an opinion provided by qualified legal counsel. The securitised assets held by the issuer will not be consolidated with the assets of the originator or the issuer's parent in a bankruptcy or insolvency of any of those entities.

(c) Holders of the *Sukūk* (investors) have a claim only to the underlying pool of assets, and have no claim against the transferor.

(d) The immediate transferee is an SPE, and the holders of the legal and beneficial interests in that entity have the right to pledge or exchange such interests without restriction.

(e) Clean-up calls<sup>128</sup> must be at the discretion of the issuer (SPE). They must not be structured to provide credit enhancement<sup>129</sup> and must be exercisable only when 10% or less of the purchase consideration for the underlying assets (e.g. in an IMB) remains to be paid. The issuer's rights to make clean-up calls, and the terms on which they are made, are subject to *Sharī'ah* approval.

481. In order to comply with *Sharī'ah* rules and principles, the structure must transfer all ownership rights in the assets from the originator via the issuer to the investors. Depending on the applicable legal system, these ownership rights do not necessarily include registered title.<sup>130</sup> The transfer could be a simple collection of ownership attributes that allow the investor (a) to step into the shoes of the originator and (b) to perform (sometimes via a servicer) duties related to ownership. The transfer could also include rights granting access to the assets, subject to notice, and, in the case of default, the right to take

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<sup>127</sup> These *Sukūk* are sometimes termed "*Sukūk al-Istithmar*".

<sup>128</sup> A clean-up call is an option that permits the securitisation exposures to be called before all of the underlying exposures or securitisation exposures have been repaid. It is generally accomplished by repurchasing the remaining securitisation exposures once the pool balance or outstanding securities have fallen below some specified level.

<sup>129</sup> If a clean-up call is considered as a credit enhancement at the time of exercise, such exercise should be considered as a form of implicit support provided by the IIFS and should be dealt with accordingly, based on the relevant supervisory guidance. In the case such support is recognized by the supervisory authority and approved by relevant SSB, the originator will be expected to hold capital against exposures associated with the securitisation transaction.

<sup>130</sup> In most jurisdictions, however, legal systems require some kind of notice, registration or filing to "perfect" the ownership of the underlying assets.

possession of the assets.<sup>131</sup>

482. The transfer raises questions of whether one transfers (a) the control of assets, and (b) substantial risks and rewards of ownership of the assets. As explained in [section 5.2.4](#), for the purpose of tax, accounting and/or regulation, the derecognition of the assets from the originator's balance sheet relies on a "true sale", meaning that the economic value of assets has been transferred from one party to another in a way that prevents the creditors or liquidator of the seller from claiming the assets from the buyer, thus creating "bankruptcy remoteness" for the assets. The question whether legal isolation has been achieved is to be judged by best practice standards. Differences in legal systems are to be taken into account in making this judgement.

483. In the case of bankruptcy remoteness, subject to the legal framework in the jurisdiction, the conditions include the following:

(a) If there were a bankruptcy of the issuer, the assets of the issuer would be distributed in accordance with the law or a court order, rather than in accordance with the contractual arrangements involving the issuer.

(b) Separateness covenants will be required to ensure bankruptcy remoteness (as well as non-consolidation).

(c) Another provision to ensure bankruptcy remoteness relates to non-competition and bankruptcy declarations. The originator, investors, credit enhancers and others agree in the transaction documents not to initiate involuntary bankruptcy proceedings against the issuer. The issuer also provides, in both its constitutive documents and the transaction documents, not to initiate voluntary bankruptcy proceedings. The parties should seek a legal opinion from jurists in the jurisdiction concerned and ensure that these types of agreements and warranties are legally valid and enforceable.

## 5.7 Operational Requirements for Credit Analysis

484. IIFS are required to carry out the credit analysis of their securitisation exposure based on the following criteria, so as to use the risk weights suggested in the next sub-section. If an IIFS is unable to perform the due diligence and maintain the information specified in the following, it will be required to deduct the securitisation exposure from its regulatory capital. The criteria will be applicable to securitisation exposures of IIFS both in the banking and trading book.

(a) An IIFS should have a clear understanding of the nature and features of its individual securitisation exposures, including the risk characteristics of the pools underlying such exposure on an ongoing basis. This requirement applies to both on- and off-balance sheet securitisation exposures.

(b) As the payments to *Sukūk* holders are dependent on the performance of underlying assets, an IIFS should be able to assess the performance information on an ongoing basis.

(c) An IIFS should be able to thoroughly understand all the structural features of a *Sukūk* that can materially impact the performance of its exposures to the transaction. Such exposures may include credit enhancements, liquidity enhancements, triggers, and deal-specific default definitions.

## 5.8 Treatment for Regulatory Capital Purposes for *Sukūk* and Securitisation Exposures

485. In conventional securitisations, it is common to have a structure in which the cash flows from an underlying pool of assets are used to service at least two different stratified risk positions or *tranches*

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<sup>131</sup> This right is comparable to the right of collateral over the assets, but strictly speaking the term "collateral" is inappropriate since the investors already have ownership rights over the asset; hence, the term "quasi-collateral" is preferred in this Standard.

reflecting different degrees of credit risk. Junior securitisation tranches can absorb losses without interrupting contractual payments to more senior tranches. A key objective of such structures is credit enhancement for the senior tranche, such that it achieves at least an investment-grade credit rating.<sup>132</sup>

486. Apart from being a holder of *Sukūk* (which exposes an IIFS to various credit and market risks of the *Sukūk*), an IIFS may act in various capacities in a *Sukūk* securitisation and hence be exposed to risks that may be similar to those in a conventional securitisation. However, *Sharī'ah* rules and principles may add an extra dimension to the existing risk exposures and may have a material effect on the risk profile of *Sukūk* holders.

487. When referring to securitisations, it is customary to use the term “exposures” to refer to either (the credit risk of) assets involved in the securitisation, or to other exposures such as those resulting from credit enhancements or those from acting as sponsor, issuer or servicer. In Islamic finance, in addition to credit risk, there may be other exposures attaching to certain asset categories.

488. Since securitisations may be structured in many different ways, the capital treatment of a securitisation exposure must be determined on the basis of the economic substance rather than the legal form of the securitisation structure. Similarly, supervisors will look to the economic substance of a transaction to determine whether it should be subject to the securitisation framework for purposes of determining regulatory capital. IIFS are encouraged to consult with their national supervisors when there is uncertainty about whether a given transaction should be considered a securitisation.

489. One key issue for IIFS is the extent to which the exposures or obligations attaching to the underlying assets have been effectively transferred to the *Sukūk* holders. A related issue is whether any types of risk other than credit risk need to be considered, such as price risk in the context of a securitisation where the underlying asset is a *Salam* or *Istisnā`* asset.

490. While it is clear that the tradability of *Sukūk* is often a key issue, and is of fundamental importance if an IIFS is acting as a sponsor of a securitisation programme involving assets of a customer, it is emphasised that *Sharī'ah* criteria for being tradable are unrelated to the capital treatment of the underlying assets by the originator.

491. The rating of *Sukūk* must be from an eligible ECAI as recognised by the IIFS's supervisory authority, and must take into account the entire amount of the credit exposure of the IIFS with regard to all amounts owed to it. Where *Sharī'ah* requirements can materially affect the credit risk, these will be considered.

492. When an IIFS is required to deduct a securitisation exposure from its capital, the deduction will be equivalent to a risk weight of 1250% if the minimum capital requirement is 8%. Deductions from capital may be calculated net of any specific provisions taken against the relevant securitisation exposures.

## 5.9 Capital Requirements for *Sukūk*

493. The following sets out the minimum capital requirements to cover the credit risk and market risk arising from the holding of a *Sukūk* in the “banking book” by an IIFS. Supervisory authorities have discretion to specify measurement approaches as they think appropriate for other types of *Sukūk* which are not listed in this sub-section, provided they are approved by a relevant *Sharī'ah* board. For unrated *Sukūk* that use a combination of more than one of the *Sharī'ah*-compliant contracts outlined below, the capital requirement will be calculated taking into account the risk implications of the overall structure.

494. As in principle *Sukūk* are externally rated, the relevant risk weight will be based on the ECAI ratings in accordance with the standardised approach covered in this Standard. It is implied that ECAI has

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<sup>132</sup> Conventional securitisations are categorised as either *traditional* or *synthetic*. In a traditional securitisation, payments to the investors depend on the performance of the specified underlying exposures, as opposed to being derived from an obligation of the entity originating those exposures. In a synthetic securitisation, the credit risk of an underlying pool of exposures is transferred, in whole or in part, through the use of credit derivatives or guarantees that serve to hedge the credit risk of the exposures by transferring significant credit risk to investors as holders of the securities.

taken into account the structure and other features of *Sukūk* while suggesting the ratings. Where there are no acceptable ECAI ratings,<sup>133</sup> the RWs will be determined on the basis of the underlying assets as set out below, which may involve market risk as well as credit risk.

495. Though the RWs suggested in the following are based on an acceptable ECAI rating, an IIFS should have methodologies that enable it to assess the credit risk involved in securitisation exposures at individual and portfolio levels. An IIFS should assess exposures, regardless of whether they are rated or unrated, and determine whether the RWs applied to such exposures, under the standardised approach, are appropriate for their inherent risk. In those instances where an IIFS determines that the inherent risk of such an exposure, particularly if it is unrated, is significantly higher than that implied by the RW to which it is assigned, the IIFS should consider the higher degree of credit risk in the evaluation of its overall capital adequacy.

496. For *Sukūk* classified in the trading book, the market risk capital requirement as mentioned in [section 3.2.3](#) on market risk is applicable.

### **5.9.1 Salam Sukūk**

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

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

499. The market risk in *Salam Sukūk* (in the absence of a parallel *Salam* contract or other hedge) is likewise the same as that of the underlying contract, namely a long position in the underlying commodity. This risk can be measured according to either the maturity ladder approach or the simplified approach as set out in [section 3.2.4.4](#) (commodities and inventory risk).

500. A *Salam Sukūk* issuance which is structured with an undertaking from the issuer that the underlying commodity will be sold to a third party at a specified selling price (by means of a parallel *Salam* contract) shall carry the RW of the buyer of that underlying commodity in the parallel *Salam* contract.<sup>134</sup>

### **5.9.2 Istisnā` Sukūk**

501. *Istisnā` Sukūk* represent proportionate shares in the financing of a project to construct an asset at a price to be paid in future instalments, the total of which equals the total face value of the *Sukūk*, in addition to mark-up. The *Sukūk* can be in the form of serial notes or certificates with different maturity dates that match the progress schedule of instalments as agreed between the *Sukūk* issuer (as manager

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<sup>133</sup> "Unacceptable ratings" refers to either the *Sukūk* being unrated or the rating of the *Sukūk* not being acceptable to the supervisory authority.

<sup>134</sup> For this type of *Salam Sukūk*, there is no capital charge for market risk that consists of basis and forward gap risks (namely, the risk that the hedge may be impaired because the underlying commodity delivered may be of inferior quality or may be delivered later than the contractual date) as the underlying commodity is normally traded on an exchange that eliminates the risk of late/non-delivery or delivery of a commodity of inferior quality.



on behalf of the *Sukūk* investors) and the construction firm. It is allowed to trade in *Istisna Sukūk* in cases where the funds have been utilised to build or construct the assets for the *Sukūk* holders during the *Istisna* period. In the case of parallel *Istisna*, if the value of *Istisna* is being paid in cash or the assets have already been delivered to the buyers, then tradability of such *Sukūk* will be subject to the rules of dealing with debt. The subject matter in *Istisna Sukūk* is considered to be a non-financial asset (WIP inventory).

502. The asset may be constructed on behalf of an ultimate customer or off-taker with whom the IIFS enters into a parallel *Istisnā`* contract. In this case, there is a credit risk exposure to the ultimate customer for the payment due under the parallel contract. This credit risk occurs upon commencement of the construction work by construction firm, until the whole amount or all the instalments (progress billings) are paid by the ultimate customer. The RW for this credit exposure is that of the ultimate customer, unless there is a guarantee, in which case the RW is that of the guarantor if lower.

503. The RW for *Istisnā` Sukūk* where there is no parallel *Istisnā`* is based on that of the issuer, which is 100% for an unrated issuer, unless a third party provides a guarantee, in which case the third party's RW (if lower than that of the issuer) will be applicable. In addition, a RW of 20% will be added to cater for the price risk to which the underlying *Istisnā`* is exposed. In the case of ECAI-rated *Istisnā` Sukūk*, the ECAI rating will apply.

504. In the event the returns to the *Sukūk* holder are from the cash flow of the underlying assets, which fall under the category of "Exposure to Assets" *Istisnā`*, the RW shall be based on the "supervisory slotting criteria" approach which carries RW of 70–250%.

505. Please refer to [section 4.4](#) on *Istisnā`* for detailed treatment.

### **5.9.3 *Ijārah and IMB Sukūk***

506. *Ijārah* and IMB *Sukūk* represent the holder's proportionate ownership in leased assets where the *Sukūk* holders will collectively assume the rights and obligations of the lessor. The *Sukūk* holders are entitled to a share of the lease rentals in proportion to their ownership shares in the leased assets. *Ijārah* and IMB *Sukūk* are tradable from the issuance date, as the subject matter is a non-financial asset owned by the *Sukūk* holders. As a proportionate owner, an *Ijārah* or IMB *Sukūk* holder assumes a proportionate share of any loss if the leased asset is destroyed, or of the cost of meeting the obligation to provide an alternative asset, failing which the lessee can terminate the lease without paying future rentals.

507. The RW for IMB rentals is based on the lessee's counterparty credit risk, since the bearer of the residual value risk of the underlying asset is not borne by the *Sukūk* holders. Please refer to [section 4.5](#) on *Ijārah* and IMB for detailed treatment.

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

### **5.9.4 *Mushārahah Sukūk***

509. *Mushārahah Sukūk* represent the direct proportionate ownership shares of the holders in the assets of a private commercial enterprise or project, where the subscription money is normally employed in purchasing non-liquid assets or assets such as real estate or movable assets. A *Mushārahah sakk* is a profit- and loss-sharing instrument where the exposure is of the nature of an equity position in the banking book, except in the case of investments (normally short-term) in assets for trading purposes.

510. The capital treatment of *Mushārahah Sukūk* is based on the intent of the underlying investments in *Mushārahah* that can be categorised as follows:

(a) *Private commercial enterprise to undertake trading activities in, for example, commodities*  
The RW shall be based on the applicable underlying assets as set out in the market risk section of [section 3.2](#).

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

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

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

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

Income-producing *Mushārah* investments with *Murābahah* sub-contracts carry the RW of the *Murābahah*. However, such *Sukūk* are not tradable in most jurisdictions.

511. Please refer to [section 4.6](#) on *Mushārah* for detailed treatment.

### **5.9.5 Muḍārahah Sukūk**

512. *Sukūk* holders subscribe to the certificates issued by a *Muḍārib* and share the profits and bear any losses arising from the *Muḍārahah* operations. The returns to the holders are dependent on the revenue by the underlying investment.

513. The treatment of *Muḍārahah Sukūk* is based on the intent of the underlying investments in *Muḍārahah*, which can be categorised as follows:

(a) *Private commercial enterprise to undertake trading activities in, for example, commodities*

The RW shall be based on the applicable underlying assets as set out in the market risk section in [section 3.2](#).

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

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

514. In the case of ECAI-rated *Muḍārahah Sukūk*, the ECAI rating will apply.

515. Please refer to [section 4.7](#) on *Muḍārahah* for detailed treatment.

### **5.9.6 Wakālah Sukūk**

516. The *Wakālah Sukūk* holders provide the capital for *Sharī'ah*-compliant investment activity, and the investment agent (*Wakīl*) undertakes investment of the funds. These *Sukūk* entitle the holders to a return in proportion to their investment in the underlying assets and a right under a purchase undertaking to buy all or a proportion of the underlying assets if certain conditions are fulfilled.

517. The SPE acting as the principal on behalf of the *Sukūk* holders appoints a *Wakīl* to invest funds provided by the *Sukūk* holders into a pool of investments or assets. The *Wakīl* lends its expertise and manages those investments on behalf of the SPE for a particular duration, in order to generate a return for the benefit of the *Sukūk* investors. The SPE and the *Wakīl* enter into a *Wakālah* agreement, which will govern the appointment, scope of services and fees payable to the *Wakīl*, if any. While the *Wakālah* structure has some similarities to the *Muḍārahah* structure, the main difference is that unlike a *Muḍārahah*, in which profit is divided between the parties according to certain ratios, *Sukūk* holders via a *Wakālah* structure will receive the return on the investments less the management fees payable to the *Wakīl*. The tradability of such *Sukūk* will be based on the underlying assets purchased by the *Wakīl*.

518. In this type of *Sukūk* structure, the portfolio of assets may comprise a broad range of *Sharī'ah*-compliant assets that will be selected by the *Wakīl* for a period of time corresponding to the duration of the *Sukūk*. The range of assets may include: *Sharī'ah*-compliant equities; *Sharī'ah*-compliant assets such as real estate and cars; *Murābahah*, *Istisnā'* or even other *Sukūk*, etc.

519. The treatment of *Wakālah Sukūk* is based on the intent of the underlying investments in *Wakālah*, which can be categorised as follows:

(a) *To undertake trading activities in foreign exchange, shares or commodities*

The RW shall be based on the applicable underlying assets as set out in the market risk section in [section 3.2](#).

(b) *To invest in assets that can be leased or sold on a Murābahah basis*

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

Income-producing *Wakālah* investments with *Murābahah* sub-contracts carry the RW of the *Murābahah*. However, such *Sukūk* are not tradable in most jurisdictions.

(c) *To invest in a combination of assets comprising shares, leasable assets, receivables from Murābahah or Salam, etc.*

The RW shall be measured according to the percentage of assets allocated in the investment portfolio of *Wakālah Sukūk* based on (a) and (b), above.

520. In the case of ECAI-rated *Wakālah Sukūk*, the ECAI rating will apply.

521. Please refer to [section 4.9](#) on *Wakālah* for detailed treatment.

### **5.9.7 Murābahah Sukūk**

522. In this case, the originator (and also, in some cases, the issuer) of the *Sukūk* is the buyer (on credit) of the *Murābahah* asset, the *Sukūk* investors are the sellers (on credit) of that asset, and the credit provided by the *Sukūk* investors and received by the issuer consists of the *Murābahah* selling price of the asset, which the originator sells to obtain the funds it seeks. The *Sukūk* holders own the *Murābahah* and are entitled to receive payment of that receivable (the selling price of the asset) either in instalments or in a lump sum at the end of the *Murābahah* contract. Such *Sukūk*, being securitised receivables, are not generally considered tradable in most jurisdictions.

523. The applicable RW shall be based on the standing of the obligor/issuer as rated by the ECAI. In cases where the obligor is unrated, a RW of 100% shall apply. If the *Sukūk* structure involves funding of an asset purchase in foreign currency, the relevant exposure shall be calculated based on measures of foreign exchange risk described in [section 3.2.4.3](#) (foreign exchange risk).

524. Please refer to [section 4.1](#) on *Murābahah* for detailed treatment.

### **5.9.8 Exclusions**

525. For all those *Sukūk* structures where legal transfer of assets has not taken place due to the reasons outlined in [section 5.2.1](#), the applicable RW shall be the credit RW of the originator, subject to any *Sharī'ah*-compliant credit enhancement by the issuer. The applicable credit RWs are based on credit ratings issued by a recognised ECAI (see [section 3.1.13](#)). Similarly, *Sukūk* which are issued by a sovereign shall carry the RW applicable to that sovereign, according to its respective rating as assigned by an ECAI that is approved by the supervisory authority. In some cases, a number of originators may form a pool to contribute assets in an asset-based structure (e.g. multiple sovereigns). In such cases, the rating of the *Sukūk* will be that of the pool, subject to any *Sharī'ah*-compliant credit enhancement.

## **5.10 Capital Requirements where the IIFS is the Originator**

### **Retained Securitisation Exposures**

526. An IIFS taking the role of an originator is required to hold regulatory capital against all of its retained securitisation exposures, including those arising from the provision of credit risk mitigants to a securitisation transaction, investments in a securitisation originated by it, and extension of a liquidity facility or credit enhancement. Repurchased securitisation exposures must be treated as retained securitisation exposures.

527. The risk-weighted asset amount of a securitisation exposure is computed by multiplying the amount of the exposure by the appropriate risk weight. For off-balance sheet exposures, IIFS must apply a credit conversion factor and then risk-weight the resultant credit-equivalent amount. Please refer to [section 3.1.2](#) (off-balance sheet exposures).

528. The credit risk weights for the retained securitisation exposures where the IIFS is the originator are covered in paragraphs 535–536, [section 5.15](#).

### 5.11 Treatment of Liquidity Facilities

529. The liquidity facilities in certain types of *Sukūk* structures are commitments from the facility provider to provide liquid funds if these are needed to meet contractual payments to *Sukūk* holders and there is a delay between the date of their collection and the date on which the payment to the *Sukūk* holders is due. The need for such facilities may result from a timing mismatch between cash collections from the underlying *Sukūk* assets (such as *Ijārah* rentals) and the scheduled payments due under the programme to the *Sukūk* holders. In this context, it is assumed the liquidity facilities comply with *Sharī'ah* rules and principles and meet operational requirements for the eligibility of a *Sukūk* liquidity facility set out by the national supervisory authority. The requirements may include requiring the facility documentation to identify clearly and limit the circumstances under which the facility may be drawn down. Subject to meeting such requirements, the proposed risk weight for liquidity facilities is set at a 50% CCF regardless of the maturity of the liquidity facility. However, if an external rating of the facility itself is used for risk-weighting the facility, a 100% CCF must be applied.

530. A servicer cash advance, based on *Qarḍ* (interest-free loan), is an advance granted by the servicer to the SPE to ensure timely payment to the investors<sup>135</sup> – for instance, in cases of timing differences between collection and payments.<sup>136</sup> However, it is a *Sharī'ah* requirement that such facilities remain essentially separate from the *Sukūk* undertaking and that this separation be properly documented. In the case of servicer cash advances, the national supervisory authority has discretion to assign a risk weight of 0% to such facilities.

### 5.12 Treatment of Credit Risk Mitigation for Securitisation Exposures

531. The treatment applies to an IIFS that has obtained a credit risk mitigant to a securitisation exposure. Credit risk mitigants include guarantees, collateral and on-balance sheet netting or any other *Sharī'ah*-compliant credit risk mitigation as recognised by the regulatory authority. Collateral in this context is that used to mitigate the credit risk of a securitisation exposure, rather than the underlying exposures of the securitisation transaction, subject to fulfilling criteria in [section 5.2.3](#).

532. Eligible collateral is limited to that recognised under the standardised approach for credit risk mitigation ([section 3.1.8](#)). Collateral pledged by SPEs may be recognised as a credit risk mitigation.

### 5.13 Treatment of Credit Enhancement Provided by an Issuer or Originator

533. For *Sukūk* with credit enhancement provided by the issuer or the originator, the RW is based on the credit rating of the credit enhancer. See [section 5.3](#) for details of various types of credit enhancements.

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<sup>135</sup> It is, however, not permissible for the manager of *Sukūk*, whether the manager acts as *Muḍārib* (investment manager), or *Shārik* (partner) or *Wakīl* (agent) for investment, to undertake to offer loans to *Sukūk* holders when actual earnings fall short of expected earnings. It is permissible, however, to establish a reserve account for the purpose of covering such shortfalls to the extent possible, provided the same is mentioned in the prospectus. It is not objectionable to distribute expected earnings, on account, or to obtain project financing on account of the *Sukūk* holders.

<sup>136</sup> A *Qarḍ* (interest-free loan) made to enhance earnings raises issues of *Sharī'ah* compliance and must be distinguished from credit enhancement by means of "excess spread", as described above.

#### 5.14 Capital Requirements where the IIFS is the Credit Enhancer

534. When the IIFS provides credit protection to a securitisation exposure, it must calculate a capital requirement on the covered exposure as if it were an investor in that securitisation. If the IIFS provides protection to a *Sukūk* issuance, it must treat the credit protection provided based on the risk of the underlying assets of the *Sukūk*. If the IIFS provides protection to a *Sukūk* issuance that has no legal transfer of assets, it must treat the credit protection provided based on the ECAI rating of the originator (as shown in the table in the next paragraph).

#### 5.15 Treatment of Credit Enhancement Provided by a Structure

535. Exposures in a *Sharī'ah*-compliant credit enhancement structure (covered in [section 5.3](#)) and retained securitisation exposures (covered in [section 5.10](#)) would be risk-weighted as shown in the following table.

Rating	Risk Weights				
	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to BB-	B+ and below or Unrated
Risk weight	20%	50%	100%	350%	1250%

536. For off-balance sheet exposures, the IIFS should apply CCF and then risk-weight the resulting credit-equivalent amount. If such an exposure is rated, a CCF of 100% will be applicable. A RW of 1250% will be applicable for positions with long-term rating of of B+ and below.<sup>137</sup> The same RW shall also be applicable for unrated positions.

<sup>137</sup> For short-term positions, a RW of 1250% will be applicable for a rating below A-3/P-3.

## SECTION VI: REAL ESTATE ACTIVITIES

### 6.1 Current Regulatory Environment of Real Estate Activities

537. Regulatory and/or supervisory authorities in a number of jurisdictions permit IIFS to invest in real estate directly on their balance sheets, or as part of off-balance sheet asset management activities, or indirectly through a wholly or majority-owned subsidiary. Real estate lends itself as a permissible asset class, as *Sharī'ah* rules and principles allow such investment. However, there is a general concern that such investments may expose the IIFS to the effects of cyclical real estate markets.

538. Conventional financial institutions in general cannot engage in real estate investments unless they obtain consent from the regulatory authority. These institutions are required to comply with applicable capital standards, and the authority determines that the activity poses no significant risk to the depositors. They also need to have an adequate risk management process in place, and the overall financial conditions (including capital requirements) should be able to withstand potential risk associated with the holding of investment or financing property. In most instances, the authorities require conventional institutions to establish a subsidiary or dedicated branch to conduct the real estate activities, so as to place these activities in a separate corporate entity and thus not expose their depositors to the risks of such investments.

539. In the case of IIFS, the IFSB conducted a survey which indicated that, following the last financial crisis, supervisory authorities in many jurisdictions have been quite pro-active in supervising the real estate portfolios of the IIFS in their jurisdictions, and some of them have updated their regulations and guidelines to align with the rapidly changing market conditions.

540. The IFSB survey also revealed that, in some cases, certain real estate activities are classified as financing rather than investment. The regulatory authorities treat these exposures as a type of mortgage, and they require them to be treated with the same regulatory credit risk treatment. In contrast, some IIFS act as property developers and/or then owners, an activity which is normally undertaken by real estate specialists. Such types of real estate activities raise supervisory issues, particularly with respect to risk management and capital adequacy,<sup>138</sup> especially during economic downturns. In certain jurisdictions, the supervisory authorities provide more detailed and specific guidance on the definition and classification of permitted activities.

### 6.2 Definitions

541. *Real estate activities* include various types of “financing” or “investment” in completed and under-construction properties, as well as land used for such purposes. Real estate investment activity involves, among other things, the purchase, sale and development of land, as well as residential and non-residential buildings.

542. *Financing* of real estate refers to an IIFS providing financing<sup>139</sup> as a part of usual financial intermediation activities to generate revenues from scheduled payments made by its customers. Similar to other types of financing, real estate financing exposes the IIFS to a variety of risks, requiring effective risk management practices to be in place. In the case of an IMB contract, since the customers intend ultimately to purchase the underlying asset,<sup>140</sup> the assets held by the IIFS under such a contract during the lease period will be considered as part of financial intermediation activities – that is, Islamic financing.

543. *Investment* in real estate essentially refers to an IIFS investing in immovable properties when the IIFS invests its own and/or customers' funds directly in real estate assets or in real estate projects (or in

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<sup>138</sup> IFSB *Guidance on Key Elements in the Supervisory Review Process for IIFS*, December 2007, paragraph 63.

<sup>139</sup> Usually, real estate financing is provided by IIFS to enable customers to acquire residential or commercial property or the usufruct thereof. Commonly used *Sharī'ah*-compliant structures to provide real estate financing include: operating *Ijārah*, IMB, diminishing *Mushārahah*, *Murābahah* and *Istisnā'*. Since acting as lessor under operating *Ijārah* is also a way in which IIFS hold real estate assets as income-producing investments, for the purpose of this section it is considered as real estate investment, whereas IMB is considered as real estate financing.

<sup>140</sup> In an IMB contract, title to the leased asset is normally acquired by the customer (lessee) at the end of the lease period either by purchase of the asset for a token consideration or payment of the residual value, or as a gift from the lessor.

partnerships in real estate or real estate projects) for commercial purposes to achieve profits from property development, or to benefit from asset price appreciation. In the case of an operating *Ijārah* contract, though an IIFS leases a specified asset to the customer for an agreed period against specified instalments of lease rental, the market or price risk attached to the residual value of the leased asset at the end of the contract remains with the IIFS. Thus, an operating *Ijārah* is considered as real estate investment for the purpose of calculating capital adequacy under this section.

544. With the exception of operating *Ijārah* mentioned in the above paragraph, the main criterion in distinguishing between real estate investment and financing is the existence of a regular cash flow due or receivable from a customer in respect of the asset. The existence of such a cash flow indicates that the IIFS is providing financing to the customer for the asset, and the customer, in turn, is servicing that financing; while the absence of such a cash flow indicates that the IIFS has invested in the asset on its own account (or jointly in its own and its unrestricted IAH accounts<sup>141</sup>). The supervisory authority should determine the precise criteria that characterise real estate investments of IIFS within its jurisdiction.

545. In the context of this document, a real estate investment (as opposed to a real estate financing transaction) may fall into one of three broad categories:

- (a) The activity of holding real estate at any stage of the development process, or even completed properties, where such a holding is not part of a financing transaction for a third party (such as IMB or *Murābahah*).
- (b) An asset holding where there is no binding promise from a third party to acquire (by *Murābahah*) or to lease the asset (by IMB), and the holding period has exceeded a relatively short period such as six months (at supervisory discretion) and based on evidence of management intention.
- (c) Operating *Ijārah*.

### 6.3 Risk Exposures in Real Estate Activities

546. Investments in real estate – that is, holding the assets – at any stage of the development process, or completed properties, can be generally characterised as risky owing to the illiquidity and volatility of the asset class, which is prone to cyclical "booms" (asset bubbles) and subsequent "busts" entailing the risk of a significant loss of capital. The risk is likely to be higher for properties under development compared to completed ones, as the former are particularly illiquid.

547. Real estate financing exposure might reach a level that could lead to undesirable outcomes in the event of a significant economic downturn, when the delinquency rate becomes a critical issue for an exposed IIFS, as this might render the related assets non-performing and seriously affect its cash flows. In such economic conditions, the value of the collateral (i.e. of the leased assets as "quasi-collateral") may be significantly impaired if a large number of recipients of real estate financing become financially distressed. In a period of excessive credit growth in the economy, an IIFS's financing behaviour might become quite aggressive, resulting in the compromise of its due diligence process in credit evaluation. To guard against such an over-lenient attitude in the due diligence process, IIFS should have control procedures in place, with regular monitoring by senior management and relevant committees.

548. In the case of a non-binding promise to purchase an asset in *Murābahah*, or to lease an asset under a contract of IMB, the circumstance that gives rise to the risks is the possibility of loss on disposal of such an asset, or from having a property vacant over a certain period, or from a significant drop in prices during the holding period.

549. Real estate investment exposes unrestricted investment account holders to the same risks as those borne by the IIFS when the funds are commingled. During downturns in the property cycle, the returns to UIAH could decline sharply or become losses owing to the level of delinquency in real estate financing and a fall in the market value of real estate. The UIAH are typically risk-averse investors who trust the IIFS to earn a reasonable level of safe, sustainable returns for them. Moreover, UIAH have no

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<sup>141</sup> The investment of funds supplied by current accounts and CMT-based deposits is in a different category from the investment of UIAH funds, since the capital of the former is a liability of the IIFS and, provided it remains solvent, the fund providers are not exposed to adverse outcomes on real estate investments.

representation on the IIFS's board of directors or other representation with regard to the management of their funds.

550. Owing to the risks outlined above, real estate investment activities are suitable for an IIFS only on a very limited scale and under restrictive conditions designed to control the various risks posed to the IIFS and its UIAH. Supervisory authorities should lay down guidelines for IIFS' real estate exposures, requiring them to demarcate clearly such exposures into financing and investment categories. Supervisors should also meticulously monitor real estate exposures at both the micro (IIFS) and macro (jurisdiction) levels.

#### **6.4 Indirect Exposure in Real Estate**

551. IIFS can engage in indirect real estate activities where real estate business is conducted by separate entities. Such exposure can take a number of forms. For example, an IIFS can: (a) be involved in real estate activities through a joint venture or equity participation with a property development company; (b) establish a real estate subsidiary to carry out related commercial activities; or (c) accept real estate as collateral against its financing to the customers.

##### **6.4.1 Treatment of Real Estate Investment Exposures through Joint Venture or Equity Participation**

552. As mentioned in [section 4.6.4](#) (equity position risk, paragraph 409(b)), an IIFS can enter into a private commercial enterprise to undertake a business venture (which can include real estate). There are two possible methods used to calculate equity exposures in this type of investment. According to the simple risk-weight method, the RW shall be applied to the exposures (net of specific provisions) based on the treatment of equity exposures in the banking book. The applicable RW for such exposures shall entail a 400% RW for investments in shares that are not publicly traded less any specific provisions for impairment. Alternatively, a 300% RW will be applicable for investments in shares that are publicly traded less any specific provisions for impairment. If there is a third-party guarantee to make good impairment losses, the RW of the guarantor shall be substituted for that of the assets for the amount of any such guarantee. In order to use the alternative slotting method for calculation of RWs, an IIFS shall be required to seek supervisory approval and map its RWs into four supervisory categories as set out in [Appendix E](#) (specialised financing).

##### **6.4.2 Treatment of Investment Exposures in Real Estate Subsidiaries of IIFS**

553. From a capital adequacy perspective, where an IIFS has a subsidiary through which it carries out real estate investment, its investments in the capital of such a subsidiary should be treated in the same way as an investment in a non-banking commercial entity – that is, by application of a 1250% RW (assuming a minimum capital requirement of 8%) for the investment if this amount is greater than 15% of its regulatory capital. This RW will be applicable on the portion of the investment that exceeds the 15% threshold. The investment in real estate entities below the 15% level will be risk-weighted not lower than 100%.

##### **6.4.3 Treatment of Real Estate Taken as Collateral**

554. If an IIFS accepts real estate as collateral – whether residential or commercial – from customers against its financing activities, the eligibility of such real estate as a credit risk mitigant will be subject to the provisions of paragraphs 166–170, [section 3.1.7](#). Furthermore, to pledge a real estate asset as collateral, the requirements explained in paragraphs 180–182, [section 3.1.7\(d\)](#) and paragraph 185, [section 3.1.8\(h\)](#) will apply. Moreover, an IIFS is expected to take the following steps when the collateral is in the form of real estate:

- (a) It should be ensured that any claim on a collateral is properly filed on a timely basis. Collateral interests must reflect a perfected lien; that is, appropriate steps are taken in relation to the real estate so that security interest of the IIFS is effective against customer's default and/or third parties.



- (b) The collateral agreement and the underlying legal process should enable the IIFS to have access to and to dispose of the collateral within a reasonable time frame.
- (c) The realisable value of the collateral (after deducting any haircuts) should be able adequately to cover the amount of financing.
- (d) Depending on the type of real estate and market conditions prevailing in the relevant property market, the valuation should be performed at a minimum once every year, or more frequently if needed.
- (e) The real estate should be insured under a *Takāful* scheme against damage and deterioration.
- (f) Ongoing claims on property (such as tax) should be regularly monitored.
- (g) Any risk of environmental liability arising from the property such as contamination in the soil, or of ground water, etc., should be taken into account.

## 6.5 Supervision of Real Estate Activities

555. In jurisdictions where real estate investment is permissible, some supervisory authorities adopt a combined approach in limiting the risks to which the IIFS or its IAH are exposed through restricting the total amount of exposures in the sector, restricting the usage of unrestricted investment accounts, or applying specific RWs for this financing or investment.<sup>142</sup>

556. Primarily, the supervisory authority needs to satisfy itself that the IIFS meets the prudential requirements in respect of its engaging in real estate activities on its own balance sheet or indirectly through equity investment or in a wholly/majority-owned subsidiary. The authority may, among other things, set the type of activity, the level of real estate finance or investment which is suitable for the IIFS, and the concentration level of risks. It may also set the financial conditions and managerial resources of the IIFS in order to ensure the IIFS's ability to manage competently its real estate activities, to determine that the IIFS is adequately protected from litigation risk,<sup>143</sup> and to set robust risk management, stress testing and valuation processes, as well as appropriate practices with regard to the IIFS commingling its funds with those of its UIAH.

557. In the case of restricted investment accounts, which are clearly for the purpose of real estate investment, supervisory authorities may apply a limit to single exposures at their discretion in order to cater for the risks related to cyclical movements in the real estate market.

## 6.6 Risk-Weighting of Real Estate Exposures

558. Section 6.2 has delineated the criteria for demarcating real estate exposures of IIFS into financing and investment exposures. The calculation of RWs for real estate financing and investment exposures is summarised below.

### 6.6.1 Real Estate Financing

559. As mentioned in footnote 142, an IIFS can provide real estate financing on the basis of *Ijārah*, IMB, diminishing *Mushārah*, *Murābahah* and *Istisnā`*. Except for operating *Ijārah*, use of other contracts to provide real estate finance to customers will commonly fall in the category of financing. The RWs for these exposures should be calculated based on the guidance provided in the relevant sections, as set out below:

- (a) IMB: Section 4.5

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<sup>142</sup> For conventional institutions, the normal treatment is for a bank's investment as a parent in a real estate subsidiary or affiliate to be deducted from its capital (equivalent to a 1250% RW if the minimum capital requirement is 8%). IIFS in some countries currently follow a similar deduction approach, but other countries apply risk weights of 100% or less (i.e. treatment as credit risk) or risk weights of other assets.

<sup>143</sup> In order to reduce litigation risk, an IIFS should have clearly defined and properly documented contractual relationships and rights and obligations of the parties involved in its real estate financing and investment activities. IIFS are also expected to execute legal documentation in correct order and sequence for each type of underlying contract, as advised by the respective SSB to minimise legal and *Shari'ah* non-compliance risk.

- (b) Diminishing *Mushārahah*: Sections 3.1.3 and 4.6.3
- (c) *Murābahah*: Section 4.1
- (d) *Istisnā`*: Section 4.4
- (e) For all the above contracts used to provide real estate financing, the RW of a debtor, counterparty or other obligor can be reduced and given preferential treatment if criteria mentioned in section 3.1.4 are applicable.

### **6.6.2 Real Estate Investment**

560. The RWs for an IIFS's indirect exposure in real estate investment activities have been covered in section 6.4. In the following, the RWs for direct exposure to real estate investment are elucidated.

561. IIFS are required to hold regulatory capital against all of their real estate investment exposures.<sup>144</sup> The risk-weighted amount of a real estate investment exposure is computed by multiplying the amount of the carrying value<sup>145</sup> by the appropriate risk weight.

562. Referring to the three categories of real estate investment as mentioned in paragraph 545 (section 6.2), the applicable risk weights of a single investment exposure for each category are as follows:

- (a) The treatment for a single investment exposure is a 187.5%<sup>146</sup> RW.
- (b) The treatment for an exposure due to a holding for financing purposes during the non-binding stage of the transaction is a 187.5% RW.
- (c) The treatment of an exposure resulting from operating *Ijārah* is the risk weights as mentioned in paragraph 398 (section 4.5.5.1).

563. When IIFS are involved extensively in real estate investment activities, supervisors may impose a higher capital charge on a solo basis to cushion unexpected losses. Further, the supervisory authority may increase the level of CCF in case IIFS are engaged in real estate as part of off-balance sheet asset management activities.

### **6.7 Valuation of Real Estate Activities**

564. The measurement of risk exposures in real estate activities is dependent on sound and proper valuations from third parties.<sup>147</sup> The risks inherent in the real estate activities depend on a number of factors, including the type of property and the independent parties who will assess these activities. Therefore, it is vital that the supervisory authority satisfy itself that an IIFS has in place adequate valuation rules and proper valuation methodologies. Such methodologies should include the assessment of market value derived from chosen valuation models,<sup>148</sup> and of the reliability of data used for the purpose of valuation.

565. It is essential that a supervisory authority ensures that IIFS within its jurisdiction value their property activities on a consistent basis. Otherwise, there can be no level playing field for capital

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<sup>144</sup> When the standard IFSB formula for calculating the capital adequacy ratio is applied, assets financed by IAH funds are not included in computing the risk-weighted assets in the denominator of the CAR, so that the risk weights are irrelevant. When the supervisory discretion version of the CAR formula is applied, a proportion – “alpha” – of the RWA financed by IAH funds is included in the denominator of the CAR; thus the risk weights apply only to the proportion “alpha” of the assets financed by IAH funds.

<sup>145</sup> See section 6.7 of this document on the valuation of real estate investments.

<sup>146</sup> The RW of 187.5% is equivalent to a capital charge of 15% if the minimum capital requirement is 8%.

<sup>147</sup> Based on the size of an IIFS's involvement in real estate activities as well as its in-house expertise and control procedures, supervisory authorities may allow the IIFS to use in-house valuations. This function can also undertake property research, carry out valuations, provide technical advice and execute marketing strategies for real estate activities.

<sup>148</sup> Commonly used valuation models for real estate include the fair value model and the cost model. The use of these models shall be subject to supervisory guidelines and management intention for categorising such investments as held-for-use or held-for-sale.

adequacy treatment. In the case of assets under *Murābahah* or *Ijārah*/IMB transactions, the supervisory authority should satisfy itself on appropriate valuation to estimate the amount for which a property switches from investment to financing, or vice versa.

566. The valuation of an IIFS's real estate investments shall be determined by independent third parties<sup>149</sup> or an in-house function. The valuations so conducted should be used as a basis for capital adequacy calculation and monitoring of statutory limits on real estate exposure, if any. Supervisory authorities should require IIFS to have robust procedures to substantiate the results of valuations while comparing them with some independent information source such as property market reports or reliable publications. IIFS should scrutinise any significant variations in these valuations and make any necessary rectifications.

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<sup>149</sup> Normally this task is undertaken by specialised valuation or appraiser companies that are authorised/approved by the relevant supervisory authorities or banking associations.

## DEFINITIONS

The following definitions are intended to assist readers in their general understanding of the terms used in the Guiding Principles. The list is by no means exhaustive. Some of the wordings differ slightly from those in previously issued IFSB standards in the interest of greater clarity, and do not affect the substance of the definitions.

Diminishing <i>Mushārahah</i>	A form of partnership in which one of the partners promises to buy the equity share of the other partner over a period of time 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 takes 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 promise to buy. It is also not permitted that one contract be entered into as a condition for concluding the other.
<i>Hibah</i>	A unilateral transfer of ownership of a property to another without any counter-value from the recipient.
<i>Ijārah</i>	An agreement made by an institution offering Islamic financial services to lease to a customer an asset specified by the customer for an agreed period against specified rental. An <i>Ijārah</i> contract commences with a promise to lease that is binding on the part of the potential lessee prior to entering the <i>Ijārah</i> contract.
<i>Ijārah Muntahia Bittamlik</i> (or <i>Ijārah wa Iqtinā`</i> )	A form of lease contract that provides a separate promise of the lessor giving 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 <i>Hibah</i> contract.
Investment risk reserve (IRR)	The amount appropriated by the institution offering Islamic financial services out of the income of investment account holders (IAH), after deducting the <i>Muḍārib's</i> share, in order to cushion against future investment losses for the IAH.
Islamic window	An Islamic window is part of a conventional financial institution (which may be a branch or dedicated unit of that institution) that provides both fund management (investment accounts) and financing and investment that are <i>Sharī'ah</i> compliant, with separate funds.
<i>Istisnā`</i>	A contract of sale of specified objects to be manufactured or constructed, with an obligation on the part of the manufacturer or builder to deliver the objects to the customer upon completion.
<i>Mubāra'at</i>	An agreement between the IIFS and its customer whereby at the time of early withdrawal, the customer will waive a certain portion of his profits earned during the investment period and the IIFS will waive any losses that could appear in the investment period.
<i>Muḍārabah</i>	A partnership contract between the capital provider ( <i>Rabb al-Māl</i> ) and an entrepreneur ( <i>Muḍārib</i> ) whereby the capital provider would contribute capital to an enterprise or activity that is to be managed by the entrepreneur. Profits generated by that enterprise or activity are shared in accordance with the percentage specified in the contract, while losses are to be borne solely by the capital provider unless the losses are due to the entrepreneur's misconduct, negligence or breach of contracted terms.
<i>Murābahah</i>	A sale contract whereby the institution offering Islamic financial services sells to a customer a specified kind of asset that is already in its possession, whereby the selling price is the sum of the original price and an agreed profit margin.

<i>Murābahah</i> for the purchase orderer (MPO)	A sale contract whereby the institution offering Islamic financial services (IIFS) sells 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.
<i>Mushārahah</i>	A contract between the IIFS and a customer whereby both would contribute capital to an enterprise, whether existing or new, or to ownership of a real estate or movable 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 the <i>Mushārahah</i> agreement, while losses are shared in proportion to each partner's share of capital.
Profit equalisation reserve (PER)	The amount appropriated by the institution offering Islamic financial services out of the <i>Muḍārahah</i> income, before deducting the <i>Mudārib</i> 's share, in order to maintain a certain level of return on investment for investment account holders and to increase owners' equity.
<i>Qard</i>	A loan intended to allow the borrower to use the funds for a period with the understanding that this would be repaid at the end of the period, where it is not permissible for any increase in cash or benefit.
Restricted investment accounts	The account holders authorise the institution offering Islamic financial services to invest their funds based on <i>Muḍārahah</i> or agency contracts with certain restrictions as to where, how and for what purpose these funds are to be invested.
<i>Salam</i>	An agreement to purchase, at a pre-determined price, a specified kind of commodity not currently available to the seller, which is to be delivered on a specified future date as per agreed specifications and specified quality. The institution offering Islamic financial services as the buyers make full payment of the purchase price upon conclusion of a <i>Salam</i> contract. The commodity may or may not be traded over-the-counter or on an exchange.
<i>Sharī'ah</i>	The practical divine laws deduced from its legitimate sources: the <i>Qur'an</i> , <i>Sunnah</i> , <i>consensus (Al-Ijma')</i> and <i>analogical reasoning (Al-Qiyas)</i> .
<i>Sharī'ah</i> board	An independent body set up or engaged by the institution offering Islamic financial services to supervise its <i>Sharī'ah</i> compliance and governance system.
<i>Sukūk</i> (sing. <i>Sakk</i> )	Certificates that represent a proportional common ownership right in tangible assets, or a pool of assets that are <i>Sharī'ah</i> compliant.
<i>Takāful</i>	The term " <i>Takāful</i> " is derived from an Arabic word which means solidarity, whereby a group of participants agree among themselves to support one another jointly against a defined loss. In a <i>Takāful</i> arrangement, the participants contribute a sum of money as wholly or partially <i>Tabarru'</i> (donation) into a common fund, which will be used for mutual assistance for the members against a defined loss or damage, according to the terms and conditions of the <i>Takāful</i> .
Unrestricted investment accounts	The account holders authorise the institution offering Islamic financial services (IIFS) to invest their funds based on <i>Muḍārahah</i> contracts without imposing any restrictions. The IIFS can commingle these funds with their own funds and invest them in a pooled portfolio.
<i>Wadī'ah</i>	The term " <i>Wadī'ah</i> " means custody or safe-keeping whereby the items are a trust for the safe-keeper. The items are not guaranteed by the safe-keeper, except in the case of misconduct, negligence or violation of the conditions. The safe-keeper may charge a fee for looking after the items or funds and may pay <i>Hibāh</i> (gift) to the principal.
<i>Wakālah</i>	An agency contract where the customer (principal) appoints the IIFS as agent ( <i>Wakīl</i> ) to carry out the business on their behalf and where a fee (or no fee) is charged to the principal based on the contract agreement.

## APPENDICES

### APPENDIX A: CAPITAL RATIO FORMULA

#### (a) Standard formula

##### Eligible Capital

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**{ Total risk-weighted assets<sup>150</sup> (Credit<sup>151</sup> + Market<sup>151</sup> risks) Plus Operational risks**

**Less:**

**Risk-weighted assets funded by PSIA<sup>152</sup> (Credit<sup>151</sup> + Market<sup>151</sup> risks) }**

#### (b) Supervisory discretion formula

This formula is applicable in jurisdictions where supervisory authority considers the IIFS is obliged to smooth income to the investment account holders as part of a mechanism to minimise withdrawal risk and is concerned with systemic risk.

##### Eligible Capital

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**{ Total risk-weighted assets (Credit<sup>151</sup> + Market<sup>151</sup> risks) Plus Operational risks**

**Less:**

**Risk-weighted assets funded by restricted PSIA<sup>152</sup> (Credit<sup>151</sup> + Market<sup>151</sup> risks) Less:**

**(1 – α)<sup>153</sup> [Risk-weighted assets funded by unrestricted PSIA<sup>152</sup> (Credit<sup>151</sup> + Market<sup>151</sup> risks)] Less:**

**α [Risk-weighted assets funded by PER and IRR of unrestricted PSIA<sup>154</sup> (Credit<sup>151</sup> + Market<sup>151</sup> risks)] }**

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<sup>150</sup> Total RWA include those financed by both restricted and unrestricted PSIA.

<sup>151</sup> Credit and market risks for on- and off-balance sheet exposures.

<sup>152</sup> Where the funds are commingled, the RWA funded by PSIA are calculated based on their pro-rata share of the relevant assets. PSIA balances include PER, IRR or other equivalent reserves.

<sup>153</sup> Alpha (α) refers to the proportion of assets funded by unrestricted PSIA which is to be determined by the supervisory authorities. The value of α would therefore vary based on supervisory authorities' discretion on a case-by-case basis.

<sup>154</sup> The relevant proportion of risk-weighted assets funded by the PSIA's share of PER and by IRR is deducted from the denominator. The PER has the effect of reducing the displaced commercial risk, and the IRR has the effect of reducing any future losses on the investment financed by the PSIA.

## APPENDIX B: OPERATIONAL GUIDELINES FOR COUNTERCYCLICAL BUFFER

1. This appendix sets out the guidelines for calculating various components of the credit-to-gross domestic product (GDP) gap measure as a tool for implementing the countercyclical buffer (CCB) regime. The appendix also suggests other metrics and indicators that can support the supervisory authorities in estimating an appropriate level of CCB in the jurisdiction. It also provides additional guidance to supervisory authorities at various phases of operating the CCB regime, and deals with some related operational issues – for example, the application of CCB to domestic versus internationally active institution(s) offering Islamic financial services (IIFS), and the maximum suggested ceiling.

### Computation of Credit-to-GDP Add-on for CCB

2. The numerator of this measure – that is, credit – will include all types of financing provided by IIFS to the private sector, including that based on profit-sharing contracts such as *Muḍārabah* and *Mushārahah*. This harmonised definition of credit and uniform applicability of the CCB in the jurisdiction stems from the following constructions:

- i) A period of excessive credit growth can impact the IIFS undesirably, even if it has not been the main contributor to such growth.
- ii) An IIFS operating in a jurisdiction will bear the consequences of a credit boom, whether or not it has been involved in excessive credit distribution. Therefore, CCB will apply equally to all banks and IIFS in the jurisdiction.
- iii) A broad, harmonised definition of credit may limit the incentive for banks and IIFS to divert the supply of credit to other parts of the financial system. Thus, it will provide immunity to the calibration and operation of CCB to changes over time in the types of institutions providing the funds to the private sector.

3. The definition of credit shall include all credit provided to households and other non-financial private sector entities by all types of domestic and international banks, IIFS and non-bank financial institutions operating in the jurisdiction, whether domestically or directly from abroad. The definition of credit also includes all kinds of *Sukūk* or other types of *Shari'ah*-compliant securities, debt securities issued by conventional banks (including securitisation), issued domestically or internationally to fund households and other non-financial private sector entities, regardless of who holds the securities. The definition of credit also encompasses securities and *Sukūk* held by banks, IIFS and other financial institutions in their trading portfolios and banking books, as well as securities held by other residents and non-residents. Depending on the sophistication and size of the inter-financial system flows in a jurisdiction and its relevance for gauging the excessive credit growth and build-up of system-wide risk, supervisory authorities may wish to include gross credit flows between various banking and non-banking financial institutions in the definition of credit.

4. For calculating the jurisdiction-specific CCB add-on, as a percentage of risk-weighted assets (RWAs), the following steps will be carried out:

- i) Calculate the aggregate private sector credit-to-GDP ratio:

This ratio in period  $t$  for each jurisdiction shall be calculated as:

$$\text{Ratio}_t = \text{Credit}_t / \text{GDP}_t \times 100\%$$

[in notational form]  $y_t = \text{aggregate private sector credit-to-GDP ratio}$

$\text{GDP}_t$  is domestic GDP and  $\text{Credit}_t$  is a broad measure of credit to the private, non-financial sector in period  $t$ . Both GDP and Credit are in nominal terms and on a quarterly frequency.

- ii) Calculate the credit-to-GDP gap:

The credit-to-GDP ratio is compared to its long-term trend. If the credit-to-GDP ratio is significantly above its trend (i.e. there is a large positive gap), then this is an indication that credit may have grown to excessive levels relative to GDP.

The gap (Gap) in period  $t$  for each country is calculated as the actual credit-to-GDP ratio minus its long-term trend (Trend):

$$\text{Gap}_t = \text{Ratio}_t - \text{Trend}_t$$

[in notational form]

$\hat{y}_t = \text{Hodrick-Prescott trend of } y_t$

$z_t = y_t - \hat{y}_t = \text{credit-to-GDP gap}$

For calculating the Trend in time  $t$ , a simple moving average or linear time trend can be used. Supervisory authorities may opt to use the Hodrick-Prescott filter, which has an additional advantage that it tends to give higher weights to more recent observations that can help to identify any structural breaks more effectively. To establish the trend ( $\text{Trend}_t$ ), a one-sided Hodrick-Prescott filter with a high smoothing parameter (lambda) of 400,000 will be used. The information available at only each point in time shall be used in these computations.

iii) Transform the credit-to-GDP gap into the CCB add-on:

The size of the buffer add-on ( $VB_t$ ), in percentage of RWAs, shall be zero when  $\text{GAP}_t$  is below a threshold level  $L$ , which shall be equal to 2. It then increases with the  $\text{GAP}_t$  until the buffer reaches its maximum level ( $VB^{\max}$ ), when the GAP exceeds an upper threshold  $H$ , which shall be equal to 10.

[in notational form]

$$VB_t = 0$$

if  $z_t < L$

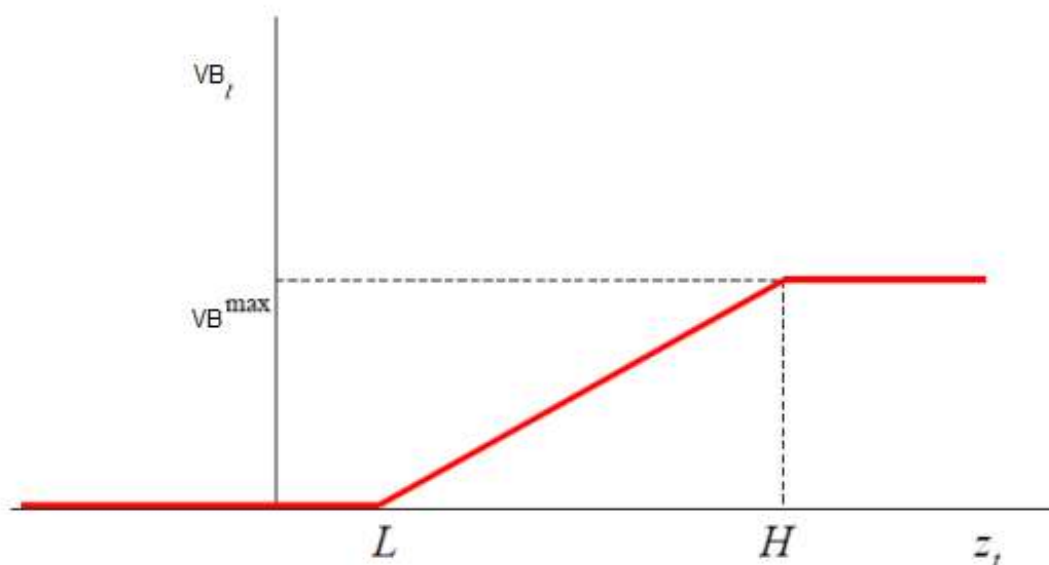
$$VB_t = \{(z_t - L) / (H - L)\} \times VB^{\max}$$

if  $L \leq z_t \leq H$

$$VB_t = VB^{\max}$$

if  $z_t > H$

Where:  $L = 2\%$ ,  $H = 10\%$  and  $VB^{\max} = 2.5\%$  of RWAs



### Role of the Supervisory Authority

5. After the implementation of the CCB at a specified level, in a stressed economic environment supervisory authorities should manage their use of the CCB in order to make sure that the credit supply is not inhibited by the regulatory capital requirements. Depending on the conditions of credit supply in the jurisdiction, the CCB can be released either gradually or more rapidly. The CCB can be released gradually



when credit growth slows down and systemic risk reduces in a smooth manner. In other situations, given that credit growth can be a lagging indicator of stress, the CCB could be released rapidly to ensure that the supply of credit in the jurisdiction is not unduly restricted by capital requirements. Supervisory authorities may also choose to release the CCB concurrently with the publication of the financial results of the banking system, so that a reduction in the CCB can accommodate losses of capital or, alternatively, accommodate increases in financing by IIFS.

6. When supervisory authorities decide to release the CCB rapidly, they can also specify the duration of release. This will help to reduce the uncertainty for IIFS and other banks regarding future supervisory actions relating to the CCB. It will also provide comfort to them to know that the released capital requirement can be used to accommodate losses of capital. Supervisory authorities shall review, update and publicly disseminate information about the future outlook regarding the CCB – for example, on a quarterly basis. This will help IIFS, other banks, authorities in other jurisdictions and other stakeholders to build an understanding of the buffer decisions taken by the supervisor.

7. With the release of the CCB down to zero, the capital so released as surplus would in principle be available for distribution or other uses without restriction. IIFS or other banks may choose to use the released capital to accommodate losses or to protect themselves against any future unexpected losses. Supervisory authorities may, however, use their discretion to impose any restrictions on the use or distribution of the released capital, if circumstances so demand.

8. Supervisory authorities should be cautious about some potentially unintended consequences of introduction or release of the CCB, and should take appropriate steps through their communication strategies to minimise such impacts. The dangers resulting from, or aggravated by, inadequate communication may include:

(i) IIFS and other banks may already have in their pipeline a set of approved credits and commitments for expansion of credit which cannot be easily withdrawn. In that case, customers may rush to draw down their credit lines in the expectation of tightening credit conditions and increased costs, thereby creating a sudden increase in credit demand.

(ii) Financial markets may react negatively to the imposition of a CCB, particularly if the basis of determination is unclear and the buffer is unexpected. The decision may be perceived negatively, as a signal that the supervisor is anticipating a credit bubble in that jurisdiction or banking sector, thereby creating a systemic risk of withdrawals.

(iii) The release of the buffer may also be perceived negatively as a signal that the supervisor is expecting losses in a particular market, thereby increasing systemic risk.

#### **Additional Metrics and Indicators**

9. In the previous section, guidance has been provided on the use of a credit-to-GDP ratio for the application and release of the CCB in each jurisdiction. As highlighted by the Basel Committee on Banking Supervision, this indicator has been chosen due to a number of advantages for the purpose of predicting a period of excess credit growth. This ratio tends to rise smoothly well above the trend before the most serious episodes of financial stress. There have been a number of benefits from using this ratio instead of using a simple measure of credit growth in the economy:

(i) The ratio is normalised by the size of the economy and, thus, is not influenced by the normal cyclical patterns of credit demand.

(ii) A credit-to-GDP gap allows for calculating a financial deepening trend,<sup>155</sup> due to being measured as a deviation from a long-term trend.

(iii) It is smoother than a variable calculated as differences in levels, such as credit growth.

(iv) It minimises spurious volatility; that is, there are no large quarter-to-quarter swings.

(v) It addresses directly the CCB's objective to protect the banking sector from periods of excess credit growth.

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<sup>155</sup> Financial deepening is a process which states that credit typically grows more quickly than GDP as an economy develops.

10. Notwithstanding the above, use of the credit-to-GDP indicator and the consequent decisions related to the application and release of CCB requires extra caution and vigilance on the part of supervisory authorities for various reasons, such as:

- (i) The rise in the ratio may be due to a cyclical slowdown or outright decline in GDP.
- (ii) Conversely, the ratio might decline due to a rise in the GDP as a result of high commodity prices – for example, in oil- and gas-based economies, high oil and gas prices can sharply reduce the indicator – which would be unrelated to the economic fundamentals related to the growth of credit and output in the economy.
- (iii) The calculated long-term trend of this ratio is a purely statistical measure that does not capture turning points well.
- (iv) Ex-post revisions of GDP estimates may change the trend and the resultant gap, making the decisions related to the CCB prone to reconsideration.
- (v) End-of-sample estimates<sup>156</sup> of the trend may be unreliable.
- (vi) Credit growth can be a lagging indicator of stress; therefore, in downturns, a credit-to-GDP indicator continues to increase due to a greater demand for credit by firms and households notwithstanding slower GDP growth.
- (vii) The indicator does not take into account the mechanisms used to restrict the growth in demand for credit and to manage it.
- (viii) Credit growth might not be an issue where there is an expansion of demand for credit – for example, in the case of emerging economies.
- (ix) Being a lagging indicator, it may not be an appropriate indicator in a phase when the CCB is being released.

11. In view of the above, the credit-to-GDP gap indicator may have certain drawbacks and may not transmit the right signals in all circumstances concerning the build-up, and especially the release, of the CCB. In this regard, it is advisable for supervisory authorities not to apply the benchmark in a mechanical way. This metric should be accompanied by other indicators of systemic risk both of a national and an international origin, some of which are outlined in the following paragraphs. Relying on a suite of indicators for macroprudential regulation instead of a single indicator would also make it more difficult for IIFS and other banks to evade new regulatory requirements. Depending on the specificities of the jurisdiction, the following indicators could be useful in informing authorities in their decisions as to whether and when IIFS and other banks should build up or release capital buffers. Since not meeting capital adequacy requirements by an IIFS or other bank can result in the imposition of restrictions on capital distributions in the form of dividends, share repurchases, and especially discretionary bonus payments to staff, supervisory authorities should be wary of the tendencies of these institutions to reduce credit instead.

12. *GDP*: Both nominal and real GDP, or key sectoral components thereof, can provide guidance on the various phases of business cycles in the economy. Though business and financial cycles are related, fluctuations in output have a higher frequency than those of financial cycles associated with serious financial distress. Episodes of financial distress are rare and reflect longer and larger cycles in credit and asset prices. However, in emerging markets, this measurement may be a useful tool for supervisory authorities to monitor in order to detect any system-wide heating-up of the economy. In some other cases, gross national income (GNI) might be a useful tool for evaluating the economic strength of a country, instead of looking at overall economic output at the jurisdiction level only.

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<sup>156</sup> When a sample of data has a short duration – that is, the number of observations is relatively small in the sample over the period for which the data was collected or drawn from a population – the sample is called *end-of-sample data*. This sort of sample is mainly contained in time series data, generated on a regular basis indexed by time epoch. The major point of interest is the stability of the data collected over such a short duration – that is, the consistency of the sample estimates – and whether or not they can be used for inference (forecasting or prediction) on to the whole population, particularly in financial time series data. Normally, end-of-sample data, due to its short duration, generates bias in its sample estimates; thus, this *bias* is called *end-of-sample bias*.

13. *Asset prices*: Deviations of property and equity prices from trend can help to identify the build-up phase, especially for IIFS which normally invest some part of their funds in these asset classes. However, the deviations tend to narrow way ahead of the emergence of financial strains, suggesting that this might result in starting to release the buffer too early. On the whole, the past performance of such prices could be useful in helping authorities to assess and explain the need to release the buffer after the financial system comes under stress.

14. *Credit process*: Supervisory authorities may also monitor the credit-granting process by the IIFS and other banks in the jurisdiction, as lax credit provision is a key cause of asset price bubbles.

15. *Bank profits*: The performance of pre-tax bank profits as a signal for the build-up in good times varies from jurisdiction to jurisdiction. However, from historical data, supervisory authorities may gauge the suitability of this indicator for their jurisdictions.

16. *Gross bank losses*: Proxies for gross bank losses do not perform well in building up buffers in good times. The reason is that the simple absence of losses in good times does not differentiate between magnitudes of losses during various phases of good times. Building up the buffer on the absence of losses would tend to call for very high buffers early on in the expansion.

17. *Loan loss provisioning*: The gross loan loss provisioning being made by IIFS and other banks in the jurisdiction may indicate the build-up of system-wide stress.

18. *Stress testing*: IIFS and other banks are required to conduct stress tests as a part of their capital planning process. Stress scenarios can envisage a severe cyclical downturn, possibly as a result of excessive credit growth, and consider whether the firms have sufficient capital to meet these shocks. Similarly, supervisory authorities can conduct macro-level stress testing<sup>157</sup> which can include scenarios relating to excessive credit growth in the economy, the results of which can provide a lead to take CCB-related decisions.

19. *Public debt*: This tends to fall in good times, and to increase in periods of economic weakness, due to the cyclical properties of fiscal policy. However, supervisory authorities may study the behaviour of public debt as one of the indicators, as excessive growth in public debt can contribute to a growth in financial system-wide risk.

20. *Business models of the banks*: Though the CCB regime suggests a universal application of the buffer to all types of IIFS and other banks, the risk of credit growth may be very different depending on the business model being applied by the institutions concerned. Therefore, the study of the business model of a particular type of IIFS or other bank, its impact on credit growth, and its overall contribution to building up system-wide risks could be helpful for supervisory authorities in making decisions about the use of the CCB and/or other macroprudential tools to stabilise the underlying risk.

21. *Sectoral issues*: Supervisory authorities should have specific macroprudential policy instruments at hand that would allow them to address sector-specific issues as well, such as by: (a) setting specific capital requirements or increasing risk weights at a sectoral, as well as the aggregate level, if necessary; and (b) establishing specific requirements for those types of exposure which, in a given situation, may lead to the destabilisation of the financial market and macroeconomic imbalances.<sup>158</sup>

22. *Other measures under the supervisory review process*: CCB is one of the many tools for macroprudential supervision that can be used by supervisory authorities. During the build-up phase of system-wide stress, as supplementary measures, supervisory authorities may make use of some other indicators or steps, such as:

- increasing the financing-to-value (FTV) ratio;
- imposing an additional capital charge on an individual IIFS or group of IIFSs, under the supervisory review process;

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<sup>157</sup> See, for details, principle 4.3 of IFSB-13 entitled “designing and implementing system-wide stress tests and specific scenarios”.

<sup>158</sup> Such a situation could occur, for example, when the only category of financing found to be growing excessively would be real estate financing in foreign currencies. Excessive growth in this category could lead to speculative bubbles in the markets for real estate assets, weaken the effectiveness of monetary policy, and constitute an additional risk factor for the stability of financial markets and the economy.

- studying funding spreads and taking steps to control their direction;
- conducting credit condition surveys;
- studying data on the ability of non-financial entities to meet their financial obligations on a timely basis;
- adjusting payment-to-income (PTI) ratios;<sup>159</sup> and
- tightening financing margins and collateral requirements.

## **Other Issues Relating to the CCB**

### ***Domestic versus International Banks***

23. Jurisdictional reciprocity will be applied in the case of internationally active IIFS. The host authorities take the lead in setting the buffer requirement that would apply to credit exposures held by local entities located in their jurisdiction. They would also be expected to inform promptly their foreign counterparts regarding buffer decisions, so that the authorities in the other jurisdictions could require their IIFS to respect them. Meanwhile, the home authorities will be responsible for ensuring that the IIFS they supervise correctly calculate their buffer requirements based on the geographic location of their exposures. The home authorities will always be able to require that the IIFS they supervise maintain higher buffers if they judge the host authorities' buffer to be insufficient. However, the home authorities should not implement a lower buffer add-on in respect of their IIFSs' credit exposures to the host jurisdiction. In cases where IIFS have exposures to jurisdictions that do not operate and publish buffer add-ons, the home authorities will be free to set their own buffer add-ons for exposures to those jurisdictions.

24. The CCB regime will have different impacts on domestic and internationally active institutions. In particular, internationally active banks are, on average, expected to face a more stable buffer requirement over time, given the broad geographic diversification of their portfolios and the proposed weighting mechanism applied to the buffer add-ons. At the same time, domestically active banks will be exposed to the buffer requirements of their respective jurisdictions, which may either be higher or lower than the above-mentioned "internationally weighted average". Overall, the essence of the mechanism is that the buffer requirements will depend on the geographical orientation of banks' portfolios, and not on the location of the banks' establishments that generate the exposures. In this regard, the CCB is neutral with respect to the nationality of the originating institution and thus ensures a level playing field for domestic and foreign banks.

### ***Ceiling for the CCB***

25. Setting a ceiling for the CCB might have certain drawbacks in cases when excessive credit growth continues at a national level despite the application of the CCB. In such situations, the ongoing credit expansion could raise concerns from a financial stability perspective, while, at the same time, the ceiling could unduly limit the powers of authorities to intervene. Therefore, supervisory authorities can apply a higher CCB requirement for IIFS and other banks in their jurisdiction. In this case, however, the international reciprocity provisions apply to the CCB only up to the maximum of 2.5%. In particular, a local buffer beyond the 2.5% cap used as a last resort option to curb excessive credit expansion could discriminate against local IIFS and other banks vis-à-vis foreign entities. Therefore, the possible application of the buffer above the 2.5% ceiling will require a coordinated policy action by the respective supervisory authorities.

### ***Supervisory Disclosure Related to the CCB***

26. Supervisory authorities should develop a communication strategy before taking on the task of publicly explaining buffer decisions. Once they have implemented their communication strategies, providing regular updates on their assessment of the macrofinancial situation and the prospects for

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<sup>159</sup> It is the ratio of monthly payments (against financing) to monthly income that provides a measure of the ability of the customer to service the financing on a monthly basis.

potential buffer actions is a useful way of preparing banks and their stakeholders for buffer decisions. In turn, that should help to smooth the adjustment of financial markets to those actions, as well as giving IIFS and other banks as much time as possible to adjust their capital planning accordingly. When there are significant changes to the supervisors' outlook for the prospect of changes to the CCB, communications may be conducted on an "as needed" basis to explain buffer actions and to advise IIFS and other stakeholders promptly.

27. To enable accountability, national authorities should disclose publicly their respective national decisions and the underlying reasoning. In particular, given that the choice of indicators to be used for the application and release of the CCB could be quite wide, it is of paramount importance that buffer decisions be clearly explained to market participants in order to enhance the credibility of the buffering mechanism. Transparency on decisions for the CCB is of particular importance to ensure that the CCB is indeed drawn upon in the event of a downturn and does not constitute a new level of permanent minimum requirements. Public communication is necessary to avoid misinterpreting the decline in the total level of capital and penalising banks that use their CCB. A communications strategy can also help to promote a clear distinction between macroprudential decisions on the CCB and microprudential decisions on the capital of individual institutions, ensuring that the macroprudential reasons for buffer requirements are well understood.

#### ***Application to Islamic Investment Banks***

28. As a general principle, it is the activity of a given IIFS, rather than its legal form, that should be the deciding criterion in the application of the CCB. In this context, all IIFS which are active in the provision of credit should be treated in the same way by the CCB mechanism. Therefore, to the extent that Islamic investment banks provide credit to their customers, they should be subject to the CCB, both to ensure that they can maintain financing in the event of shocks – at the time of release of the CCB – and also to ensure a level playing field with their competitors in credit supply – that is, IIFS and other banks.

## APPENDIX C: CURRENT EXPOSURE METHOD

1. The current exposure method is to be applied to over-the-counter (OTC) *Sharī'ah*-compliant hedging transactions for determining the exposure for capital adequacy purposes. For OTC *Sharī'ah*-compliant hedging contracts, institutions offering Islamic financial services (IIFS) are not exposed to credit risk for the full face value of the contracts, but only to the potential cost of replacing the cash flow if the counterparty defaults.<sup>160</sup> As such, the credit-equivalent amount for *Sharī'ah*-compliant hedging instruments will depend, *inter alia*, on the maturity of the contract and the volatility of the rates underlying that type of instrument.

2. Under the current exposure method, banks must calculate the current replacement cost by marking contracts to market, thus capturing the current exposure without any need for estimation, and then adding a factor (the "add-on") to reflect the potential future exposure over the remaining life of the contract. Thus, the credit-equivalent amount of OTC *Sharī'ah*-compliant hedging instruments will be the summation of the following two factors:

- (a) the total replacement cost of all its contracts with positive values, which is obtained by "marking to market" (using a value of zero for contracts with negative replacement costs); and
- (b) the amount of potential future credit exposure, calculated by multiplying the total notional principal amount of each contract by an "add-on" factor – that is:

$$\text{Credit-equivalent amount} = \text{Positive mark-to-market} + [\text{Notional principal} \times \text{"Add-on" factor (\%)}]$$

3. The following "add-on" factors shall be used for various types of *Sharī'ah*-compliant hedging contracts:

TENOR	<i>Sharī'ah</i> -Compliant Profit Rate Swaps	<i>Sharī'ah</i> -Compliant Foreign Currency Swaps	Other <i>Sharī'ah</i> -Compliant Hedging Contracts
<= 1 Year	0.0%	1.0%	10%
>1 Year to <= 5 Years	0.5%	5.0%	12%
>5 Years	1.5%	7.5%	15%

4. The "add-on" factors that are used in computing the potential future exposure are calculated based on the type of exposure and the residual maturity of each contract, as shown above. Supervisory authorities should take care to ensure that the add-ons are based on effective, rather than apparent, notional amounts.

5. IIFS can obtain capital relief for collateral as defined under the comprehensive approach of credit risk mitigation.

6. The credit-equivalent amounts of exchange rate and profit rate contracts are to be risk-weighted according to the category of the counterparty, including the use of concessionary weightings in respect of exposures backed by eligible guarantees and collateral. Nevertheless, supervisory authorities can raise the risk weights (RWs) if the average credit quality deteriorates or if loss experience increases.

7. The computation of the exposure for an individual contract for collateralised OTC *Sharī'ah*-compliant hedging instruments will be as follows:

$$\text{Counterparty charge} = \text{Positive mark-to-market} + [\text{Notional principle} \times \text{"Add-on" factor (\%)}] - \text{CA} \times r \times 8\%$$

<sup>160</sup> The potential cost will be mostly the difference between the contract price and the market price for the underlying variables.

Where:

Positive mark-to-market = Total replacement cost of all its contracts with positive values, which is obtained by "marking to market" (zero values are used for contracts with negative replacement costs);

Add-on = Amount for potential future exposure calculated based on the above matrix;

CA = Volatility-adjusted collateral amount under the comprehensive approach, or zero if no eligible collateral is applied to the transaction; and

$r$  = the RW of the counterparty.

8. The consideration for any bilateral netting contract – that is, weighting the net rather than the gross claims with the same counterparties arising out of the full range of *Sharī'ah*-compliant hedging contracts – is subject to *Sharī'ah* approval. In such a case, the provisions of Basel II, paragraph 96(i)–(v) will apply.

9. Once the bank has calculated the credit-equivalent amounts, they are to be weighted according to the category of counterparty in the same way as indicated in Section III, including concessionary weighting in respect of exposures backed by eligible guarantees and collateral.

#### APPENDIX D: COMPARISON BETWEEN *SUKŪK*, CONVENTIONAL BONDS AND SHARES

	<i>Sukūk</i>	Bonds	Shares
<b>Nature</b>	Not a debt of issuer but common ownership share in specific assets or business ventures	Debt of issuer	Ownership share in a corporation
<b>Assets</b>	A minimum of certain percentage of tangible assets. Assets must meet <i>Sharī'ah</i> compliance criteria	Generally not required	Not required
<b>Claims</b>	Ownership claims on the specific assets or business venture	Creditors' claims on the borrowing entity, and in some cases liens on assets	Ownership claims on the company
<b>Security</b>	Secured by ownership rights in the underlying assets or venture in addition to any additional collateral enhancement structure	Generally unsecured debentures except in cases such as mortgage-backed securities, collateralised debt obligations, equipment trust certificates, etc.	Unsecured
<b>Principal and return</b>	Not guaranteed by issuer	Guaranteed by issuer	Not guaranteed by company
<b>Purpose</b>	Must be issued only for <i>Sharī'ah</i> -compliant purposes	Can be issued for any purpose	Can be offered for any purpose
<b>Trading of security</b>	Sale of ownership interest in a specific asset or venture	Sale of a debt instrument	Sale of shares in a company
<b>Responsibility of holders</b>	Responsibility for defined duties relating to the underlying assets/venture limited to the extent of participation in the issue	Bondholders do not have any responsibilities for the circumstances of the issuers	Responsibility for the affairs of the company limited to the extent of holding in the company
<b>Asset-related expenses</b>	Asset-related expenses may be attached to <i>Sukūk</i> holders	Bondholders are not required to pay any asset-related expenses, if any	Not required to pay
<b>Prices</b>	Notwithstanding an obligor's creditworthiness, <i>Sukūk</i> prices depend on the market value of underlying assets	Based on creditworthiness of the issuer	Based on the future expectations of, <i>inter alia</i> , earnings and dividends of the firm
<b>Insolvency of the originator/ issuer</b>	<i>Sukūk</i> holder's recovery depends on the quality of underlying assets	Complete or partial loss of lent money and/or interests for the bondholders	Shareholders are second in line to bondholders in the event of insolvency

Modified from: Adam Nathif and Thomas Abdulkader, *Islamic Bonds (Euromoney, 2004)*, p. 54.



**APPENDIX E: SUPERVISORY SLOTTING CRITERIA FOR *ISTISNĀ'* IN PROJECT FINANCE AND *MUSHĀRAKAH* IN A BUSINESS VENTURE**

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

**APPENDIX E: SUPERVISORY SLOTING CRITERIA FOR *ISTISNĀ`* IN PROJECT FINANCE AND *MUSHĀRAKAH* IN A BUSINESS VENTURE**

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

**APPENDIX E: SUPERVISORY SLOTTING CRITERIA FOR *ISTISNĀ'* IN PROJECT FINANCE AND *MUSHĀRAKAH* IN A BUSINESS VENTURE**

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

**APPENDIX E: SUPERVISORY SLOTTING CRITERIA FOR *ISTISNĀ`* IN PROJECT FINANCE AND *MUSHĀRAKAH* IN A BUSINESS VENTURE**

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

**APPENDIX E: SUPERVISORY SLOTTING CRITERIA FOR *ISTISNĀ'* IN PROJECT FINANCE AND *MUSHĀRAKAH* IN A BUSINESS VENTURE**

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

**APPENDIX E: SUPERVISORY SLOTTING CRITERIA FOR *ISTISNĀ`* IN PROJECT FINANCE AND *MUSHĀRAKAH* IN A BUSINESS VENTURE**

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

**APPENDIX E: SUPERVISORY SLOTTING CRITERIA FOR *ISTISNĀ`* IN PROJECT FINANCE AND *MUSHĀRAKAH* IN A BUSINESS VENTURE**

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

**APPENDIX E: SUPERVISORY SLOTTING CRITERIA FOR *ISTISNĀ`* IN PROJECT FINANCE AND *MUSHĀRAKAH* IN A BUSINESS VENTURE**

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

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



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

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

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

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

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

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

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

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

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

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

## APPENDIX G: FACTORS IN DETERMINING DOMESTIC SYSTEMICALLY IMPORTANT BANKS

1. As mentioned in section 2.6.3, supervisory authorities should decide the broad category of factors that will be used for assessing the impact of the failure of a Domestic Systemically Important Bank (D-SIB). Supervisory authorities can use, *inter alia*, some or all of the four factors mentioned below. For each factor, a number of possible indicators have been mentioned which can be used by supervisory authorities as a measure of the relevant factor.

### (a) Size

2. The size of a bank is central for its significance in the financial system, as its size indicates the extent of financial services supplied by the institution to the real economy and the financial system. Any possible damaging effects in the form of risks for the economy (negative externalities) if a bank fails are likely to increase more than proportionally with the size of the institution. If a large institution fails, this may, to a greater extent than for smaller institutions, damage public confidence in the financial system as a whole.<sup>161</sup>

3. The size of a bank can be measured in several ways. Some possible measures include:

- *Total assets.*
- *Total exposure*, as measured for leverage ratio in section 2.4.3.2.
- *Market shares within systemically important business areas (deposits, financing and clearing).*
- *Size of total assets in relation to GDP:* If a bank is relatively large in size compared to the domestic GDP, it can be identified as a D-SIB, whereas a same-sized bank in another jurisdiction that is smaller relative to the GDP of that jurisdiction may not be identified as a D-SIB.
- *RWAs as a percentage of GDP:* RWAs express the risks relating to the bank's specific activities and may reduce any overrating of how systemic the bank is, as low-risk items may be included in the total assets of the institution. The downside is that the RWAs may change due to increased use of internal models without a corresponding change in how systemic the institution is.
- *Value of uncovered deposits/unrestricted PSIA:* Deposits/unrestricted PSIA not covered by a *Shari'ah*-compliant deposit guarantee scheme or an equivalent scheme must be expected to suffer losses in connection with a winding-up, and for households and enterprises such losses may limit their consumption and investments, and ultimately mean that they are not capable of fulfilling their obligations. At the same time, if more households and enterprises suffer losses in connection with a winding-up, this creates more uncertainty and general lower confidence in the banks. This may give rise to financial instability and limit the possibility that the sector will provide the services that it is expected to deliver, and thus also restrict economic activity. The relevant indicator for deposits is deemed to be the size of the deposits in relation to the sector's overall deposits, as this expresses the relative size of the institution and also the potential consequences of a winding-up.

### (b) Interconnectedness

4. Interconnectedness means that problems in a bank may spread to the rest of the sector – for example, as a consequence of contractual obligations between the financial institutions. The interconnectedness of a bank with the rest of the financial system may, for example, pose a risk that winding-up the institution reduces the loss-absorbing capacity of the rest of the sector due to losses on exposures incurred by the D-SIB. This could be in the form of unsecured and secured financing, *Sukūk* portfolios, etc., which limit the total credit supply of the sector and thus, potentially, economic growth.

5. To assess the interconnectedness of a bank with the rest of the financial system, the following indicators can be considered:

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<sup>161</sup> Arguably also small institutions may have systemic importance if they encounter difficulties at the same time. However, deposit insurance schemes and other measures by supervisory authorities can help make the damage control a little easier than those of systemically important significance.

- intra-financial system assets;
- intra-financial system liabilities;
- wholesale funding ratio;
- financing to financial institutions (secured);
- financing to financial institutions (unsecured);
- financing/deposits from financial institutions;
- investment securities held;
- financing-to-deposit ratio;
- intra-group exposures; and
- importance of the institution in secured interbank market.

**(c) Substitutability/financial institution infrastructure**

6. In emerging markets, most banking institutions, including IIFS, undertake financing as their core business activity. Financing comprises activities which can be difficult or impossible for other banks to take over or replace in the short term. In order to be able to provide financing, the bank must have sufficient liquidity and capital to meet the statutory requirements even after having provided the financing; and, in relation to some customer or product segments, highly specialised credit expertise. It is likely that the larger the financing portfolio, the more difficult it will be to take the portfolio over from other institutions. Extensive losses and subsequent winding-up of a D-SIB may therefore result in limitation of the financing capacity in the sector, which will mostly be noticeable in terms of new financing. This may limit economic growth. Therefore, financing is considered difficult to substitute and to be of particularly significant systemic character. Some other measures that can be considered in this context include:

- market share of financing to various sectors of the economy;
- assets under custody;
- payments cleared and settled through payment systems;
- values of underwritten transactions in debt and equity markets;
- financing to households;
- financing to non-financial corporations;
- financing to the general government;
- financing to community service and non-profit organisations; and
- international payments, clearing and advisory services.

**(d) Complexity**

7. A bank's systemic importance will be higher if its business model, structure and operations make it particularly costly to wind up. The winding-up of complex institutions is likely to generate higher costs than winding-up less complex institutions, and will therefore, all else being equal, have a greater impact on financial stability and economic development. Factors which complicate winding-up may include the scope of over-the-counter (OTC) trading of *Sukūk*, large trading portfolios, or the fact that the institution has many assets in its balance sheet which have not been measured at market value and thus may prove to have a significantly different realisable value. Finally, the costs of winding-up an institution with significant cross-border activities will increase operational risks and put pressure on the time aspects of crisis management because of the need for coordination between national authorities.

8. The complexity of a credit institution is very closely linked to the size of the institution, as the large institutions, in particular, will also be the most complex in relation to the organisation, business model, etc. Accordingly, some possible indicators for complexity include:

- OTC trading of *Sukūk* notional value;
- held for trading and available for sale securities;
- investment securities;
- trading book exposure;

- the risk profile of the institution; and
- number of jurisdictions.

**(e) Country-specific factors**

9. Various jurisdiction-specific factors may be considered by supervisory authorities, in addition to those already mentioned. One such indicator is the degree of concentration in the banking sector or the size of the banking sector relative to GDP. Specifically, countries that have a larger banking sector relative to GDP are more likely to suffer larger direct economic impacts of the failure of a D-SIB than those with smaller banking sectors. While size-to-GDP is easy to calculate, the concentration of the banking sector could also be considered, as a failure in a medium-sized highly concentrated banking sector would likely create more of an impact on the domestic economy than if it were to occur in a larger, more widely dispersed banking sector.