EXPOSURE DRAFT NO. 2

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

Comments on this Exposure Draft should be sent to the IFSB’s Secretariat not later than 15 September 2005 at email ifsb_sec@ifsb.org or facsimile +603-26984280

15 March 2005
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<th>Name</th>
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<th>Acronym</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1996 Market Risk Amendment</td>
<td>Amendment to the Capital Accord to incorporate Market Risks, January 1996</td>
</tr>
<tr>
<td>AL</td>
<td>Agreement to Lease</td>
</tr>
<tr>
<td>AP</td>
<td>Agreement to Purchase</td>
</tr>
<tr>
<td>CAS</td>
<td>Capital Adequacy Standard</td>
</tr>
<tr>
<td>CRE</td>
<td>Commercial Real Estate</td>
</tr>
<tr>
<td>CRM</td>
<td>Credit Risk Mitigation</td>
</tr>
<tr>
<td>ECA</td>
<td>Export Credit Agencies</td>
</tr>
<tr>
<td>ECAI</td>
<td>External Credit Assessment Institution</td>
</tr>
<tr>
<td>HJ</td>
<td><em>Hamish Jiddiyyah</em>, a security deposit held as collateral upon entering into AP or AL</td>
</tr>
<tr>
<td>IAH</td>
<td>Investment Account Holders</td>
</tr>
<tr>
<td>IIFS</td>
<td>Institutions (other than Insurance Institutions) offering only Islamic Financial Services</td>
</tr>
<tr>
<td>IMB</td>
<td><em>Ijārah Muntahia Bittamleek</em> (or known as <em>Ijārah wa Iqtinā</em>)</td>
</tr>
<tr>
<td>IRR</td>
<td>Investment Risk Reserve</td>
</tr>
<tr>
<td>MDB</td>
<td>Multilateral Development Bank</td>
</tr>
<tr>
<td>MPO</td>
<td><em>Murābahah</em> for the Purchase Orderer</td>
</tr>
<tr>
<td>PER</td>
<td>Profit Equalisation Reserve</td>
</tr>
<tr>
<td>PSIA</td>
<td>Profit Sharing Investment Accounts (or <em>Muḍārabah</em> Investment Account)</td>
</tr>
<tr>
<td>RRE</td>
<td>Residential Real Estate</td>
</tr>
<tr>
<td>RW</td>
<td>Risk Weight</td>
</tr>
<tr>
<td>RWA</td>
<td>Risk-weighted Assets</td>
</tr>
<tr>
<td>SSB</td>
<td><em>Sharī‘ah</em> Supervisory Board</td>
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A. INTRODUCTION

Purpose
1. This Section provides a general introduction to the Islamic Financial Services Board’s Capital Adequacy Standard (CAS) for institutions (other than insurance institutions) offering only Islamic financial services (IIFS). The term “IIFS” as used in this document refers to such financial institutions that mobilise funds as deposits and investment accounts in accordance with *Sharī`ah* rules and principles.

2. The objectives of the CAS are to:
   - address the specific structure and contents of the *Sharī`ah* compliant products and services offered by the IIFS that are not specifically addressed by the currently adopted and proposed international capital adequacy standards, and *Sharī`ah*-compliant mitigation; and
   - standardise the approach in identifying and measuring risks in *Sharī`ah* compliant products and services and in assigning risk weights (RW) thereto, thereby, creating a level playing field amongst the IIFS, in adopting and developing risk identification and measurement practices that meet internationally acceptable prudential standards.

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

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

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

Scope of Application
6. This document is intended to be applied to non-insurance institutions offering only Islamic financial services. Supervisory authorities may, at their discretion, extend the calculation of the minimum capital adequacy requirements to Islamic “window” operations that are self-contained or other institutions offering Islamic financial services that fall within their jurisdictions.

7. This document will be applicable to any IIFS that falls within the scope as stated herein, on a fully consolidated basis at the holding company level within a group or sub-group of IIFS, or as appropriate, on an individual basis subject to approval of the supervisory authorities. The CAS 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 this document.
Specificities of Islamic Financial Instruments

8. Islamic financial instruments are asset-based (Murābahah, Salam and Istisnā‘ which are based on the sale or purchase of an asset, and Ījārah which is based on the leasing of such an asset), profit-sharing (Mushārakah and Muḍārabah), or sukūk (securities) 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, Mushārakah and Muḍārabah, the exposure is of the nature of an equity position not held for trading similar to an ‘equity position in the banking book’ as described in Basel II, and is likewise dealt with under credit risk, except in the case of investments (normally short-term) in assets for trading purposes, which are dealt with under market risk.

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

Structure of the CAS

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

- Murābahah and Murūbahah for the Purchase Orderer;
- Salam;
- Istisnā‘;
- Ījārah and Ījārah Muntahia Bittamleek;
- Mushārakah and Diminishing Mushārakah;
- Muḍārabah; and
- Sukūk.

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

11. The CAS has been endorsed by the Sharī‘ah Advisory Committee of the Islamic Development Bank and co-opted Sharī‘ah scholars representing central banks and monetary agencies, which are members of the IFSB on 27 February 2005. The Sharī‘ah rules and principles as set out in the CAS do not represent an exhaustive list of diverse practices amongst the various IIFS and compliance with the principles stated herein shall not be construed as a formal endorsement by the IFSB that the products and services offered by the IIIFS are in accordance with the Sharī‘ah principles. The IIIFS are expected to fulfil the requirements set by their supervisory authorities in determining and ensuring that their activities are in compliance with the Sharī‘ah rules and principles.

Implementation Date

12. The CAS is scheduled for finalisation in the year 2005 and is expected to be implemented with effect from the year 2007.
B. PRINCIPLES FOR MINIMUM CAPITAL ADEQUACY REQUIREMENTS

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

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

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

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

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

18. The Shari`ah rules and principles whereby IAH provide funds to the IIFS on the basis of profit-sharing and loss-bearing Mu`ḍarabah contracts instead of debt-based deposits, i.e. lending money to the IIFS, would mean that the IAH would share in the profits of a successful operation, but could also lose all or part of their investments. The liability of the IAH is exclusively limited to the provided capital and the potential loss of the IIFS is restricted solely to the value or opportunity cost of its work. However, if negligence, mismanagement or fraud can be proven, the IIFS will be financially liable for the capital of the IAH. Therefore, credit and market risks of the investment made by the IAH shall normally be borne by themselves, while the operational risk is borne solely by the IIFS.
B.1 CREDIT RISK

19. Credit risk exposures in Islamic financing arise in connection with accounts receivable in Murābahah contracts, counterparty risk in Salam contracts, accounts receivable and counterparty risk in Istisnā’ contracts and lease payments receivable in Ijārah contracts. In this 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 Mushārakah or Muḍārabah contracts in assets that are not held for trading. The latter are to be treated as giving rise to credit risk (in the form of capital impairment risk), and risk-weighted using the methods proposed in Basel II either for “equity exposures in the banking book” or, at the supervisor’s discretion, the supervisory sloting criteria for specialised financing.

20. The assignment of RW shall take into consideration the followings:

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

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

(i) Individual Claims based on External Credit Assessments

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

<table>
<thead>
<tr>
<th>Risk Weights</th>
</tr>
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<tbody>
<tr>
<td>Rating/Risk Score†</td>
</tr>
<tr>
<td>-------------------</td>
</tr>
<tr>
<td>ECA Country Risk Score</td>
</tr>
<tr>
<td>Sovereigns and Central Banks (A)</td>
</tr>
<tr>
<td>Risk Weight (RW)</td>
</tr>
<tr>
<td>Non-Central Government Public Sector Entities (PSEs) (C)</td>
</tr>
<tr>
<td>Risk Weight (RW)</td>
</tr>
<tr>
<td>Multilateral Development Banks (MDBs) (D)</td>
</tr>
<tr>
<td>Risk Weight (RW)</td>
</tr>
<tr>
<td>IIFS, banks and securities firms</td>
</tr>
<tr>
<td>Option 1*</td>
</tr>
<tr>
<td>Option 2a **</td>
</tr>
<tr>
<td>Option 2b**/i (E)</td>
</tr>
<tr>
<td>Rating/Risk Score</td>
</tr>
<tr>
<td>-------------------</td>
</tr>
<tr>
<td>Corporates (F)</td>
</tr>
</tbody>
</table>

* 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

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

Inclusive of official entities that will receive a 0% RW as determined by supervisory authorities.

PSEs, such as regional government and local authorities, may be risk-weighted as sovereigns if they have the power of raising revenue and a specific institutional arrangement to reduce their default risk. An administrative body owned by the government or a local authority may be treated in the same manner as IIFS even though it has sovereign immunity but has no power of raising revenue or a specific institutional arrangement.

Certain MDBs are eligible for a 0% RW as determined by the supervisory authorities.

Under Option 2b, the RW are one category less favourable than that assigned to claims on the sovereigns subject to a floor of 20% when the exposure is denominated and funded in domestic currency.

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%.

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

<table>
<thead>
<tr>
<th>Rating/Risk Score</th>
<th>A-1 / P-1</th>
<th>A-2 / P-2</th>
<th>A-3 / P-3</th>
<th>Others</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk Weight</td>
<td>20%</td>
<td>50%</td>
<td>100%</td>
<td>150%</td>
</tr>
</tbody>
</table>

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

Exposures in Investments Made Under Profit Sharing Modes

An IIFS may hold investments made under profit-sharing and loss-bearing mode (Muḍārakah) and profit and loss sharing mode (Mushārakah) that are made not for trading or liquidity purposes but for the purpose of earning investment returns from medium to long-term financing. Such investments
- are not held with the intent of trading or short-term resale benefiting from the actual or expected price movements;
- are not marked-to-market on a daily basis;
- are not actively monitored with reference to market sources; and
- are exposed to credit risk in the form of capital impairment risk.

In this standard, the RW for such investments shall be calculated according to one of the following two methods for equity exposure not held in the trading book (i.e. held in the banking book):

a) Simple risk-weight method
A 400% RW is to be applied to all equity exposures in private and commercial enterprise. However, funds invested on a Muḍārakah basis may be subject to withdrawal by the investor at short notice, and in that case may be considered as being as liquid as shares that are publicly traded. The applicable RW in such a case is 300%.

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

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

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

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

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

(iii) Credit Risk Mitigation

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

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

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

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

(b) ‘*Urbūn* (earnest money held as collateral)

The ‘*urbūn*’ taken from a purchaser or lessee when a contract is established can be retained by the IIFS if the purchaser or lessee fails to perform its contractual obligations.

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

The guarantor may or may not have recourse to the debtor (i.e. purchaser or lessee) and the guarantee can be for a fixed period and for a limited amount, without any consideration being received by the guarantor. The IIFS has the right to choose between claiming the amount due either from the debtor or from the guarantor and it is permissible to stipulate that the payment shall first be demanded from the debtor and then from the guarantor.

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

(d) Pledge of assets as collateral

The pledged asset must be a valuable asset that can be lawfully owned, and is saleable, specifiable, deliverable and free of encumbrance. The asset pledged must either be the
underlying asset or any other asset owned by the customer. The pledge of an asset owned by a third party is subject to the owner’s consent to the pledge.

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

The IIFS that takes collateral of an asset pledged to multiple pledgees shall not take the full value of the collateral (or the value after deducting a haircut3 under the Simple Approach, the Standard Supervisory Haircuts or the Internal Haircut Approach) to offset its credit exposure but should first ascertain the recoverability value of the asset after taking into consideration the IIFS’s position as a pledgee as to whether it ranks pari passu with the other pledgee(s) or ranks junior to a pledgee that is registered earlier than the IIFS.

31. The collateralisation under the concept of “rahn” or “kafâlah” shall be properly documented in a security agreement or, in the body of a contract to the extent permissible by Sharî`ah, and must be binding on all parties and legally enforceable in the relevant jurisdictions.

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

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

(a) Hamish jiddiyah (security deposit) only for binding agreements to purchase or lease

(b) ‘Urbûn (earnest money)

(c) Profit sharing investment account or cash on deposit4 with the IIFS which is incurring the exposure

(d) Sukûk rated by an external rating agency which are issued by:
   (i) Sovereigns and PSEs (treated as sovereigns) with a minimum rating of BB-; or
   (ii) Issuers other than the above, with a minimum rating of BBB- or A-3 / P-3.

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3 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.

4 Must be supported by an agreement or documentation that gives IIFS the right of set-off against the amount of receivables due.
(e) *Sukūk* that are unrated by an ECAI but fulfil each of the following criteria:
(i) issued by an IIFS or a conventional bank;
(ii) listed on a recognised exchange;
(iii) all other rated issues by the IIFS or conventional bank of the same seniority of at least BBB - or A-3/P-3 by a recognised ECAI, as determined by the supervisory authorities;
(iv) the IIFS which incurs the exposure or is holding the collateral has no information to suggest that the issue would justify a rating below BBB- or A-3/P-3; and
(v) the supervisory authorities are sufficiently confident about the market liquidity of the securities.

(f) Guarantees issued by third parties that fall within the following categories:
(i) Sovereigns and central banks;
(ii) PSEs;
(iii) MDBs;
(iv) International organisations/official entities with 0% RW
(v) IIFS or conventional banks; and
(vi) Corporate entities (including insurance and securities firms) either by the parent, subsidiary and affiliates, of a minimum rating of A-.

(g) Assets pledged as collateral as in paragraph 30 (d) above.

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

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

(a) Simple Approach
The IIFS can substitute the RW of the collateral for the RW of the counterparty for the collateralised portion of the exposure subject to the collateral be pledged for at least the duration of the contract. The RW of that collateralised portion shall not be lower than 20%.

(b) Standard Supervisory Haircuts
Both the amount of exposure to a counterparty and the value of collateral received are adjusted by using standard supervisory haircuts as set out below:

<table>
<thead>
<tr>
<th>Types of Collateral*</th>
<th>Residual Maturity (yrs)</th>
<th>Haircuts (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Sovereigns[^b]</td>
</tr>
<tr>
<td>Cash</td>
<td>All</td>
<td>0</td>
</tr>
<tr>
<td>Sukūk</td>
<td>≤ 1</td>
<td>0.5</td>
</tr>
</tbody>
</table>
| Long-term: AAA to AA- and A-1
                     | > 1 to ≤ 5             | 2            | 4       |
| Short-term: A-1      | > 5                    | 4            | 8       |
| Sukūk               | ≤ 1                    | 1            | 2       |
| Long-term: A+ to BBB- and A-2 to A-3
                     | > 1 to ≤ 5             | 3            | 6       |
| Short-term: A-2 to A-3 | > 5               | 6            | 12      |
| Sukūk               | All                    | 15           | 15      |
| Long-term: BB+ to BB-
                     |                        |              |         |
| Sukūk (unrated)     | All                    | 25           | 25      |
| Equities (included in main index) | All | 15 | 15 |
| Equities (not included in main index but listed) | All | 25 | 25 |

[^b]: Collateral denominated in different currency will also be subject to additional 8% haircut to cater for foreign exchange risk

[^5]: Includes PSEs and MDBs
Subject to obtaining the approval from its supervisory authority, an IIFS may use its own estimate of haircuts to measure market price and foreign exchange volatilities. Such approval will normally require the fulfilling of certain qualitative and quantitative criteria set by the supervisory authority, inter-alia:

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

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

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

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

38. An IIFS may also place liquid funds with a central bank or another bank on a short-term *Muḍārabah* basis in order to obtain a return on those funds. Such placements serve as an interbank market with maturities ranging from an overnight market up to three months, but the funds may be withdrawn on demand before the maturity date in which case no return would be earned. Although from a juristic point of view the amounts so placed do not constitute as 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 latter 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 risk weight applicable to the *Muḍārib* as counterparty.

(v) Preferential Risk Weights based on Underlying Assets

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

<table>
<thead>
<tr>
<th>Murābahah</th>
<th>Ijārah</th>
</tr>
</thead>
</table>
| Retail    | The RW shall be 75% if the Murābahah receivables are due from an individual person or persons or a small business provided that:  
- the subject matter which is sold on the basis of Murābahah is pledged to the IIFS; and  
- the aggregate accounts receivable, consisting of accounts receivable in Murābahah and Istisnāʾ; and lease payments receivable in Ijārah, due from a single counterparty or person shall not exceed USD250,000 or lower as determined by the supervisory authorities. | The RW shall be 75% if the lease payments receivable in Ijārah are due from an individual person or persons or a small business provided that the aggregate receivables, consisting of accounts receivable in Murābahah and Istisnāʾ; and lease payments receivable in Ijārah, due from a single counterparty or person shall not exceed USD250,000 or lower as determined by the supervisory authorities. |

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6 Any such guarantee would be provided free of charge in order to be *Sharīʿah* compliant.
A Murābahah contract which is collateralised by an asset other than the subject matter, shall not qualify for this preferential treatment unless such collateral represents a close substitute for the subject matter and has a “forced sale” market value higher than the Murābahah contract selling price throughout the tenure of the Murābahah contract.

For any sale on a Murābahah basis that is secured by real estate, the accounts receivable arising from the sale can be excluded from this category and qualify for a lower RW as stated below.

<table>
<thead>
<tr>
<th>Residential real estate (RRE)</th>
<th>The RW will be 35% subject to meeting the prudential criteria imposed by the supervisory authorities, which amongst others include:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>▪ the subject matter of the RRE must be pledged to the IIFS;</td>
</tr>
<tr>
<td></td>
<td>▪ the total accounts receivable in the Murābahah contract do not exceed 50% of the market value of the collateralised RRE subject to professional valuation of the RRE made within one year preceding the Murābahah contract date;</td>
</tr>
<tr>
<td></td>
<td>▪ there exists a substantial margin of additional security over the total amount due based on strict valuation rules; and</td>
</tr>
<tr>
<td></td>
<td>▪ there exists a legal infrastructure that can enforce the repossession and liquidation of the RRE.</td>
</tr>
<tr>
<td>The supervisory authorities have discretion to apply a higher RW up to 100% if any of the above criteria is not met.</td>
<td></td>
</tr>
</tbody>
</table>

| Commercial real estate (CRE) | The RW shall be 100%, but in exceptional circumstances for well-developed and long-established markets, Murābahah for, and collateralised by, office and/or multi-purpose premises and/or multi-tenanted premises may have the potential to receive a preferential RW of 50% for the tranche of the Murābahah facility that does not exceed 50% of the market value of the collateralised CRE, provided the IIFS is able to show that its total losses |
|                            | The RW shall be 100%, but in exceptional circumstances for well-developed and long-established markets, Ijārah for office and/or multi-purpose premises and/or multi-tenanted premises may have the potential to receive a preferential RW of 50% for the tranche of the Ijārah facility that does not exceed 50% of the market value of the leased CRE, provided the IIFS is able to show that its total losses from CRE financing (Murābahah or Ijārah) do not exceed |

<table>
<thead>
<tr>
<th>Murābahah</th>
<th>Ijārah</th>
</tr>
</thead>
<tbody>
<tr>
<td>qualify for a lower RW as stated below.</td>
<td></td>
</tr>
</tbody>
</table>

The supervisory authorities have discretion to apply a higher RW up to 100% if any of the above criteria is not met.
Murābahah | Ijārah
---|---
from CRE financing (Murābahah or Ijārah) do not exceed 0.5% of the total amount due in respect of such financing in any given year. | 0.5% of the total amount due in respect of such financing in any given year.

(vi) Past Due Receivables
40. 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.

<table>
<thead>
<tr>
<th>Type</th>
<th>RW</th>
<th>% of Specific Provisions for Past Due Receivables</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unsecured exposure (other than unsecured portion of receivable partly secured by RRE) that is past due more than 90 days, net of specific provisions</td>
<td>150%</td>
<td>Less than 20% of the outstanding receivables.</td>
</tr>
<tr>
<td></td>
<td>100%</td>
<td>At least 20% of the outstanding receivables.</td>
</tr>
<tr>
<td></td>
<td>100%</td>
<td>At least 50% of the outstanding receivables but Supervisory authorities have discretion to reduce RW to 50%.</td>
</tr>
<tr>
<td>Exposure fully secured by other than eligible collateral (as set out in paragraph 33)</td>
<td>100%</td>
<td>At least 15% of the outstanding receivables.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Supervisory authorities are to set strict operational criteria to ensure quality of collateral.</td>
</tr>
<tr>
<td>Exposure secured by RRE</td>
<td>100%</td>
<td>For receivables that are past due for more than 90 days, net of specific provisions.</td>
</tr>
<tr>
<td></td>
<td>50%</td>
<td>The RW can be reduced to 50% RW if specific provisions are at least 50% of the outstanding receivables.</td>
</tr>
</tbody>
</table>
B.2 MARKET RISK

41. Market risk is defined as the risk of losses in on- and off-balance sheet positions arising from movements in market prices. The risks in IIFS that are subject to the market risk capital requirement are:
   - equity position risk in the trading book, and market risk on trading positions in Sukūk;
   - foreign exchange risk; and
   - commodities and inventory risk.

(i) Equity Position Risk and Trading Positions in Sukūk
42. The capital charge for equities held for trading or available for sale comprises two charges that are separately calculated for the following types of risk:

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

(b) General Market Risk
   The capital charge for general market risk is 8% on the difference between the summation of the long position and short position, i.e. the overall net position. These positions must be calculated on a market by market basis.

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

<table>
<thead>
<tr>
<th>Government*</th>
<th>0%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment Grade</td>
<td>0.25% (residual term to final maturity 6 months or less)</td>
</tr>
<tr>
<td></td>
<td>1.00% (residual term to final maturity 6 and 24 months)</td>
</tr>
<tr>
<td></td>
<td>1.60% (residual term to final maturity exceeding 24 months)</td>
</tr>
<tr>
<td>Others</td>
<td>8%</td>
</tr>
</tbody>
</table>

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

The provision for general market risk 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:

<table>
<thead>
<tr>
<th>Residual term to maturity</th>
<th>RW</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 month or less</td>
<td>0.00%</td>
</tr>
<tr>
<td>1-3 months</td>
<td>0.20%</td>
</tr>
<tr>
<td>3-6 months</td>
<td>0.40%</td>
</tr>
<tr>
<td>6-12 months</td>
<td>0.70%</td>
</tr>
<tr>
<td>1-2 years</td>
<td>1.25%</td>
</tr>
<tr>
<td>2-3 years</td>
<td>1.75%</td>
</tr>
<tr>
<td>3-4 years</td>
<td>2.25%</td>
</tr>
<tr>
<td>4-5 years</td>
<td>2.75%</td>
</tr>
<tr>
<td>5-7 years</td>
<td>3.25%</td>
</tr>
<tr>
<td>7-10 years</td>
<td>3.75%</td>
</tr>
<tr>
<td>10-15 years</td>
<td>4.50%</td>
</tr>
<tr>
<td>15-20 years</td>
<td>5.25%</td>
</tr>
<tr>
<td>&gt; 20 years</td>
<td>6.00%</td>
</tr>
</tbody>
</table>

---

7 An equity position treated under “equity exposures in the banking book” is dealt with under the Credit Risk as set out in Section B1.
43. In the case of equity investments made by means of a Mushārakah or a Mudārabah contract where the underlying assets are commodities held for trading, the market risk provisions for commodities, as described below, will be applicable.

(ii) Foreign Exchange Risk
44. The capital charge to cover the risk of holding or taking long positions in foreign currencies, and gold and silver, is calculated in two steps by:
   (a) Measuring the exposure in a single currency position; and
   (b) Measuring the risks inherent in an IIFS’s portfolio mix of long and short positions in different currencies.

Measuring the Exposure in a Single Currency and Open Position in Gold and Silver
45. 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 by the IIFS to buy and/or sell currencies on a specified future date (that are not included in the spot position);
   (c) Guarantees and similar off-balance sheet instruments that are likely to be called and irrecoverable; and
   (d) Any other items representing a profit or loss in foreign currencies, e.g. specific provision held in the currency in question but the underlying asset is held in a different currency.

46. The net open position in gold or silver should first be expressed in terms of the standard unit of measurement (i.e. ounces or grams) and then be converted at current spot rate into the reporting or base currency.

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

48. 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
49. The IIFS are allowed to use either a Shorthand Method or Internal Models Approach in calculating the risks inherent in the IIFS’s mix of long and short positions in different currencies. However, the Shorthand Method as stated below is recommended for the IIFS.
   (a) Convert the nominal amount of the net position (net long or net short positions) in each foreign currency and in gold/silver into the reporting currency using spot rates.
   (b) Aggregate the sum of converted net short positions or the sum of converted net long positions.
   (c) The greater sum of net short positions or net long positions calculated in (b) is added to the net position of gold/silver, either short or long position regardless of sign to derive at the overall net position

50. The capital charge is 8% on the overall net position as calculated in 49(c) above.

51. 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

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

9 A binding bilateral promise in an exchange of currencies is equivalent to a forward contract which is prohibited by most Shari‘ah jurists as the delivery of one or both countervales is deferred.
factors being captured into the IIFS's risk management system, quantitative standards, comprehensive stress testing program and validation of the models by external auditors and/or supervisory authorities. Those requirements are not included in this section.

(iii) Commodities and Inventory Risk

52. This section sets out the minimum capital requirements to cover the risks of holding or taking long positions in commodities, including precious metals but excluding gold and silver (which falls under foreign exchange risk as set out in paragraphs 44 to 51), as well as the inventory risk which results from IIFS holding assets with a view to re-selling or leasing them. A commodity is defined as a physical product which is and can be traded on a secondary market, e.g. agricultural products, minerals (including oil) and precious metals. Inventory risk is defined as arising from holding items in inventory either for resale under a Murābahah contract, or with a view to leasing under an Ijārah contract. In the case of inventory risk, the simplified approach described in paragraph 58 below should be applied.

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

54. Positions in different group of commodities\textsuperscript{10} cannot be offset unless:
(a) The sub-categories of commodities are deliverable against each other;
(b) The commodities represent close substitutes for each other; and
(c) A minimum correlation of 0.9 between the price movements of the commodities can be established over a minimum period of 1 year.

55. 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:

<table>
<thead>
<tr>
<th>Time-band</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1)</td>
<td>0 – 1 month</td>
</tr>
<tr>
<td>2)</td>
<td>1 – 3 months</td>
</tr>
<tr>
<td>3)</td>
<td>3 – 6 months</td>
</tr>
<tr>
<td>4)</td>
<td>6 – 12 months</td>
</tr>
<tr>
<td>5)</td>
<td>1 – 2 years</td>
</tr>
<tr>
<td>6)</td>
<td>2 – 3 years</td>
</tr>
<tr>
<td>7)</td>
<td>Over 3 years</td>
</tr>
</tbody>
</table>

56. A separate maturity ladder is used for each type of commodities, while the physical stocks are allocated to the first time-band. The calculation of capital charge is made in the following three steps:
(a) The sum of short and long positions that are matched will be multiplied by the spot price for the commodity and then by the appropriate spread rate of 1.5% for each time band.
(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%.

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

\textsuperscript{10} Commodities can be group into clans, families, sub-groups and individual commodities, e.g. a clan might be Energy Commodities, within which Hydro-carbons is a family with Crude Oil being a sub-group and West Texas Intermediate, Arabian Light and Brent being individual commodities.
58. Under the simplified approach as applied to commodities, the net position, long or short, in each commodity requires a capital charge of 15% to cater for directional risk plus an additional capital charge of 3% of the gross positions, i.e. long plus short positions, to cater for basis risk. For inventory exposures, assets held in the IIFS’s possession 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.

59. The funding of a commodities position that exposes the IIFS to foreign exchange exposure is also subject to capital charge as measured under the foreign exchange risk (please refer to paragraphs 44 to 51).
B.3 OPERATIONAL RISK

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

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

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

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

(a) **Murābahah and Ijārah contracts**
- The asset is in existence at the time of sale or lease or, in case of Ijārah, the lease contract should be preceded by acquisition of the usufruct of that asset.
- The asset is legally owned by the IIFS when it is offered for sale.
- The asset is intended to be used by the buyer/lessee for activities or businesses permissible by Sharī`ah; if the asset is leased back to its owner in the first lease period, it should not lead to contract of ‘inah, by varying the rent or the duration.
- There is no late payment, penalty fee or increase in price in exchange for extending or rescheduling the date of payment of accounts receivable or lease receivable, irrespective of whether the debtor is solvent or insolvent.

(b) **Salam and Istisna` contracts**
- A sale and purchase contract cannot be inter-dependent and inter-conditional on each other, such as *Salam* and Parallel *Salam; Istisna`* and Parallel *Istisna`*.
- It is not allowed to stipulate a penalty clause in respect of delay in delivery of a commodity that is purchased under Salam contract or Parallel Istisna`.
- The subject-matter of an Istisna` contract does not physically exist upon entering into the contract.

(c) **Mushārakah and Muḍārabah contracts**
- The capital of the IIFS is to be invested in Sharī`ah compliant investments or business activities.
- A partner in Mushārakah cannot guarantee the capital of another partner or a Muḍārib guarantees the capital of the Muḍārabah.
- The purchase price of other partner’s share in a Mushārakah with a binding agreement to purchase can only be set as per the market value or as per the agreement at the date of buying. It is not permissible, however, to stipulate that the share be acquired at its face value.

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

65. Gross income is defined as:
   (a) Net income from financing activities (e.g. selling price less purchase price) which is gross of any provisions and operating expenses;
   (b) Net income from investment activities; and
   (c) Fee income (e.g. commission and agency fee)

Less:
Investment account holders’ share of income

_The gross income excludes extraordinary income. Net income from investment activities includes the IIFS’s share of profit from Mushārakah and Muḍārabah financing activities._
B.4 PROFIT SHARING INVESTMENT ACCOUNTS

66. This section deals with the capital adequacy requirement for assets financed by Profit Sharing Investment Accounts (PSIA), a pool of investment funds placed with an IIFS on the basis of Muḍārabah. Where investment accounts are managed under Wakālah contract, the relationship between IIFS and the investors is a simple agency relationship with the IIFS earning a flat fee rather than a share of profit. Hence, paragraphs 68, 70 and 71 would apply.

67. The PSIA (commonly referred to as “investment accounts” or “special investment accounts”) can be further categorised into:
(a) Unrestricted PSIA; and
(b) Restricted PSIA.

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

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

(i) Adjustment to the Capital Ratio Denominator
70. The capital amount of PSIA is not guaranteed by the IIFS and any losses arising from investments or assets financed by PSIA are to be borne by the IAH except under certain circumstances as described in paragraph 71. In principle, therefore, the commercial risk on assets financed by PSIA do not represent risks for the IIFS’s own (shareholders’) capital and thus would not entail a regulatory capital requirement for the IIFS. This implies that assets funded by either unrestricted or restricted PSIA would be excluded from the calculation of the denominator of the capital ratio. In practice, however, the IIFS may forgo its rights to some or all of its Muḍārib share of profits in order to offer its IAH a more competitive rate of return on their funds, or may be treated as constructively obliged to do so by the supervisory authority as a measure of investor protection and in order to mitigate potential systemic risk resulting from massive withdrawals of funds by dissatisfied IAH. The implications of this for capital adequacy purposes are addressed under “displaced commercial risk” in paragraph 72 and supervisory discretion in paragraphs 73 to 75.

(ii) Impact on Capital
71. The IIFS is liable for losses arising from its negligence, misconduct or breach of its investment mandate, and the risk of losses arising from such events is characterised as a fiduciary risk. The capital requirement for this fiduciary risk is dealt with under operational risk (see paragraphs 60 to 65).

(iii) Displaced Commercial Risk
72. The term “displaced commercial risk” refers to the risk arising from assets managed on behalf of IAH which is effectively transferred to the IIFS’s own capital because the IIFS follows the practice of foregoing part or all of its Muḍārib share of profit on such funds, when it considers this necessary as a result of commercial pressure in order to increase the return that would otherwise be payable to the IAH. This practice may also be required by the supervisory authority as mentioned in paragraph 70 above. The rate of return paid to the IAH is thus “smoothed” at the expense of the profits attributable to the IIFS’s shareholders. Such a situation would most often arise as a result of rate of return risk, where the IAH’s funds are invested in assets such as Murābāhah or Ijārah with a relatively long maturity and at a rate of return which no longer meets current market expectations. However, it might also arise in respect of other market risks (such as price risk) or credit risk when an IIFS wishes to protect its IAH from the effects of the poor overall performance of a portfolio of assets under its management (subject to the Shari‘ah prohibition of the Muḍārib making good an overall loss to the investor). While in principle the IIFS has full discretion as to whether it performs this displacement of commercial risk, in practice it may find itself virtually obliged to do so (as a result of commercial and/or supervisory pressure), and this has implications for its capital adequacy which needs to be considered by its supervisory
authority as discussed in paragraph 73. It should be noted that displaced commercial risk does not relate to cover an overall loss attributable to IAH by reallocating profit from shareholders, as Sharī`ah rules and principles do not permit this.

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

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

75. In such an environment, the supervisory authority has discretion to require the IIFS to which the circumstances mentioned in paragraphs 73 and 74 apply, to include a specified percentage of assets financed by PSIA in the denominator of the CAR (represented by $\alpha$ in the Supervisory Discretion Formula as set out in Appendix A). This would apply to RWA financed by both unrestricted and restricted PSIA, unless the practice of income smoothing for IAH by the IIFS had been confined to the unrestricted PSIA.

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

(a) Profit equalisation reserve (PER)
PER comprises amounts appropriated out of the gross income from the Muḍārabah to be available for smoothing returns paid to the investment account holders and the shareholders, and consists of a PSIA portion and a shareholder’s portion; and/or

(b) Investment risk reserve (IRR)
IRR comprises amounts appropriated out of the income of investment account holders after deduction of the Muḍārib share of income, to meet any future losses on the investments financed by the PSIA.

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11 In some countries, the appropriation of income is to be made out of income after taking into consideration the tax effect.
C. MINIMUM CAPITAL REQUIREMENTS FOR ISLAMIC FINANCING ASSETS

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

C.1 MURĀBAHAH AND MURĀBAHAH FOR THE PURCHASE ORDERER

1. Introduction

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

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

80. 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.

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

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

Murābahah and Non-binding MPO

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

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

Binding MPO

85. 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 predetermined 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 AP, resulting in the IIFS selling the asset to a third party at a selling price which may be lower than the cost to the IIFS. The risk of selling at a loss is mitigated by securing a HJ upon executing the AP with the customer, as commonly practised in the case of binding MPO. The IIFS would have recourse to the customer for any shortfall in the HJ to compensate for the loss.

Collateralisation

86. As one of the CRM techniques, the IIFS can secure a pledge of the sold asset/underlying asset or another tangible asset ("collateralised Murābahah"). The collateralisation is not automatically provided in a Murābahah contract but must be explicitly stated and must be documented in a separate security agreement. The IIFS may employ other techniques such as pledge of deposits or a third party financial guarantee. The RW of a financial guarantor can be
substituted for the RW of the purchaser provided that the guarantor has a better credit rating than the purchaser and that the guarantee is legally enforceable.

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

2. Credit Risk

Murābahah and Non-binding MPO

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

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

Binding MPO

90. In a binding MPO, an IIFS is exposed to default on the purchase orderer’s obligation to purchase the commodity in its possession. In the event of the orderer defaulting on its AP, the IIFS will dispose of the asset to a third party. The IIFS will have recourse to any HJ paid by the orderer, and (a) may have a right to recoup from the orderer any loss on disposing of the asset, after taking account of the HJ, or (b) may have no such 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 purchase orderer.

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

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

93. In applying the treatment as set out in paragraph 91, the IIFS shall ensure that the AP is properly documented and it is legally enforceable. In the absence of a proper documentation and legal enforceability, the asset is to be treated similar to a non-binding MPO which is exposed to price risk, where the measurement approach is set out in paragraphs 98 to 99.

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

(i) Exclusions

95. The capital requirement is to be calculated on the receivable amount, net of specific provisions, any amount that is secured by eligible collateral as defined in paragraph 33 and/or any amount that is past due by more than 90 days. The portions that are collateralised and past due are subject to the relevant RW as set out in paragraphs 35 and 40 respectively.
(ii) Preferential RW
96. Subject to meeting the minimum requirements as set out in paragraph 39, the RW of collateralised Murābahah may be given preferential RW as set out below for the following types of collateralised asset:

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

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

(iii) Treatment of Import Financing
97. An import financing, which is based on Murābahah where the underlying goods/shipment are collateralised and insured, shall attract a 20% credit conversion factor to the IIFS that issues or confirms the letter of credit.

3. Market Risk

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

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

Binding MPO
100. In a binding MPO the orderer has the obligation to purchase the asset at the agreed price, and the IIFS as the seller is only exposed to credit risk as indicated in paragraph 90 above.

Foreign Exchange Risk
101. The funding of an asset purchase or the selling of an asset may well open an IIFS to foreign exchange exposures; therefore, the relevant positions should be included in the measures of foreign exchange risk described in paragraphs 44 to 51.
4. Summary of Capital Requirement at Various Stages of the Contract

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

(a) *Murābahah and Non-binding MPO*

<table>
<thead>
<tr>
<th>Applicable Stage of the Contract</th>
<th>Credit RW</th>
<th>Market Risk Capital Charge</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset available for sale (asset on balance sheet)*</td>
<td>Not applicable</td>
<td>15% capital charge (187.5% RW)</td>
</tr>
<tr>
<td>Asset is sold and delivered to a customer, and the selling price (accounts receivable) is due from the customer</td>
<td>Based on customer’s rating or 100% RW for unrated customer (see paragraphs 88 to 89)</td>
<td>Not applicable</td>
</tr>
<tr>
<td>Maturity of contract term or upon full settlement of the purchase price, whichever is earlier</td>
<td>Not applicable</td>
<td>Not applicable</td>
</tr>
</tbody>
</table>

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

(b) *Binding MPO*

<table>
<thead>
<tr>
<th>Applicable Stage of the Contract</th>
<th>Credit RW **</th>
<th>Market Risk Capital Charge</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset available for sale (asset on balance sheet)*</td>
<td>Asset acquisition cost less market value of asset as collateral (net of any haircut) less any HJ x 100% RW (see paragraphs 90 to 93)</td>
<td>Not applicable</td>
</tr>
<tr>
<td>Asset is sold and delivered to a customer (accounts receivable is due from a customer)</td>
<td>Based on customer’s rating or 100% RW for unrated customer (see paragraph 94)</td>
<td>Not applicable</td>
</tr>
<tr>
<td>Maturity of contract term or upon full settlement of the selling price, whichever is earlier</td>
<td>Not applicable</td>
<td>Not applicable</td>
</tr>
</tbody>
</table>

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

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

If the IIFS has no such right, the cost of the asset to the IIFS constitutes a market risk (as in the case on a non-binding MPO), but this market risk exposure is reduced by the amount of any HJ that the IIFS has the right to retain.
C.2 SALAM

1. Introduction
103. 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 the (a) credit (counterparty) risk of not receiving the purchased commodity after disbursing the purchase price to the seller, and (b) price risk that the IIFS incurs from the date of execution of a Salam contract, which is applicable throughout the period of the contract and beyond the maturity date of the contract as long as the commodity remains on the balance sheet of the IIFS.

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

105. A Salam contract refers to an agreement to purchase, at a predetermined price, a specified kind of commodity 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.

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

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

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

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

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

(i) Exclusions
111. The capital requirement is to be calculated on the receivable amount, net of specific provisions, of any amount that is secured by eligible collateral as defined in paragraph 33 and/or any amount which is past due by more than 90 days. The portions that are collateralised and past due are subject to the relevant RW as set out in paragraphs 35 and 40 respectively.

(ii) Applicable Period
112. The credit RW is to be applied from the date when the purchase price is paid by the IIFS until the maturity of the Salam contract, which is upon receipt of the purchased commodity.

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12 A commodity is defined as a physical product which is and can be traded on a secondary market, e.g. agricultural products, minerals (including oil) and precious metals. The commodity may or may not be traded on an organised exchange.
(iii) **Offsetting Arrangement between Credit Exposures of Salam and Parallel Salam**

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

3. **Market Risk**

114. The price risk on the commodity exposure in *Salam* can be measured in two ways, either the maturity ladder approach (see paragraphs 53 to 57) or the simplified approach. Under the simplified approach, the capital charge will equal to 15% of the net position, long or short, 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.

115. 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**

116. The funding of a commodity purchase or selling of a commodity may well leave an IIFS open to foreign exchange exposures, and in that case the relevant positions should be included in the measures of foreign exchange risk described in paragraphs 44 to 51.

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

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

(ii) **Supervisory Discretion**

118. Under the maturity ladder approach, the supervisory authority has discretion to allow netting between different categories of commodities where the commodities are deliverable against each other or represent close substitutes for each other and have a minimum correlation of 0.9 between the price movements that can be established over a minimum period of one year (see paragraph 55).

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

119. The following tables set out the applicable period of the contract that attracts capital charges:
### (a) *Salam* with Parallel *Salam*

<table>
<thead>
<tr>
<th>Applicable Stage of the Contract</th>
<th>Credit RW</th>
<th>Market Risk Capital Charge</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payment of purchase price by the IIFS to a <em>Salam</em> customer</td>
<td>Based on customer’s rating or 100% RW for unrated customer</td>
<td>Two approaches are applicable</td>
</tr>
<tr>
<td></td>
<td>No netting of <em>Salam</em> exposures against Parallel <em>Salam</em> exposures</td>
<td>Maturity Ladder Approach (see paragraphs 53 to 57)</td>
</tr>
<tr>
<td></td>
<td>See paragraphs 110 to 113</td>
<td>The Simplified Approach 15% capital charge (187.5% RW equivalent) on net long or short position (i.e. netting of <em>Salam</em> exposures against Parallel <em>Salam</em> exposures) plus 3% capital charge (37.5% RW equivalent) on gross positions (i.e. <em>Salam</em> exposures plus Parallel <em>Salam</em> exposures)</td>
</tr>
<tr>
<td>Receipt of the purchased commodity by the IIFS</td>
<td>Not applicable</td>
<td>Not applicable</td>
</tr>
<tr>
<td>The purchased commodity is sold and delivered to a buyer</td>
<td>Not applicable</td>
<td>Not applicable</td>
</tr>
</tbody>
</table>

### (b) *Salam* without Parallel *Salam*

<table>
<thead>
<tr>
<th>Applicable Stage of the Contract</th>
<th>Credit RW</th>
<th>Market Risk Capital Charge</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payment of purchase price by the IIFS to a <em>Salam</em> customer (seller)</td>
<td>Based on customer’s rating or 100% RW for unrated customer</td>
<td>The Simplified Approach 15% capital charge (187.5% RW equivalent) on long position of <em>Salam</em> exposures</td>
</tr>
<tr>
<td></td>
<td>See paragraphs 110 to 113</td>
<td></td>
</tr>
<tr>
<td>Receipt of the purchased commodity by the IIFS</td>
<td>Not applicable</td>
<td></td>
</tr>
<tr>
<td>The purchased commodity is sold and delivered to a buyer</td>
<td>Not applicable</td>
<td>Not applicable</td>
</tr>
</tbody>
</table>
C.3 ISTISNĀ`

1. Introduction

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

121. An Istisnā` contract refers to an agreement to sell to or buy from a customer a non-existent asset which is to be manufactured or built according to the ultimate buyer’s specifications and is to be delivered on a specified future date at a predetermined selling price. The IIFS as the seller has the option to manufacture or build the asset on its own or to engage the services of a party other than the Istisnā` ultimate buyer as supplier or subcontractor, by entering into a Parallel Istisnā` contract (please refer to paragraph 129).

122. 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 (WIP).

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

124. 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.

125. 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.

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

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

(b) Limited and Non-recourse Istisnā`
   The receipt of the selling price by the IIFS is dependent partially or primarily on the amount of revenue generated by the asset being manufactured or constructed by selling its output or services to contractual or potential third party buyers. This form of Istisnā` faces “revenue risk” arising from the asset’s ability to generate cash flows, instead of the creditworthiness of the customer or project sponsor.

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

13 In conventional project financing, the completion risk is normally borne by the project sponsor and not the bank because the project sponsor has most often been asked to provide an undertaking to cover cost overruns.
128. The selling price of an asset sold based on *Istisnā* is agreed or determined on the contractual date and such a contract is binding. The price cannot be increased or decreased on account of an increase or decrease in commodity prices or labour cost. The price can be changed subject to the mutual consent of the contracting parties due to alteration or modifications to the contract or unforeseen contingencies, which is a matter for the commercial decision of the IIFS and can result in a lower profit margin.

*Istisnā* with Parallel *Istisnā*

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

130. The failure of the Parallel *Istisnā* seller to deliver a completed asset which meets the customer’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.

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

2. Credit Risk

Full Recourse *Istisnā*’

132. The receivable amount generated from selling of an asset based on an *Istisnā* contract with full recourse to the 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 paragraph 22 for RW of the customers. In case the customer is unrated, a RW of 100% shall apply.

Limited and Non-Recourse *Istisnā*’

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

<table>
<thead>
<tr>
<th>Supervisory Categories</th>
<th>Strong</th>
<th>Good</th>
<th>Satisfactory</th>
<th>Weak</th>
</tr>
</thead>
<tbody>
<tr>
<td>External Credit Assessments</td>
<td>BBB- or better</td>
<td>BB+ or BB</td>
<td>BB- to B+</td>
<td>B to C-</td>
</tr>
<tr>
<td>Risk Weights</td>
<td>70%</td>
<td>90%</td>
<td>115%</td>
<td>250%</td>
</tr>
</tbody>
</table>

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

(a) the segregation of the project’s liabilities from the balance sheet of the *Istisnā*’ ultimate buyer (or project sponsor) from a commercial and accounting perspective which is generally achieved by having the *Istisnā* contract made with a special purpose entity set up to acquire and operate the asset/project concerned;

(b) the ultimate buyer is dependent on the income received from the assets acquired/ projects to pay the purchase price;

(c) the contractual obligations give the manufacturer/constructor/IIFS a substantial degree of control over the asset and the income it generates, for example under BOT (built, operate and transfer) arrangement where the manufacturer builds a highway and collects tolls for a specified period as a consideration for the selling price; and

(d) the primary source of repayment is the income generated by the asset/project rather than relying on the capacity of the purchaser.
(i) Exclusions
135. The capital requirement is to be calculated on the receivable amount, net of specific provisions, any amount that is secured by eligible collateral as defined in paragraph 33 and/or any amount which is past due by more than 90 days. The portions that are collateralised and past due are subject to the relevant RW as set out in paragraphs 35 and 40 respectively.

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

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

(iii) Offsetting Arrangement between Credit Exposures of Istisnā` and Parallel Istisnā`
138. The credit exposure amount of an Istisnā` contract is not to be offset against the credit exposure amount of a Parallel Istisnā` contract because an obligation under one contract does not discharge an obligation to perform under the other contract.

3. Market Risk
Full Recourse Istisnā`
(a) Istisnā` with Parallel Istisnā`
139. There is no capital charge for market risk to be applied in addition to provisions in paragraphs 132 to 138 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, is also eligible for this treatment.

(b) Istisnā` without Parallel Istisnā`
140. A capital charge of 1.6% (equivalent to a 20% RW) is to be applied to the balance of unbilled WIP inventory to cater for market risk, in addition to the credit RW stated in paragraphs 132 to 138 above.

141. This inventory is held subject to the binding order of the Istisnā` customer and is thus not subject to inventory price as described in paragraphs 52 to 59. However this inventory is exposed to the price risk as described in paragraph 128.

Foreign exchange risk
142. Any foreign exchange exposures arising from the purchasing of input materials, or from Parallel Istisnā` contracts made, or the selling of a completed asset in foreign currency should be included in the measures of foreign exchange risk described in set out in paragraphs 44 to 51.
4. **Summary of Capital Requirement at Various Stages of the Contract**

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

(a) **Full Recourse Istisnā’**

(i) *Istisnā’ with Parallel Istisnā’*

<table>
<thead>
<tr>
<th>Applicable Stage of the Contract</th>
<th>Credit RW</th>
<th>Market Risk Capital Charge</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unbilled work-in-process</td>
<td>Based on customer’s rating or 100% RW for unrated customer</td>
<td>Nil provided that no provision in the Parallel <em>Istisnā’</em> contract that allows the seller to increase or vary the selling price</td>
</tr>
<tr>
<td></td>
<td>No netting of <em>Istisnā’</em> exposures against Parallel <em>Istisnā’</em> exposures</td>
<td>See paragraph 139</td>
</tr>
<tr>
<td>Amounts receivable after contract billings</td>
<td>See paragraphs 132 to 138</td>
<td>Not applicable</td>
</tr>
<tr>
<td>Maturity of contract term or upon full settlement of the purchased price by an <em>Istisnā’</em> customer, whichever is the earlier</td>
<td>Not applicable</td>
<td>Not applicable</td>
</tr>
</tbody>
</table>

(ii) **Istisnā’ without Parallel Istisnā’**

<table>
<thead>
<tr>
<th>Applicable Stage of the Contract</th>
<th>Credit RW</th>
<th>Market Risk Capital Charge</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unbilled work-in-process</td>
<td>Based on customer’s rating or 100% RW for unrated customer</td>
<td>1.6% capital charge (equivalent to 20% RW) on work-in-process inventory</td>
</tr>
<tr>
<td></td>
<td>See paragraphs 140 to 141</td>
<td>Not applicable</td>
</tr>
<tr>
<td>Progress billing to customer</td>
<td>Based on customer’s rating or 100% RW for unrated</td>
<td>Not applicable</td>
</tr>
<tr>
<td></td>
<td>See paragraphs 132 to 138</td>
<td></td>
</tr>
<tr>
<td>Maturity of contract term or upon full settlement of the purchased price by an <em>Istisnā’</em> customer, whichever is the earlier</td>
<td>Not applicable</td>
<td>Not applicable</td>
</tr>
</tbody>
</table>
(b) Limited and Non-Recourse *Istīsnā*`  
(i) *Istīsnā*` with Parallel *Istīsnā*` (for project finance)

<table>
<thead>
<tr>
<th>Applicable Stage of the Contract</th>
<th>Credit RW</th>
<th>Market Risk Capital Charge</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unbilled work-in-process</td>
<td>Based on customer’s rating, if available, or supervisory slotting criteria that ranges from 70% to 250% RW</td>
<td>Not applicable</td>
</tr>
</tbody>
</table>
| Amounts receivable after contract billings | No netting of *Istīsnā*` exposures against Parallel *Istīsnā*` exposures  
See paragraphs 133 to 134 | |
| Maturity of contract term or upon full settlement of the purchased price by an *Istīsnā*` customer, whichever is the earlier | Not applicable | Not applicable |
C.4  **IJĀRAH AND IJĀRAH MUNTÅHIA BITTÅMLEEK**

1. **Introduction**

144. This section sets out the minimum capital requirement to cover counterparty risk and residual value risk of leased assets, arising from an IIFS entering into contracts or transactions that are based on the Shari‘ah rules and principles of *ijārah* and *ijārah Muntåhia Bittåmleek* (IMB), also known as *ijārah wa lqtinā*. The section also covers the market (price) risk of assets acquired for *ijārah* and IMB.

145. In an *ijārah* contract (either operating or IMB), the IIFS as the lessor maintains its ownership in the leased asset whilst transferring the right to use the asset, or usufruct, to an enterprise as the lessee, for an agreed period at an agreed consideration. All liabilities and risks pertaining to the leased asset are to be borne by the IIFS including obligations to restore any impairment and damage to the leased asset arising from wear and tear and natural causes which are not due to the lessee’s misconduct or negligence. Thus, in both *ijārah* and IMB, the risks and rewards remain with the lessor, except for the residual value risk at the term of an IMB which is borne by the lessee. The lessor is exposed to price risk on the asset while it is in the lessor’s possession prior to the signature of the lease contract, except where the asset is acquired following a binding agreement to lease as described in paragraph 147 below.

146. In an IMB contract, the lessor agrees to transfer its ownership in the leased asset to the lessee at the end of the contract as a gift or at a specified consideration, provided that the agreement is separately expressed and independent of the underlying *ijārah*.

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

**Operating *ijārah***

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

**IMB**

149. 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\(^{14}\)) and to a type of operational risk in respect of the need to compensate the lessee if the asset is permanently impaired through no fault of the latter. If the leased asset is permanently impaired and is uninsured, the IIFS suffers a loss equal to the carrying value of the leased asset, just as it would if any of its fixed assets were permanently impaired. In the event that the lessee exercises its right to cancel the lease, the lessor is exposed to the residual value of the leased asset being less than the refund of payments due to the lessee. In such case, the price risk, if any, is already reflected in a ‘haircut’ to be applied to the value of the leased asset as collateral. Therefore, the price risk, if any, is not applicable in the context of the IMB.

150. 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.

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\(^{14}\) The collateral used in the context of IMB is of the usufruct or use value of the asset, as the IIFS is the owner of the asset.
151. The IIFS may be exposed to losses in case a lessee acquiring an asset under IMB decides not to continue with the contract. In such a case, the lessor is required to refund to the lessee the capital payments (installments 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.

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

2. Credit Risk

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

154. In applying the treatment as set out in paragraph 153, the IIFS must ensure that the AL is properly documented and is legally enforceable. In the absence of a proper documentation and legal enforceability, the asset is to be treated similarly to one in a non-binding AL which is exposed to market (price) risk, using the measurement approach as set out in paragraph 160(a).

Operating ğijārah

155. In addition to paragraph 153 above, the lessor is exposed to credit risk in respect of the estimated value of the lease payments in respect of the remaining period of the ğijārah. This exposure is mitigated by the market value of the leased asset which may be repossessed. The net credit risk exposure shall be assigned a RW based on the credit standing of the lessee/counterparty as rated by an ECAI that is approved by the supervisory authority. In the case that the lessee is unrated, a RW of 100% shall apply.

IMB

156. In addition to paragraph 153, the capital requirement for IMB is based on the following two components:

(a) the total estimated future ğijārah receivable amount over the duration of the lease contract. This exposure is mitigated by the market value of the leased asset which may be repossessed. The net credit risk exposure shall be assigned a RW based on the credit standing of the lessee/counterparty as rated by an ECAI that is approved by the supervisory authority. In the case that the lessee is unrated, a RW of 100% shall apply; and

(b) the price risk attached to the expected residual fair value of a leased asset is treated under paragraph 161.

157. The estimated future ğijārah receivable amount as indicated in paragraph 156(a) above shall be risk-weighted based on the credit standing on the standing of the lessee as rated by an ECAI or at 100%, after deduction of the value of the leased asset as collateral (subject to any haircut).

(i) Exclusions

158. The capital requirement is to be calculated on the receivable amount, net of specific provisions, of any amount that is secured by eligible collateral as defined in the paragraph 33
and/or any amount which is past due by more than 90 days. The portions that are collateralised and past due are subject to the relevant RW as set out in paragraphs 35 and 40 respectively.

(ii) Preferential RW
159. Subject to meeting the minimum requirements as set out in paragraph 39, preferential RW can be assigned for certain types of leased asset such as real estate. The supervisory authorities have discretion to apply RW appropriate for their circumstances.

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

(a) Non-binding AL
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 AL
In a binding AL, 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 AL, the IIFS will either lease or dispose of the asset to a third party. The IIFS will have recourse to any 'urbūn paid by the customer,15 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 'urbūn, 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 'urbūn paid by the lease orderer.

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

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

Operating ljārah
161. Upon expiry of the lease contract, the carrying value of the leased asset (i.e. its residual value as calculated by the lessor in pricing the lease) shall carry a capital charge of 15% until the asset is re-leased or disposed of.

IMB
162. 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.

15 The amount can only be deducted for damages, i.e. difference between the asset acquisition cost and the total of lease rentals (when the asset is leased to a third party) or selling price (when the asset is sold to a third party), whichever is applicable.
4. Summary of Capital Requirement at Various Stages of the Contract

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

**Operating Ijārah**

<table>
<thead>
<tr>
<th>Applicable Stage of the Contract</th>
<th>Credit RW</th>
<th>Market Risk Capital Charge</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset available for lease (prior to signing a lease contract)</td>
<td>Binding AL* Asset acquisition cost less (a) market value of asset as collateral (net of any haircuts) and (b) any ‘urbūn multiply with the customer’s rating or 100% RW for unrated customer.</td>
<td>Non-binding AL 15% capital charge (equivalent to 187.5% RW) until lessee takes possession</td>
</tr>
<tr>
<td>Upon consigning a leasing contract and the lease rental payments are due from the lessee</td>
<td>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. less recovery value of the leased assets</td>
<td>The carrying value of the leased asset as calculated by the lessor in pricing the lease, shall carry a capital charge of 8% (equivalent to 100% RW)</td>
</tr>
<tr>
<td>Maturity of contract term and the leased asset is returned to the IIFS</td>
<td>Not applicable</td>
<td>15% capital charge of the carrying value of the asset</td>
</tr>
</tbody>
</table>

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

If the IIFS has no such right, the cost of the asset to the IIFS constitutes a market risk (as in the case on a non-binding AL), but this market risk exposure is reduced by the amount of any ‘urbūn that the IIFS has the right to retain.
<table>
<thead>
<tr>
<th>Applicable Stage of the Contract</th>
<th>Credit RW</th>
<th>Market Risk Capital Charge</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset available for lease (prior to signing a lease contract)</td>
<td>Binding AL*&lt;br&gt;Asset acquisition cost&lt;br&gt;less (a) market value of asset as collateral (net of any haircuts), and (b) any 'urbūn multiply with customer’s rating or 100% RW for unrated customer</td>
<td>Non-binding AL&lt;br&gt;15% capital charge (187.5% RW equivalent) until lessee takes possession</td>
</tr>
<tr>
<td>Upon consigning a leasing contract and the lease rental payments are due from the lessee</td>
<td>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</td>
<td>Not applicable</td>
</tr>
<tr>
<td>Maturity of contract term and the leased asset is sold and the asset ownership is transferred to the lessee</td>
<td>Not applicable</td>
<td>Not applicable</td>
</tr>
</tbody>
</table>

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

If the IIFS has no such right, the cost of the asset to the IIFS constitutes a market risk (as in the case on a non-binding AL), but this market risk exposure is reduced by the amount of any ‘urbūn that the IIFS has the right to retain.
C.5 MUSHĀRAKAH AND DIMINISHING MUSHĀRAKAH

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

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

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

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

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

169. As a partner to a Mushāraḥah 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 Mushāraḥah 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.

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

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

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

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

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

(ii) Mushārakah with Murābahah sub-contract
The IIFS is entitled to its share of revenue generated from selling the assets to third parties by means of Murābahah contracts that expose the IIFS to credit risk in respect of the Murābahah receivables from the buyer/counterparty.

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

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

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

2. Equity Position Risk
Mushārakah
174. For Mushārakah, the equity exposure can be measured based on the nature of the underlying investments as follows:

(a) For investments held for trading or available for sale, exposure is equal to the fair value; and

(b) For investments held to maturity, exposure is equal to the historical cost less any provisions for impairment.

175. The Mushārakah exposures, net of specific provisions, shall be measured as follows:

(a) Private commercial enterprise to undertake trading activities in foreign exchange, shares or commodities
The RW shall be based on the applicable underlying assets as set out in the market risk section in paragraphs 41 to 59.
The investment in foreign exchange and trading in gold/silver shall be measured according to the treatment as set out in paragraphs 44 to 51, which requires 8% capital charge on the greater of either net long or net short positions and 8% capital charge on the net position of gold/silver.

The RW of a Mushārakah 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 'held for trading', which would incur a total capital charge of 16% (equivalent to 200% RW) as set out in paragraphs 42 to 43. The capital charge can be reduced to 12% (equivalent to 150% RW) for a portfolio that is both liquid and well-diversified, subject to meeting the criteria as determined by the supervisory authorities.

Investment in commodities shall be measured according to either the maturity ladder approach or simplified approach as set out in paragraphs 52 to 58.

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

<table>
<thead>
<tr>
<th>Supervisory Categories</th>
<th>Strong</th>
<th>Good</th>
<th>Satisfactory</th>
<th>Weak</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk Weights</td>
<td>90%</td>
<td>110%</td>
<td>135%</td>
<td>270%</td>
</tr>
</tbody>
</table>

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

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

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

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

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

**Diminishing Mushārakah**

176. The equity exposure in a Diminishing Mushārakah contract, where the IIFS intends to transfer its full ownership in movable assets and working capital to the other partner over the life of the contract, is calculated based on the remaining balance of the amount invested (measured at historical cost including any share of undistributed profits) less any specific provision for impairment. This exposure shall be risk weighted according to the nature of the underlying assets as set out in paragraph 175 above. If there is a third party guarantee to make good impairment losses, the RW of the guarantor shall be substituted for that of the assets for the amount of any such guarantee.

3. **Summary of Capital Requirements for Mushārakah Categories**

177. The following table set out the Mushārakah categories that attract capital charges:

<table>
<thead>
<tr>
<th>Mushārakah Category</th>
<th>Credit RW</th>
<th>Market Risk Capital Charge</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private commercial enterprise to undertake trading activities in the foreign exchange, share and/or commodity</td>
<td>Not applicable</td>
<td>Depends on the underlying asset as set out in the applicable market risk section</td>
</tr>
<tr>
<td>Private commercial enterprise to undertake business venture OTHER THAN trading activities in the foreign exchange, share and/or commodity</td>
<td>(a) Simple risk-weight method 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) Slotting method Between 90-270% RW of the contributed amount* to the business venture based on the four categories</td>
<td>Not applicable</td>
</tr>
<tr>
<td>Joint ownership of real estate and movable assets (Mushārakah with ḫārah sub-contract, Mushārakah with Murābahah sub-contract)</td>
<td>Based on lessee’s (for ḫārah sub-contract) or customer’s (for Murābahah sub-contract) rating or 100% RW for unrated lessee or customer</td>
<td>Please refer to the market risk capital charge requirements as set out under the sub-contracts</td>
</tr>
</tbody>
</table>

* In case of Diminishing Mushārakah, the contributed amount is based on the remaining balance of the invested amount.
C.6 MUDĀRABAH

1. Introduction

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

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

180. 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.

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

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

183. Apart from such placements, Muḍārabah contracts are commonly used for the investment purposes mentioned in paragraph 185 below.

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

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

(a) Private commercial enterprise to undertake trading activities in foreign exchange, shares or commodities
This type of Muḍārabah exposes the IIFS to the risk of the underlying activities, namely foreign exchange, equity or commodities.

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

(c) 

**Muḍārabah investments in project finance**

An IIFS advances funds to a customer who acts as Muḍārib in a construction contract for a third-party customer (ultimate customer). The ultimate customer will make progress payments to the Muḍārib who in turn make payments to the IIFS. The essential role of the IIFS in this structure is to provide bridging finance to the Muḍārib pending its receipt of the progress payments. The structure is similar in some respects to that of an Istisnā’ in which the IIFS acts as prime contractor to the third party (the ultimate customer) under an Istisnā’ contract and enters into a parallel Istisnā’ with a construction company as subcontractor. However, there are important differences between an Istisnā’ structure (in which the IIFS acts as financial intermediary between the construction company and the ultimate customer) and this Muḍārabah structure. In the latter:

(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 advanced to the Muḍārib, and as these advances are made on a profit and loss 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 “repayment account” which transfers much of the credit risk to the ultimate customer.

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

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

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

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

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

2. **Equity Position Risk**

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

(a) For investments held for trading or available for sale, exposure is equal to the fair value; or

(b) For investments held to maturity, the exposure is equal to the historical cost less any provisions for impairment.

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

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

The RW shall be based on the applicable underlying assets as set out in the market risk section in paragraphs 41 to 59.

The investment in foreign exchange and trading in gold/silver shall be measured according to the treatment of as set out in paragraphs 44 to 51, which requires 8% capital charge on the greater of either net long or net short positions and 8% capital charge on the net position of gold/silver.

The RW of a Muḍārabah that invests in quoted shares shall be measured according to equity position risk approach where positions in assets tradable in markets will qualify for treatment as ‘held for trading’, which would incur a total capital charge of 16% (equivalent to 200% RW) as set out in paragraphs 42 to 43. The capital charge can be reduced to 12% (equivalent to 150% RW) for a portfolio that is both liquid and well-diversified, subject to meeting the criteria as determined by the supervisory authorities.

Investment in commodities shall be measured according to either the maturity ladder approach or simplified approach as set out in paragraphs 52 to 58.

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

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

(i) **Simple risk-weight method:** The RW shall be applied to the exposures (net of specific provisions) based on equity exposures in the banking book. The RW under the simple risk-weight method for equity position risk in respect of an equity exposure in a business venture shall entail a 400% for shares that are not publicly traded. However, funds invested on a Muḍārabah basis may be subject to withdrawal by the investor at short notice, and in that case may be considered as being as liquid as shares that are publicly traded. The applicable RW in such a case is 300%.

(ii) **Slotting method:** An IIFS is required to map its RW into four supervisory categories as set out in the Appendix B where the RW of each category is as follows:

<table>
<thead>
<tr>
<th>Supervisory Categories</th>
<th>Strong</th>
<th>Good</th>
<th>Satisfactory</th>
<th>Weak</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk Weights</td>
<td>90%</td>
<td>110%</td>
<td>135%</td>
<td>270%</td>
</tr>
</tbody>
</table>
The above RW under the method for specialised financing include an additional fixed factor of 20% RW to cater for potential decline in the Muḍārahah's net asset value.

(c) **Muḍārahah investment in project finance**

The IIFS’s overall credit exposure in respect of the Muḍārahah 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 185(c) whereby the amount will be paid by the ultimate customer into a “repayment account” with the IIFS, a RW will reflect the credit standing of the ultimate customer.

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

(ii) the amount held in the “repayment account” with the IIFS, which would have a risk weighting of 0%;

(iii) any remaining balance of the funds advanced by the IIFS to the Muḍārib, which would incur a RW of 400% unless otherwise rated, the treatment as set out in paragraph 187(b) applies.

3. **Summary of Capital Requirements for Muḍārahah Categories**

188. The following tables set out the Muḍārahah categories that attract capital charges:

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

* 300% RW may be applied if the funds may be subject to withdrawal by the investor at short notice
<table>
<thead>
<tr>
<th>Applicable Contract Stages</th>
<th>Credit RW</th>
<th>Market Risk Capital Charge</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prior to certification where funds are already advanced by the IIFS to the Muḍārib</td>
<td>Risk weight is based on the rating of either the ultimate customer or the Muḍārib (see paragraph 187(c) above). Otherwise, 400% RW is applied to unrated Muḍārib.</td>
<td>Not applicable</td>
</tr>
<tr>
<td>After certification where amount receivable by the IIFS from the Muḍārib in respect of progress payment due to the Muḍārib from the ultimate customer</td>
<td>Based on the credit standing of the ultimate customer on the amounts receivable by the IIFS from the Muḍārib or 100% RW for unrated ultimate customer – only if a risk mitigation structure is used (collateralisation of cash flows from the ultimate customer by the use of a project account held in the IIFS into which the ultimate customer makes the progress payments and from which the Muḍārib cannot withdraw funds without the IIFS’s permission).</td>
<td>Not applicable</td>
</tr>
</tbody>
</table>
C.7  **SUKUK**

1. **Introduction**

189. This section sets out the minimum capital adequacy requirement to cover the credit risk and market risk arising from the holding of *sukūk* by the IIFS.

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

191. This section does not apply to *sukūk* held for trading, which is exposed to market risk, not credit risk and is treated in paragraph 42. As in principle *sukūk* are externally rated, the relevant risk weight will be based on these ECAI in accordance with the Standardised Approach. Where there are no acceptable ECAI ratings, the risk weights will be determined on the basis of the underlying assets as set out below, which may involve market risk as well as credit risk.

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

193. Supervisory authorities have discretion to specify measurement approaches as they think appropriate for other types of *sukūk* which are not listed in this section.

*Salam sukūk*

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

*Istisnā’ sukūk*

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

*Ijārah sukūk*

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

*Mushārakah sukūk*

197. A *Mushārakah sukūk* represents the direct pro-rata ownership of the holder in the assets of a private commercial enterprise or project where the subscription money is normally employed in purchasing non-liquid assets or such as real estate or moveable assets. A *Mushārakah sukūk* is a profit and loss sharing instrument where the exposure is of the nature of an equity position not held for trading similar to an equity position in the banking book, except in the case of investments (normally short-term) in assets for trading purposes. A *Mushārakah* certificate can be tradable provided that more than 50% by value of the underlying assets are non-financial.

*Mudāribah (Muqaraḥah) sukūk*

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

2. *Salam sukūk*

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

200. The market risk in *Salam sukūk* is likewise the same as that of the underlying contract, namely a long position in the underlying commodity. This risk can be measured according to either the maturity ladder approach or the simplified approach as set out in paragraphs 52 to 59.

201. A *Salam sukūk* which is structured with an undertaking from the issuer that the underlying commodity will be sold to a third party at a specified selling price (by means of a Parallel *Salam* contract) shall carry the RW of the buyer of that underlying commodity in the Parallel *Salam* contract.16

3. *Istisnā` sukūk*

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

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

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

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

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

206. The RW for Ijārah rentals is based on the lessee’s/counterparty risk since the bearer of the residual value risk is not borne by the sukūk holders.

207. Please refer to Section on Ijārah and IMB for detailed treatment.

5. **Mushārakah sukūk**

208. The treatment of Mushārakah sukūk is based on the intent of the underlying investments in Mushārakah that can be categorised into:

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

The risk weights (RW) shall be based on the applicable underlying assets as set out in the market risk section in paragraphs 41 to 59.

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

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

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

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

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

209. Please refer to Section on Mushārakah for detailed treatment.

6. **Muḍarabah (Muqaraḍah) sukūk**

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

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

The RW shall be based on the applicable underlying assets as set out in the market risk section in paragraphs 41 to 59.

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

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

211. Please refer to Section on Muḍarabah for detailed treatment.

7. **Exclusion**

212. A sukūk which is issued by a sovereign shall carry the RW applicable to that sovereign, according to its respective rating as assigned by an ECAI that is approved by the supervisory authority.
8. **Summary of Capital Requirements for Sukūk**

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

* **Sukūk Not Held for Trading (whether tradable or non-tradable)***

<table>
<thead>
<tr>
<th>Sukūk Category</th>
<th>Credit RW</th>
<th>Market Risk Capital Charge</th>
</tr>
</thead>
<tbody>
<tr>
<td>Externally rated</td>
<td>Relevant risk weight will be based on the ECAI ratings in accordance with the Standardised Approach</td>
<td>Not applicable</td>
</tr>
<tr>
<td>Non-rated</td>
<td>Relevant risk weight will be based on the underlying contract</td>
<td>Relevant capital charge will be based on the underlying contract</td>
</tr>
</tbody>
</table>

* Tradable sukūk that is classified as “not held for trading” must follow the accounting policy adopted that is neither held for trading nor available for sale.

* Tradable sukūk that is classified as held for trading or available for sale is exposed to market risk.
APPENDIX A: CAPITAL RATIO FORMULA

(a) Standard Formula

Eligible Capital

\[
\left\{ \text{Total Risk-weighted Assets (Credit* + Market* Risks) Plus Operational Risks} \right. \\
\left. \text{Less} \right. \\
\text{Risk-weighted Assets funded by PSIA** (Credit* + Market* Risks)} \right\}
\]

(b) Supervisory Discretion Formula

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

Eligible Capital

\[
\left\{ \text{Total Risk-weighted Assets (Credit* + Market* Risks) Plus Operational Risks} \right. \\
\left. \text{Less} \right. \\
(1 - \alpha) \left[ \text{Risk-weighted Assets funded by PSIA** (Credit* + Market* Risks)} \right] \\
\left. \text{Less} \right. \\
\alpha \left[ \text{Risk-weighted Assets funded by PER and IRR*** (Credit* + Market* Risks)} \right] \right\}
\]

* Credit and market risks for on and off-balance sheet exposures.
\(\alpha\) Refers to the proportion of assets funded by Profit Sharing Investment Accounts (PSIA) which is to be determined by the supervisory authorities. The value of \(\alpha\) would not normally be expected to exceed 30%.
** PSIA balances include PER and Investment Risk Reserve (IRR)
*** The relevant proportion of risk-weighted assets funded by PER and IRR is deducted from the denominator because these reserves have the effect of reducing the displaced commercial risk (see paragraph 73).
### APPENDIX B: SUPERVISORY SLOTTING CRITERIA FOR *ISTISNÄʿ* IN LIMITED AND NON-RECURSE PROJECT FINANCE AND *MUSHĀRAKAH* IN A BUSINESS VENTURE

<table>
<thead>
<tr>
<th>Financials</th>
<th>Strong</th>
<th>Good</th>
<th>Satisfactory</th>
<th>Weak</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Market conditions</strong></td>
<td>Few competitors or substantial and durable advantage in location, cost, or technology</td>
<td>Few competitors or better than average location, cost, or technology but this situation may not last</td>
<td>Project/business venture has no advantage in location, cost, or technology</td>
<td>Project/business venture has worse than average location, cost, or technology</td>
</tr>
<tr>
<td></td>
<td>Demand is strong and growing</td>
<td>Demand is strong and stable</td>
<td>Demand is adequate and stable</td>
<td>Demand is weak and declining</td>
</tr>
<tr>
<td><strong>Financial ratios</strong></td>
<td>Strong financial ratios considering the level of project/business venture risk; very robust economic assumptions.</td>
<td>Strong to acceptable financial ratios considering the level of project/business venture risk; robust project/business venture economic assumptions.</td>
<td>Standard financial ratios considering the level of project/business venture risk.</td>
<td>Aggressive financial ratios considering the level of project/business venture risk.</td>
</tr>
<tr>
<td><strong>Stress analysis</strong></td>
<td>The project/business venture can meet its financial obligations under sustained, severely stressed economic or sectoral conditions</td>
<td>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</td>
<td>The project/business venture is vulnerable to stresses that are not uncommon through an economic cycle, and may default in a normal downturn</td>
<td>The project/business venture is likely to default unless conditions improve soon</td>
</tr>
</tbody>
</table>
### APPENDIX B: SUPERVISORY SLOTTING CRITERIA FOR \textit{ISTISNĀ`} IN LIMITED AND NON-RECURSE PROJECT FINANCE AND \textit{MUSHĀRAKAH} IN A BUSINESS VENTURE

<table>
<thead>
<tr>
<th>Financing structure</th>
<th>Strong</th>
<th>Good</th>
<th>Satisfactory</th>
<th>Weak</th>
</tr>
</thead>
<tbody>
<tr>
<td>Duration of the contract compared to the duration of the project/ business venture</td>
<td>Useful life of the project/ business venture significantly exceeds tenor of the financing contract</td>
<td>Useful life of the project/ business venture exceeds tenor of the financing contract</td>
<td>Useful life of the project/ business venture exceeds tenor of the financing contract</td>
<td>Useful life of the project/ business venture may not exceed tenor of the contract</td>
</tr>
<tr>
<td>Payment structure of selling price</td>
<td>Partly in advance and in instalments</td>
<td>Instalments</td>
<td>Instalments with limited bullet payment</td>
<td>Bullet payment or in instalments with balloon structure (higher instalment amounts towards end of the contract)</td>
</tr>
<tr>
<td>(Note: applicable to \textit{Istisnā' only})</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Political and legal environment</td>
<td>Very low exposure; strong mitigation instruments, if needed</td>
<td>Low exposure; satisfactory mitigation instruments, if needed</td>
<td>Moderate exposure; fair mitigation instruments</td>
<td>High exposure; no or weak mitigation instruments</td>
</tr>
<tr>
<td>Political risk, including transfer risk, considering project/business venture type and mitigants</td>
<td>Low exposure</td>
<td>Acceptable exposure</td>
<td>Standard protection</td>
<td>Significant risks, not fully mitigated</td>
</tr>
<tr>
<td>Force majeure risk (war, civil unrest, etc),</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
### APPENDIX B: SUPERVISORY SLOTTING CRITERIA FOR ĪSTĪSNĀ’ IN LIMITED AND NON-RE COURSE PROJECT FINANCE AND MUSHĀRAKAH IN A BUSINESS VENTURE

<table>
<thead>
<tr>
<th>Political and legal environment (cont’d)</th>
<th>Strong</th>
<th>Good</th>
<th>Satisfactory</th>
<th>Weak</th>
</tr>
</thead>
<tbody>
<tr>
<td>Government support and project/business venture’s importance for the country over the long term</td>
<td>Project/business venture of strategic importance for the country (preferably export-oriented)</td>
<td>Project/business venture considered important for the country. Good level of support from government.</td>
<td>Project/business venture may not be strategic but brings unquestionable benefits for the country. Support from government may not be explicit.</td>
<td>Project/business venture not key to the country No or weak support from government</td>
</tr>
<tr>
<td>Strong support from government</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Stability of legal and regulatory environment (risk of change in law)</td>
<td>Favourable and stable regulatory environment over the long term</td>
<td>Favourable and stable regulatory environment over the medium term</td>
<td>Regulatory changes can be predicted with a fair level of certainty</td>
<td>Current or future regulatory issues may affect the project/business venture</td>
</tr>
<tr>
<td>Acquisition of all necessary supports and approvals for such relief from local content laws</td>
<td>Strong</td>
<td>Satisfactory</td>
<td>Fair</td>
<td>Weak</td>
</tr>
<tr>
<td>Enforceability of contracts, collateral and security</td>
<td>Contracts, collateral and security are enforceable</td>
<td>Contracts, collateral and security are enforceable</td>
<td>Contracts, collateral and security are considered enforceable even if certain non-key issues may exist</td>
<td>There are unresolved key issues in respect of actual enforcement of contracts, collateral and security</td>
</tr>
<tr>
<td>Transaction Characteristics</td>
<td>Strong</td>
<td>Good</td>
<td>Satisfactory</td>
<td>Weak</td>
</tr>
<tr>
<td>-----------------------------</td>
<td>--------</td>
<td>------</td>
<td>--------------</td>
<td>------</td>
</tr>
<tr>
<td>Design and technology risk</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fully proven technology and design</td>
<td>Fully proven technology and design</td>
<td>Proven technology and design-start-up issues are mitigated by a strong completion package</td>
<td>Unproven technology and design; technology issues exist and/or complex design</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Construction Risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>(for project finance only)</td>
</tr>
<tr>
<td>Permitting and siting</td>
</tr>
<tr>
<td>Type of construction contract</td>
</tr>
<tr>
<td>Completion guarantees</td>
</tr>
</tbody>
</table>
### APPENDIX B: SUPERVISORY SLOTTING CRITERIA FOR *ISTISNÄʿ* IN LIMITED AND NON-RECOURSE PROJECT FINANCE AND *MUSHĀRAKAH* IN A BUSINESS VENTURE

<table>
<thead>
<tr>
<th>Construction Risk (for project finance only) (cont’d)</th>
<th>Strong</th>
<th>Good</th>
<th>Satisfactory</th>
<th>Weak</th>
</tr>
</thead>
<tbody>
<tr>
<td>Track record and financial strength of contractor in constructing similar project/business ventures</td>
<td>Strong</td>
<td>Good</td>
<td>Satisfactory</td>
<td>Weak</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Operating Risk (for project finance only)</th>
<th>Strong</th>
<th>Good</th>
<th>Satisfactory</th>
<th>Weak</th>
</tr>
</thead>
<tbody>
<tr>
<td>Scope and nature of operations and maintenance (O &amp; M) contracts</td>
<td>Strong long-term O&amp;M contract, preferably with contractual performance incentives, and/or O&amp;M reserve accounts</td>
<td>Long-term O&amp;M contract, and/or O&amp;M reserve accounts</td>
<td>Limited O&amp;M contract or O&amp;M reserve account</td>
<td>No O&amp;M contract: risk of high operational cost overruns beyond mitigants</td>
</tr>
<tr>
<td>Operator’s expertise, track record, and financial strength</td>
<td>Very strong, or committed technical assistance of the sponsors</td>
<td>Strong</td>
<td>Acceptable</td>
<td>Limited/weak, or local operator dependent on local authorities</td>
</tr>
</tbody>
</table>
## APPENDIX B: SUPERVISORY SLOTTING CRITERIA FOR ISTISNÄ‘ IN LIMITED AND NON-RECOUSE PROJECT FINANCE AND MUSHĀRakah IN A BUSINESS VENTURE

<table>
<thead>
<tr>
<th>Off-take risk</th>
<th>Strong</th>
<th>Good</th>
<th>Satisfactory</th>
<th>Weak</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) If there is a take-or-pay or fixed-price off-take contract:</td>
<td>Excellent creditworthiness of off-taker; strong termination clauses; tenor of off-take contract comfortably exceeds the maturity of the financing contract</td>
<td>Good creditworthiness of off-taker; strong termination clauses; tenor of off-take contract exceeds the maturity of the financing contract</td>
<td>Acceptable financial standing of off-taker; normal termination clauses; tenor of off-take contract generally matches the maturity of the financing contract</td>
<td>Weak off-taker; weak termination clauses; tenor of off-take contract does not exceed the maturity of the financing contract</td>
</tr>
<tr>
<td>(b) If there is no take-or-pay or fixed-price off-take contract</td>
<td>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</td>
<td>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</td>
<td>Product is sold on a limited market that may absorb it only at lower than projected rates</td>
<td>Project output is demanded by only one of a few buyers or is not generally sold on an organised market</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Supply risk</th>
<th>Strong</th>
<th>Good</th>
<th>Satisfactory</th>
<th>Weak</th>
</tr>
</thead>
<tbody>
<tr>
<td>(for project finance only)</td>
<td>Long-term supply contract with supplier of excellent financial standing</td>
<td>Long-term supply contract with supplier of good financial standing</td>
<td>Long-term supply contract with supplier of good financial standing – a degree of price risk may remain</td>
<td>Short-term supply contract or long-term supply contract with financially weak supplier – a degree of price risk definitely remains</td>
</tr>
</tbody>
</table>
**APPENDIX B: SUPERVISORY SLOTTING CRITERIA FOR ISTISNĀ’ IN LIMITED AND NON-RECOURSE PROJECT FINANCE AND MUSHĀRAKAH IN A BUSINESS VENTURE**

<table>
<thead>
<tr>
<th>Supply risk (cont’d) (for project finance only)</th>
<th>Strong</th>
<th>Good</th>
<th>Satisfactory</th>
<th>Weak</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reserve risks (e.g. natural resource development)</td>
<td>Independently audited, proven and developed reserves well in excess of requirements over lifetime of the project</td>
<td>Independently audited, proven and developed reserves well in excess of requirements over lifetime of the project</td>
<td>Proven reserves can supply the project adequately through the maturity of the financing contract</td>
<td>Project relies to some extent on potential and undeveloped reserves</td>
</tr>
<tr>
<td>Strength of Sponsor</td>
<td>Strong sponsor (partner) with excellent track record and high financial standing</td>
<td>Good sponsor (partner) with satisfactory track record and good financial standing</td>
<td>Adequate sponsor (partner) with adequate track record and good financial standing</td>
<td>Weak sponsor (partner) with no or questionable track record and/or financial weaknesses</td>
</tr>
<tr>
<td>Sponsor’s (or partner’s, in the case of Mushārakah) track record, financial strength, and country/sector experience</td>
<td>Strong. Project/business venture is highly strategic for the sponsor (partner), i.e. core business and long-term strategy</td>
<td>Good. Project/business venture is strategic for the sponsor (partner), i.e. core business and long-term strategy</td>
<td>Acceptable. Project/business venture is considered important for the sponsor (partner), i.e. core business</td>
<td>Limited. Project/business venture is not key to sponsor(partner)’s long-term strategy or core business</td>
</tr>
<tr>
<td>Sponsor (or partner, in the case of Mushārakah) support, as evidenced by equity, ownership clause and incentive to inject additional cash if necessary</td>
<td>Strong. Project/business venture is highly strategic for the sponsor (partner), i.e. core business and long-term strategy</td>
<td>Good. Project/business venture is strategic for the sponsor (partner), i.e. core business and long-term strategy</td>
<td>Acceptable. Project/business venture is considered important for the sponsor (partner), i.e. core business</td>
<td>Limited. Project/business venture is not key to sponsor(partner)’s long-term strategy or core business</td>
</tr>
</tbody>
</table>
APPENDIX B: SUPERVISORY SLOTTING CRITERIA FOR ISTISNĀʿ IN LIMITED AND NON-RE COURSE PROJECT FINANCE AND MUSHĀRAKAH IN A BUSINESS VENTURE

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

* In Mushārakah, the collateralisation of underlying assets is restricted to losses arising from negligence and misconduct cases only.
# APPENDIX C: SUPERVISORY SLOTTING CRITERIA FOR DIMINISHING MUSHĀRAKAH IN REAL ESTATE

<table>
<thead>
<tr>
<th>Financial strength</th>
<th>Strong</th>
<th>Good</th>
<th>Satisfactory</th>
<th>Weak</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market conditions</td>
<td>The supply and demand for the business venture’s type and location are currently in equilibrium. The number of competitive properties coming to market is equal or lower than forecasted demand.</td>
<td>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.</td>
<td>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.</td>
<td>Market conditions are weak. It is uncertain when conditions will improve and return to equilibrium. The business venture is losing tenants at ḥarābah/lease expiration. New ḥarābah/lease terms are less favourable compared to those expiring.</td>
</tr>
<tr>
<td>Stress analysis</td>
<td>The property’s resources, contingencies and liability structure allow it to meet its financial obligations during a period of severe financial stress.</td>
<td>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.</td>
<td>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.</td>
<td>The property’s financial condition is strained and is likely to default unless conditions improve in the near term.</td>
</tr>
</tbody>
</table>
### APPENDIX C: SUPERVISORY SLOTTING CRITERIA FOR DIMINISHING *MUSHĀRAKAH* IN REAL ESTATE

<table>
<thead>
<tr>
<th>Cash-flow predictability</th>
<th>Strong</th>
<th>Good</th>
<th>Satisfactory</th>
<th>Weak</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) For complete and stabilised property</td>
<td>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.</td>
<td>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.</td>
<td>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.</td>
<td>The property’s leases are of various terms with tenants that range in creditworthiness. The property experiences a very high level of tenant turnover upon lease expiration. Its vacancy rate is high. Significant expenses are incurred preparing space for new tenants.</td>
</tr>
<tr>
<td>(b) For complete but not stabilised property</td>
<td>Leasing activity meets or exceeds projection. The business venture should achieve stabilisation in the near future.</td>
<td>Leasing activity meets or exceeds projections. The project should achieve stabilisation in the near future.</td>
<td>Most leasing activity is within projections; however, stabilisation will not occur for some time.</td>
<td>Market rents do not meet expectations. Despite achieving target occupancy rate, cash flow coverage is tight due to disappointing revenue.</td>
</tr>
</tbody>
</table>
APPENDIX C: SUPERVISORY SLOTTING CRITERIA FOR DIMINISHING *MUSHĀRAKAḤ* IN REAL ESTATE

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

<table>
<thead>
<tr>
<th></th>
<th>Strong</th>
<th>Good</th>
<th>Satisfactory</th>
<th>Weak</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Property is under</strong></td>
<td><strong>Construction budget is conservative and technical hazards are limited. Contractors are highly qualified.</strong></td>
<td><strong>Construction budget is conservative and technical hazards are limited. Contractors are highly qualified.</strong></td>
<td><strong>Construction budget is adequate and Contractors are ordinarily qualified.</strong></td>
<td><strong>Business venture is over budget or unrealistic given its technical hazards. Contractors may be under qualified.</strong></td>
</tr>
<tr>
<td><strong>Construction budget</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Conservative and technical hazards are limited. Contractors are highly qualified.</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Business venture is over budget or unrealistic given its technical hazards. Contractors may be under qualified.</strong></td>
<td></td>
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<tr>
<td><strong>Contractors are highly qualified.</strong></td>
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<tr>
<td><strong>Contractors are ordinarily qualified.</strong></td>
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</tr>
<tr>
<td><strong>Contractors are under qualified.</strong></td>
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</tr>
<tr>
<td><strong>Strength of Mushārakah partner(s)</strong></td>
<td><strong>The partner has substantial resources and limited direct and contingent liabilities.</strong></td>
<td><strong>The partner’s financial condition allows it to support the property in the event of a cash flow shortfall.</strong></td>
<td><strong>The partner is average to below average in financial resources.</strong></td>
<td><strong>The partner lacks capacity or willingness to support the property.</strong></td>
</tr>
<tr>
<td><strong>Financial capacity and willingness to support the property.</strong></td>
<td></td>
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</tr>
</tbody>
</table>
APPENDIX C: SUPERVISORY SLOTTING CRITERIA FOR DIMINISHING MUSHĀRAKAH IN REAL ESTATE

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