



<b>MODULE</b>	<b>CA:</b>	<b>Capital Adequacy</b>
<b>CHAPTER</b>	<b>CA-3:</b>	<b>The Banking Book - Minimum Capital Requirements for Islamic Financing &amp; Investment Assets</b>

## CA-3.1 Background

- CA-3.1.1 Due to the nature of Islamic banking transactions, Islamic banks, as opposed to their conventional counterparts, are additionally exposed to price risk in their banking book. The CBB recognises that such risks need to be identified and measured for regulatory capital purposes.
- CA-3.1.2 Sections CA-3.2 to CA-3.11 describe the minimum capital requirements for the treatment of exposures, taking into account both credit and market risks including price risk within the banking book for each of the nine classes of Islamic financing assets.

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## CA-3.2 Murabahah and Murabahah to the Purchase Orderer

### *Introduction*

CA-3.2.1 This section sets out the minimum capital adequacy requirements to cover the transactions that are based on the Sharia rules and principles of Murabaha and Murabaha to the Purchase Orderer (MPO).

CA-3.2.2 In Murabaha and MPO, the capital requirement for credit risk refers to the risk of a counterparty not paying the purchase price of an asset to the Islamic bank licensee. In the case of market (price) risk, the capital requirement is applicable with respect to: (a) assets in the Islamic bank licensee's possession which are available for sale either on the basis of Murabaha or MPO; and (b) assets which are in its possession due to the customer's non-performance of a promise to purchase (PP) in either non-binding or binding MPO.

CA-3.2.2A The CBB has discretion to apply to Islamic bank licensee the relevant provisions of this section for other forms of sale contract, namely Musawamah and Bay` Bithaman Ajil.

### *Murabahah and Non-binding MPO*

CA-3.2.3 This section is broadly divided into (a) Murabahah and non-binding MPO and (b) binding MPO, as the types of risk faced by the Islamic bank licensee are different at the various stages of the contract for the two categories.

CA-3.2.4 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 Islamic bank licensee.

CA-3.2.5 A Murabahah contract refers to an agreement whereby the Islamic bank licensee 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 Islamic bank licensee 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 Islamic bank licensee based on a Promise to Purchase (PP) by the customer which can be a binding or non-binding PP.

CA-3.2.6 In a Murabahah transaction, the Islamic bank licensee sells an asset that is already available in its possession, whereas in a MPO transaction the Islamic bank licensee acquires an asset in anticipation that the asset will be purchased by the orderer/customer.



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## CA-3.2 Murabahah and Murabahah to the Purchase Orderer (continued)

CA-3.2.7 The price risk in Murabahah contracts ceases and is replaced by credit risk for the amount receivable from the customer following delivery of the asset. Likewise, in a non-binding MPO transaction, the Islamic bank licensee 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*

CA-3.2.8 In a binding MPO, the Islamic bank licensee has no "long" position in the asset that is the subject of the transaction, as there is a binding obligation on the customer to take delivery of the asset at a pre-determined price. The Islamic bank licensee is exposed to counterparty risk in the event that the orderer in a binding MPO does not honour his/her obligations under the PP, resulting in the Islamic bank licensee having to dispose of the asset to a third party at a selling price which may be lower than the cost to the Islamic bank licensee. Depending on the Shari'a rulings that are applicable, the risk of selling at a loss may be mitigated by requiring the customer to deposit a Hamish Jiddiyah (HJ) upon executing the PP, as commonly practised in the case of a binding MPO. The Islamic bank licensee would have recourse to the customer for any shortfall in the HJ to compensate for the loss and would be obliged to refund to the customer any amount of the HJ in excess of the loss. The HJ may be treated, after the conclusion of Murabahah, as part of the payment of the agreed selling price under the Murabahah contract. Alternatively, the Islamic bank licensee may take a down-payment (Urbun) from the purchase orderer when signing the contract. This payment is retained by the Islamic bank licensee if the purchase orderer fails to execute the contract, whereas on the execution of the contract the Urbun is treated as a payment in advance.

### *Collateralisation*

CA-3.2.9 The Islamic bank licensee can secure a pledge of the sold asset/underlying asset or another tangible asset ("collateralised Murabahah"). The collateralisation is not automatically provided in a Murabahah contract but must be explicitly stated or must be documented in a separate security agreement at or before the time of signing of the Murabahah contract. The Islamic bank licensee may employ other techniques such as pledge of deposits or a third party financial guarantee. The Risk Weight (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 (see Section CA-4.7).



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## CA-3.2 Murabahah and Murabahah to the Purchase Orderer (continued)

CA-3.2.10 In financing transactions that are collateralised, the CRM would take into account of any 'haircut' applicable to the any eligible financial collateral listed in Paragraph CA-4.7.25). Murabahah and binding MPO collateralised by real estate is covered in Paragraphs CA-4.2.19-20.

### *Credit Risk*

#### *Murabahah and Non-binding MPO*

CA-3.2.11

The credit exposure must be measured based on accounts receivable in Murabahah (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 reporting quarter less any provision for doubtful debts.

CA-3.2.12

The accounts receivable (net of specific provisions) amount arising from the selling of a Murabahah asset must 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 CBB. In case the obligor is unrated, a RW of 100% shall apply. (See Section CA-4.2).

#### *Binding MPO*

CA-3.2.13 In a binding MPO, the Islamic bank licensee is exposed to default on the purchase orderer's obligation to pay fully for the asset at the agreed price. In the event of the orderer defaulting on its PP, the Islamic bank licensee will dispose of the asset to a third party. The Islamic bank licensee will have recourse to any HJ<sup>9</sup> paid by the orderer, and (a) may have a right to recoup from the orderer any loss on disposing of the asset, after taking account of the HJ or (b) may have no such legal rights. In both cases, this risk is mitigated by the asset in possession as well as any HJ paid by the purchase orderer.

<sup>9</sup> The bank's recourse to HJ should be within the limits of the actual loss, which is the difference between the actual cost and the sale price of the asset.



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### CA-3.2 Murabahah and Murabahah to the Purchase Orderer (continued)

#### CA-3.2.14

In case (a) of Paragraph CA-3.2.13, the Islamic bank licensee 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 Islamic bank licensee, (less the value of any eligible financial collateral (see Paragraph CA-4.7.25) subject to any haircut, and less the amount of any HJ). The applicable RW must be based on the standing of the obligor as rated by an ECAI that is approved by the CBB, and in the case the obligor is unrated, a RW of 100% shall apply (See Section CA-4.2).

#### CA-3.2.15

In case (b) of Paragraph CA-3.2.13, the Islamic bank licensee has no legal right, and the cost of the asset to the Islamic bank licensee constitutes a market risk (as in the case on a non-binding MPO), but the market risk exposure is reduced by the amount of any HJ that the Islamic bank licensee has the right to retain.

#### CA-3.2.16

In applying the treatment as set out in the Paragraph CA-3.2.15, the Islamic bank licensee must ensure that the PP is properly documented and legally enforceable. In the absence of proper documentation and legal enforceability, the asset is to be treated as similar to a non-binding MPO which is exposed to price risk, where the measurement approach is as set out in Paragraphs CA-3.2.20 and CA-3.2.21.

#### CA-3.2.17

Upon selling the asset, the accounts receivable (net of specific provisions) amount must be assigned a RW based on the credit standing of the obligor as rated by an ECAI that is approved by the CBB. In case the obligor is unrated, a RW of 100% applies. (See Section CA-4.2).

#### *Exclusions*

#### CA-3.2.18

The capital requirement is to be calculated on the receivable amount, net of (i) specific provisions, (ii) any amount that is secured by eligible financial collateral (as defined in Paragraph CA-4.7.25) and/or (iii) any amount that is past due 90 days or more (see Section CA-4.2).

#### *Assignment of Risk Weights*

#### CA-3.2.19

The assets of collateralised Murabaha may be categorised as per the claim categories detailed in Section CA-4.2, and risk weighted accordingly. Islamic bank licensees should ensure that the appropriate risk weight is used based on the claim category for each transaction.



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## CA-3.2 Murabahah and Murabahah to the Purchase Orderer (continued)

### *Market Risk*

#### *Murabahah and Non-binding MPO*

##### CA-3.2.20

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

##### CA-3.2.21

Assets in possession on a 'sale or return' basis (with such an option included in the contract) are treated as accounts receivable from the vendor and as such would be offset against the related accounts payable to the vendor. If these accounts payable have been settled, the assets must attract a RW based on rating of the vendor (100% in case of unrated), 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. If the above conditions are not satisfied, capital charge will be provided as per Paragraph CA-3.2.20.

#### *Binding MPO*

CA-3.2.22 In a binding MPO the orderer has the obligation to purchase the asset at the agreed price, and the Islamic bank licensee as the seller is not exposed to market risk in respect of the asset, but only to credit risk as indicated in Paragraph CA-3.2.13.

#### *Foreign Exchange Risk*

##### CA-3.2.23

If the funding of an asset purchase or the selling of an asset opens an Islamic bank licensee to foreign exchange exposures, the relevant positions must be included in the measurement of foreign exchange risk described in Section CA-5.5.



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**CA-3.2 Murabahah and Murabahah to the Purchase Orderer (continued)**

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

**CA-3.2.24**

The following table sets out the applicable stages of the contract that attracts capital charges:

(a) Murabahah and Non-binding MPO

Applicable Stage of the Contract	Credit RW	Market Risk Capital Charge
Asset available for sale (asset on balance sheet)*	Not applicable	Price risk (15% Capital Charge)
Asset is sold and title is transferred to a customer and the selling price (accounts receivable) is due from the customer.	Based on customer's rating or 100% RW for unrated customer (see Paragraphs CA-3.2.11 and CA-3.2.12)	NA
Upon full settlement of the purchase price.	NA	NA

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



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**CA-3.2 Murabahah and Murabahah to the Purchase Orderer (continued)**

**(b) Binding MPO**

Applicable Stage of the Contract	Credit RW***	Market Risk Capital Charge
Asset available for sale (asset on balance sheet)* - If the bank has legal right to recoup from the customer any loss on disposing of the asset	Asset acquisition cost less [market value of asset if eligible as collateral (net of any haircut**) less any HJ] x applicable RW (see chapter CA-4)	NA
Asset is sold and delivered to a customer (accounts receivable is due from the customer).	Based on customer's rating or 100% RW for unrated customer (see section CA-4.2)	NA
Upon full settlement of the purchase price.	NA	NA

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

\*\* Please refer to CRM Section CA-4.7 for eligibility of collateral and application of haircuts.

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

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





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### CA-3.3 Salam and Parallel Salam

#### *Introduction*

- CA-3.3.1 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'a rules and principles of Salam. The Islamic bank licensee 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 Islamic bank licensee 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 Islamic bank licensee, in the absence of a hedge in the form of a parallel Salam contract covering the subject matter (A parallel contract may also be used to hedge part of the exposure).
- CA-3.3.2 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.
- CA-3.3.3 A Salam contract refers to an agreement to purchase, at a predetermined price, a specified kind of commodity<sup>10</sup> which is to be delivered on a specified future date in a specified quantity and quality. The Islamic bank licensee 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 Sharia Supervisory Board (SSB).
- CA-3.3.4 In certain cases the Islamic bank licensee may enter into a back-to-back contract (Parallel Salam) to sell a commodity with the same specification as the purchased commodity under a Salam contract to a party other than the original seller. The Parallel Salam allows the Islamic bank licensee to sell the commodity for future delivery at a predetermined price (thus hedging the price risk on the original Salam contract) and protects the Islamic bank licensee from having to take delivery of the commodity and warehousing it. As noted above, such a parallel contract may also be used as a partial hedge.
- CA-3.3.5 The non-delivery of the commodity by a Salam seller (i.e. counterparty risk) does not discharge the Islamic bank licensee's obligations to deliver the commodity under a Parallel Salam contract, and thus exposes the Islamic bank licensee to potential loss in obtaining the supply elsewhere.

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<sup>10</sup> 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.



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### CA-3.3 Salam and Parallel Salam (continued)

CA-3.3.6 The obligations of an Islamic bank licensee 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.

CA-3.3.7 In the absence of a Parallel Salam contract, an Islamic bank licensee may sell the subject-matter of the original Salam contract in the spot market upon receipt, or, alternatively, the Islamic bank licensee may hold the commodity in anticipation of selling it at a higher price. In the latter case, the Islamic bank licensee is exposed to price risk on its position in the commodity until the latter is sold.

#### *Credit Risk*

CA-3.3.8

The receivable amount generated from the purchase of a commodity based on a Salam contract must, in appropriate cases, be assigned a RW based on the credit standing of a supplier/counterparty as rated by an ECAI that is approved by the CBB. If the supplier/counterparty is unrated (which will normally be the case), a RW of 100% applies (See Section CA-4.2).

#### *Exclusions*

CA-3.3.9

The capital requirement is to be calculated on the receivable amount, net of specific provisions. Amounts that are secured by eligible collateral as defined are covered in Section CA-4.7 and amounts that are past due 90 days or more are covered in Paragraph CA-4.2.21.

#### *Applicable Period*

CA-3.3.10

The credit RW will be applied from the date of the contract made between both parties until the maturity of the Salam contract, which is upon receipt of the purchased commodity. However, between the date of contract and disbursement of funds to the customer the exposure is a commitment (off-balance sheet) and a credit conversion factor (CCF) of 20% will be applied before applying the relevant RW.



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### CA-3.3 Salam and Parallel Salam (continued)

#### *No Offsetting Arrangement between Credit Exposures of Salam and Parallel Salam*

CA-3.3.11

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.

#### *Market Risk*

CA-3.3.12

The price risk on the commodity exposure in Salam is measured using either: (a) the maturity ladder approach; or (b) the simplified approach (see section CA-5.6). Under the simplified approach, the capital charge will be equal to 15% of the net position in each commodity, plus an additional charge equivalent to 3% of the gross positions, long plus short, to cover basis risk and forward gap risk. The 3% capital charge is also intended to cater for potential losses in parallel Salam when the seller in the original Salam contract fails to deliver and the Islamic bank licensee has to purchase an appropriate commodity in the spot market to honour its obligation.

CA-3.3.13

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*

CA-3.3.14

If the funding of a commodity purchase or selling of a commodity leaves an Islamic bank licensee open to foreign exchange exposures, the relevant positions must be included in the measures of foreign exchange risk described in Section CA-5.5.

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

CA-3.3.15

The following table sets out the applicable stage of the contract that attracts capital charges:



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### CA-3.3 Salam and Parallel Salam (continued)

#### (a) Salam with Parallel Salam

Applicable Stage of Contract	Credit RW	Market Risk Capital Charge
Payment of purchase price by the bank to a Salam customer	Based on customer's rating or 100% RW for unrated customer.  No Netting of Salam exposures against parallel Salam exposures.  (See Section CA-4.2)	Two approaches are applicable:  Maturity Ladder Approach (see CA-5.6.)  <u>Simplified approach</u> 15% capital charge on net position (i.e. netting of Salam exposures against parallel Salam exposures)
Receipt of the purchased commodity by the bank. Asset available for delivery to the customer.	NA	Plus: 3% capital charge on gross positions (i.e. Salam exposures plus parallel Salam exposures) See Paragraphs CA-3.3.12 to CA-3.3.14.
The purchased commodity is sold and delivered to the buyer.	NA	NA



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**CA-3.3 Salam and Parallel Salam (continued)**

**(b) Salam without Parallel Salam**

<b>Applicable Stage of Contract</b>	<b>Credit RW</b>	<b>Market Risk Capital Charge</b>
Payment of purchase price by the bank to a Salam customer (seller)	Based on customer's rating or 100% RW for unrated customer.  (See Section CA-4.2)	Simplified approach 15% capital charge on long position of Salam exposures. See Section CA-3.3.12 to CA-3.3.14.
Receipt of the purchased commodity by the bank. Asset available for delivery to the customer.	NA	
The purchased commodity is sold and delivered to the buyer.	NA	NA



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## CA-3.4 Istisna'a and Parallel Istisna'a

### *Introduction*

CA-3.4.1 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 Sharia rules and principles of Istisna'a.

### *Principles of Istisna'a*

CA-3.4.2 Istisna'a and parallel Istisna'a contracts would attract a risk weighting as per the credit standing of the respective counterparties (See Section CA-4.2).

CA-3.4.3 An Istisna'a 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.

CA-3.4.3A In an Istisna'a contract, price and other necessary specifications must also be fixed and fully settled between the buyer and manufacturer/builder. The payments by the buyer in Istisna'a may be made in advance, during the period of construction reflecting stages of completion, or deferred to a specified future date. The contract of Istisna'a is a binding contract that cannot be cancelled unilaterally by either party once the manufacturing work starts. If the subject matter does not conform to the specification agreed upon, the buyer has the option to accept or to refuse the subject matter.

CA-3.4.3B The subject matter on which transaction of Istisna'a is based is always an item which needs to be manufactured or constructed, such as a ship, an aircraft or a building, and it cannot be an existing and designated asset. Istisna'a may also be used for similar projects such as installation of an air-conditioner plant in the customer's factory, or building a bridge or a highway.

CA-3.4.3C The price of an asset under this contract is agreed or determined on the contractual date, and such a contract is binding. The price cannot be increased or decreased on account of an increase or decrease in commodity prices or labour cost. The price can be changed subject to the mutual consent of the contracting parties, which is a matter for the commercial decision of the Islamic bank licensee and can result in a lower profit margin and a capital charge as outlined in Paragraph CA-3.4.24.



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## CA-3.4 Istisna'a and Parallel Istisna'a (continued)

### *Roles and Exposure of a Bank in an Istisna'a Contract*

CA-3.4.4 In practice, an Islamic bank licensee can play different roles while engaging in the contract of Istisna'a, as follows:

- (a) Islamic bank licensee as a seller (al-sani') in Istisna'a contract:
- (i) In many cases, an Islamic bank licensee acts as a "seller" in the Istisna'a contract and engages the services of a contractor (other than the client) by entering into another Istisna'a contract as buyer<sup>11</sup> or using some other Shari'a compliant contract such as Murabahah; or.
  - (ii) If a parallel Istisna'a contract is used for manufacturing the asset, the Islamic bank licensee acts as a buyer in the parallel contract. The Islamic bank licensee as an intermediary calculates its cost in the parallel contract and fixes the price of Istisna'a with its client that allows it to make a reasonable profit over his cost. The two contracts, however, need to be totally independent of each other. In order to secure the payment from the ultimate buyer (i.e. the customer), the title deeds of the underlying asset, or any other collateral, may be required by the Islamic bank licensee as a security until the complete payment is made by the ultimate buyer; and
- (b) Islamic bank licensee as a buyer (al-mustasni') in Istisna'a contract:
- (i) In some cases, an Islamic bank licensee can act as a "buyer" in an Istisna'a contract where it can have an asset constructed by a contractor: (i) for its own account (which can be, for example, subsequently sold or leased on a Murabahah or Ijara basis, respectively); or (ii) on the basis of the ultimate customer's specifications; or
  - (ii) If the parallel Istisna'a contract is used in this scenario with the ultimate customer, the Islamic bank licensee acts as seller in the parallel contract.

CA-3.4.5 This Section makes distinctions between two types of exposures in Istisna'a financing, as follows:

- (a) Exposure to customer:

The receipt of the selling price by the Islamic bank licensee is dependent on the financial strength or payment capability of the ultimate customer or the contractor (cases (a) and (b) of Paragraph CA-3.4.4 respectively), where the source of payment is derived from the various other activities of the ultimate customer or contractor and is not solely dependent on the cash flows from the underlying asset/project; and

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<sup>11</sup> Where two such parallel Istisna'a contracts exist, it is customary to refer to one of the contracts as a "parallel Istisna'a". Typically, it is the contract which is entered into second which is referred to as the "parallel Istisna'a".



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### CA-3.4 Istisna'a and Parallel Istisna'a (continued)

(b) Exposure to asset (i.e. exposure to the cash flows from the completed asset):  
The receipt of the selling price by the Islamic bank licensee 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 Istisna'a faces "revenue risk" arising from the asset's ability to generate cash flows, instead of the creditworthiness of the ultimate customer or project sponsor (cases (a) and (b) of Paragraph CA-3.4.4 respectively). Such exposure normally arises when an Istisna'a contract is used in project finance and BOT (build, operate, transfer) transactions.

CA-3.4.6 In the Istisna'a contract, the Islamic bank licensee assumes the completion risk<sup>12</sup> that is associated with the failure to complete the project at all, delay in completion, cost overruns, occurrence of a force majeure event, and unavailability of qualified personnel and reliable seller(s) or sub-contractors, including any late completion penalty<sup>13</sup> payable to the ultimate customer due to non-fulfilment of required specifications.

#### *Capital Adequacy Requirements*

CA-3.4.7 The exposures under Istisna'a 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).

CA-3.4.8 There is a capital requirement to cater for the credit (counterparty) risk of the Islamic bank licensee not receiving the selling price of the asset from the ultimate customer or contractor, either in pre-agreed stages of completion and/or upon full completion of the manufacturing or construction process. (The risk of a customer failing to complete such a transaction in project finance is referred to as "off-take risk" – see Appendix CA-5.)

CA-3.4.9 This Section also sets out the capital adequacy requirement to cater for the market risk that an Islamic bank licensee incurs from the date of manufacturing or construction, which is applicable throughout the period of the contract on unbilled WIP inventory.

CA-3.4.10 This Section is applicable to both (a) Istisna'a contracts that are executed without any parallel Istisna'a contracts, and (b) Istisna'a contracts that are backed by independently executed parallel Istisna'a contracts.

<sup>12</sup> In conventional project financing, the completion risk is normally borne by the project sponsor/contractor, and not by the bank, because the project sponsor/contractor has most often been asked to provide an undertaking to cover cost overruns.

<sup>13</sup> Normally, the contract between the bank and the contractor will specify in a penalty clause the latter's liability for penalties in case of delays for which it is responsible.





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## CA-3.4 Istisna'a and Parallel Istisna'a (continued)

### *Bank as a Seller (al sani') in an Istisna'a Contract*

#### *Istisna'a with Parallel Istisna'a*

CA-3.4.11 In cases where an Islamic bank licensee enters into a parallel Istisna'a contract to procure an asset from a party other than the original Istisna'a customer (buyer), the price risk relating to input materials is mitigated. The Islamic bank licensee remains exposed to the counterparty risk of the parallel Istisna'a seller in delivering the asset on time and in accordance with the Istisna'a ultimate buyer's specifications. This is the risk of not being able to recover damages from the parallel Istisna'a seller for the losses resulting from the breach of contract.

CA-3.4.12 The failure of the parallel Istisna'a seller to deliver a completed asset which meets the ultimate buyer's specifications does not discharge the Islamic bank licensee's obligations to deliver the asset ordered under an Istisna'a contract, and thus exposes the Islamic bank licensee to potential loss in making good the shortcomings or obtaining the supply elsewhere.

#### *Credit Risk*

#### *Exposure to Customer*

**CA-3.4.13** The receivable amount generated from selling of an asset based on an Istisna'a contract with full exposure to the customer (ultimate buyer) must be assigned a RW based on the credit standing of the customer as rated by an ECAI that is approved by the CBB. Refer to Section CA-4.2 for the RW. In cases where the ultimate buyer is unrated, a RW of 100% applies.



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### CA-3.4 Istisna'a and Parallel Istisna'a (continued)

#### *Exposure to Asset*

##### CA-3.4.14

When the project is rated by an ECAI, the RW based on the credit rating of the ultimate buyer is applied to calculate the capital adequacy requirement. Otherwise, the RW must be based on the "supervisory slotting criteria" approach for specialised financing (project finance), as set out in Appendix CA-5, which carries RWs as given below:

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

##### CA-3.4.15

Istisna'a financing with an "Exposure to Asset" structure is required to meet the characteristics as set out below in order to qualify for the above RW:

- (a) The segregation of the project's liabilities from the balance sheet of the Istisna'a ultimate buyer or project sponsor from a commercial and accounting perspective which is generally achieved by having the Istisna'a 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/ bank a substantial degree of control over the asset and the income it generates – for example, under the BOT arrangement where the manufacturer builds a highway and collects tolls for a specified period as a consideration for the selling price; and
- (d) The primary source of repayment is the income generated by the asset/project rather than relying on the capacity of the ultimate buyer.



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#### CA-3.4 Istisna'a and Parallel Istisna'a (continued)

##### *Exclusions*

**CA-3.4.16** The capital requirement is to be calculated on the receivable amount, net of:

- (a) Specific provisions;
- (b) Any amount that is secured by eligible collateral (as defined in Section CA-4.7); and
- (c) Any amount which is past due 90 days or more (see CA-4.2).

**CA-3.4.17** Any portion of an Istisna'a contract that is covered by an advanced payment must carry a RW of 0%, or the amount of the advanced payment must be offset against the total amount receivable or amounts owing from progress billings.

##### *Applicable Period*

**CA-3.4.18** 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 Islamic bank licensee, either in stages and/or on the maturity of the Istisna'a contract, which is upon delivery of the manufactured asset to the Istisna'a ultimate buyer.

##### *Offsetting Arrangement between Credit Exposures of Istisna'a and Parallel Istisna'a*

**CA-3.4.19** The credit exposure amount of an Istisna'a contract is not to be offset against the credit exposure amount of a Parallel Istisna'a contract because an obligation under one contract does not discharge an obligation to perform under the other contract.



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#### CA-3.4 Istisna'a and Parallel Istisna'a (continued)

##### *Market Risk*

##### *Exposure to Customer*

##### *(a) Istisna'a with Parallel Istisna'a*

CA-3.4.20

There is no capital charge for market risk to be applied in addition to provisions in Paragraphs CA-3.4.13 to CA-3.4.19, subject to there being no provisions in the Parallel Istisna'a contract that allow the seller to increase or vary its selling price to the Islamic bank licensee, under unusual circumstances. Any variations in a Parallel Istisna'a contract that are reflected in the corresponding Istisna'a contract which effectively transfers the whole of the price risk to an Istisna'a customer (buyer), are also eligible for this treatment.

CA-3.4.21

If the seller is allowed to vary the selling price of the asset, then the price risk must be calculated in accordance with Paragraph CA-5.2.2.

##### *(b) Istisna'a without Parallel Istisna'a*

CA-3.4.22

A capital charge of 1.6% 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 CA-3.4.13 to CA-3.4.19.

CA-3.4.23

The unbilled WIP inventory is held subject to the binding order of the Istisna' ultimate buyer and is thus not subject to inventory price as described in Section CA-5.6.

##### *Foreign Exchange Risk*

CA-3.4.24

Any foreign exchange exposures arising from the purchasing of input materials, or from Parallel Istisna'a contracts made, or the selling of a completed asset in foreign currency must be included in the measures of foreign exchange risk described in section CA-5.5.



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## CA-3.4 Istisna'a and Parallel Istisna'a (continued)

### *Bank as a Buyer (al mustasni') in an Istisna'a Contract*

#### *Istisna'a with Parallel Istisna'a*

CA-3.4.25 In cases where an Islamic bank licensee enters into Parallel Istisna'a to sell an asset to an ultimate customer, its price risk relating to input materials is mitigated. The Islamic bank licensee remains exposed to the counterparty risk of the Istisna'a supplier in delivering the asset on time and in accordance with the parallel Istisna'a ultimate buyer's specifications. This is the risk of not being able to recover damages from the Istisna'a supplier for the losses resulting from the breach of contract.

CA-3.4.26 The failure of the Istisna'a supplier to deliver a completed asset which meets the ultimate buyer's specifications does not discharge the Islamic bank licensee's obligations to deliver the asset ordered under a parallel Istisna'a contract, and thus exposes the Islamic bank licensee to potential loss in making good the shortcomings or obtaining the supply elsewhere.

#### *Credit Risk*

##### *Exposure to Customer*

**CA-3.4.27** The receivable amount generated from selling of an asset based on a parallel Istisna'a` contract with full exposure to the ultimate customer must be assigned a RW based on the credit standing of the customer as rated by an ECAI that is approved by the CBB. Refer to Section CA-4.6 for the RW. In cases where the ultimate buyer is unrated, a RW of 100% applies.



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#### CA-3.4 Istisna'a and Parallel Istisna'a (continued)

##### *Exposure to Asset*

##### CA-3.4.28

When the project is rated by an ECAI, the RW based on the credit rating of the "off-taker" (third-party buyer) is applied to calculate the capital adequacy requirement. Otherwise, the RW must be based on the "supervisory slotting criteria" approach for specialised financing (project finance) as set out in Appendix CA-5, which carries RWs as given below:

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

##### CA-3.4.29

The "Exposure to Asset" Istisna'a structure is required to meet the characteristics as set out in Paragraph CA-3.4.22.

##### *Exclusions*

##### CA-3.4.30

The capital requirement is to be calculated on the receivable amount, net of: a) specific provisions; b) any amount that is secured by eligible collateral as defined in Section CA-4.7; and c) any amount which is past due by more than 90 days as set out in Section CA-4.2. These other amounts are to be risk weighted as described in the concerned Sections.

##### CA-3.4.31

Any portion of a parallel Istisna'a contract covered by an advance payment carries a RW of 0%, or the amount of the advanced payment is offset against the total amount receivable from the ultimate customer or amounts owing from progress billings.

##### *Applicable Period*

##### CA-3.4.32

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 Islamic bank licensee, either in stages and/or on the maturity of the Istisna'a contract, which is upon delivery of the manufactured asset to the parallel Istisna'a ultimate buyer.



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#### CA-3.4 Istisna'a and Parallel Istisna'a (continued)

##### *Offsetting Arrangement between Credit Exposures of Istisna'a and Parallel Istisna'a*

CA-3.4.33

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

##### *Market Risk*

##### *Exposure to Customer*

##### *Istisna'a with Parallel Istisna'a*

CA-3.4.34

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

##### *Istisna'a without Parallel Istisna'a*

CA-3.4.35

In Istisna'a without Parallel Istisna'a, the Islamic bank licensee is making progress payments to the Istisna'a supplier, thereby acquiring title to WIP inventory. The WIP inventory is exposed to price risk. As there is no parallel Istisna'a sale to an ultimate customer, there is no credit risk.

CA-3.4.36

The WIP receives a capital charge appropriate to inventory – 15%.

##### *Foreign Exchange Risk*

CA-3.4.37

Any foreign exchange exposures arising from the purchasing of input materials, or from parallel Istisna'a contracts made, or the selling of a completed asset in foreign currency must be included in the measures of foreign exchange risk described in Section CA-5.5.



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#### CA-3.4 Istisna'a and Parallel Istisna'a (continued)

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

##### CA-3.4.38

The following tables set out the applicable period of the contract that attracts capital charges where the Islamic bank licensee is the seller.

- (a) Exposure to customer
  - (i) Istisna'a with Parallel Istisna'a

Applicable Stage of the Contract	Credit RW	Market Risk Capital Charge
Unbilled WIP inventory	Based on ultimate buyer's rating or 100% RW for unrated buyer.	Nil provided that there is no provision in the Parallel Istisna'a contract that allows the seller to increase or vary the selling price. See Paragraphs CA-3.4.20 and CA-3.2.21.
Amount receivable after contract billings	No netting of Istisna'a exposures against Parallel Istisna'a exposures.  (See Paragraphs CA-3.4.13 to CA-3.4.19)  (See Section CA-4.2)	If the seller is allowed to vary the selling price of the asset, then under the <u>market risk</u> treatment 15% capital charge on net long or short position plus 3% capital charge on gross positions (see CA-5.2.2).
Upon full settlement of the purchased price by an Istisna'a buyer.	NA	NA





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### CA-3.4 Istisna'a and parallel Istisna'a (continued)

#### (ii) Istisna'a without Parallel Istisna'a

Applicable Stage of the Contract	Credit RW	Market Risk Capital Charge
Unbilled WIP inventory	Based on ultimate buyer's rating or 100% RW for unrated buyer.	1.6% capital charge (equivalent to 20% RW) on work in progress inventory.  See relevant Paragraphs under CA-3.4.22 to CA-3.4.23
Progress billing to customer.	Based on ultimate buyer's rating or 100% RW for unrated buyer.  (See Paragraphs CA-3.4.14 to CA-3.4.22) (See Section CA-4.2)	NA
Upon full settlement of the purchased price by an Istisna'a buyer.	NA	NA



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**CA-3.4 Istisna'a and parallel Istisna'a (continued)**

**(b) Exposure to asset**

**Istisna'a with Parallel Istisna'a (for project finance)**

<b>Applicable Stage of the Contract</b>	<b>Credit RW</b>	<b>Market Risk Capital Charge</b>
<b>Unbilled WIP inventory</b>	<b>Based on buyer's ECAI rating if available or supervisory slotting criteria that ranges from 70% to 250% RW.  No netting of Istisna'a exposures against Parallel Istisna'a exposures.  (See Sections CA-4.2 and CA -4.3)</b>	<b>NA</b>
<b>Amount receivable after contract billings</b>		<b>NA</b>
<b>Upon full settlement of the purchased price by an Istisna'a buyer.</b>	<b>NA</b>	<b>NA</b>



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### CA-3.4 Istisna'a and parallel Istisna'a (continued)

#### CA-3.4.39

The following tables set out the applicable period of the contract that attracts capital charges where the Islamic bank licensee is acting as buyer.

(a) Exposure to customer

(i) Istisna'a with Parallel Istisna'a

Applicable Stage of the Contract	Credit RW	Market Risk Capital Charge
Unbilled WIP inventory	Based on ultimate buyer's rating or 100% RW for unrated buyer.	Nil provided that there is no provision in the Parallel Istisna'a contract that allows the seller to increase or vary the selling price. See Paragraph CA-3.4.20.
Amount receivable after contract billings	No netting of Istisna'a exposures against Parallel Istisna'a exposures.  (See Paragraphs CA-3.4.13 to CA-3.4.19)  (See Section CA-4.2)	If the seller is allowed to vary the selling price of the asset, then under the <u>market risk</u> treatment 15% capital charge on net long or short position plus 3% capital charge on gross positions.
Upon full settlement of the purchased price by an Istisna'a buyer.	NA	NA

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#### CA-3.4 Istisna'a and parallel Istisna'a (continued)

##### (ii) Istisna'a without Parallel Istisna'a

Applicable Stage of the Contract	Credit RW	Market Risk Capital Charge
Amounts of progress payments to suppliers for WIP inventory.	None (no ultimate Istisna'a customer)  See <u>credit risk</u> under Section CA-3.4	15% for WIP inventory See <u>Market risk</u> under Section CA-3.4.20 onward

##### (b) Exposure to asset

##### Istisna'a with Parallel Istisna'a (for project finance)

Applicable Stage of the Contract	Credit RW	Market Risk Capital Charge
Unbilled WIP inventory	Based on buyer's ECAI rating if available or supervisory slotting criteria that ranges from 70% to 250% RW.  No netting of Istisna'a exposures against Parallel Istisna'a exposures.  (See Sections CA-4.2 and CA -4.3)	NA
Amount receivable after contract billings		NA
Upon full settlement of the purchased price by an Istisna'a buyer.	NA	NA



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## CA-3.5 Ijarah and Ijarah Muntahia Bittamleek

### *Introduction*

- CA-3.5.1 This Section sets out the minimum capital requirement to cover counterparty risk and residual value risk of leased assets, arising from an Islamic bank licensee entering into contracts or transactions that are based on the Sharia rules and principles of Ijarah and Ijarah Muntahia Bittamleek (IMB), also known as Ijarah wa Iqtinā. The Section also covers the market (price) risk of assets acquired for Ijarah and IMB.
- CA-3.5.2 In an Ijarah contract (either operating or IMB), the Islamic bank licensee 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 Islamic bank licensee 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.
- CA-3.5.3 Thus, in both Ijarah and IMB, the risks and rewards remain with the lessor, except for the residual value risk at the term of an IMB which is borne by the lessee. The lessor is exposed to price risk on the asset while it is in the lessor's possession prior to the signature of the lease contract, except where the asset is acquired following a binding promise to lease as described in Paragraph CA-3.5.12.
- CA-3.5.4 In an IMB contract, the lessor promises to transfer its ownership of the leased asset to the lessee at the end of the contract as a gift or as a sale at a specified consideration, provided that (a) the promise is separately expressed and independent of the underlying Ijarah; or (b) a gift contract is entered into conditional upon fulfilment of all the Ijarah obligations, and thereby ownership shall be automatically transferred to the lessee.
- CA-3.5.5 In both operating Ijarah and IMB, the Islamic bank licensee 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. The agreement to lease may be considered as binding (binding Promise to Lease (PL)) or as non-binding (non-binding PL) depending on the applicable terms and conditions.



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### CA-3.5 Ijarah and Ijarah Muntahia Bittamleek (continued)

CA-3.5.6 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 assets either at the end of the Ijarah contract or at the time of repossession upon default, i.e. the risk of losing money on the resale of the leased asset.

#### **IMB**

CA-3.5.7 In IMB, once the lease contract is signed, the lessor is exposed to credit risk for the lease payments receivable from the lessee (a credit risk mitigated by the asset's value as collateral<sup>14</sup> in most cases) 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 Islamic bank licensee 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.

CA-3.5.8 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 Islamic bank licensee 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 value of the asset that was assumed in fixing the lease rentals is also exposed to credit risk.

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<sup>14</sup> The collateral used in the context of IMB is of the usufruct or use value of the asset, as the bank is the owner of the asset.



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### **CA-3.5 Ijarah and Ijarah Muntahia Bittamleek (continued)**

CA-3.5.9 The Islamic bank licensee may be exposed to losses in case a lessee acquiring an asset under IMB decides not to continue with the contract. The lease contract may give the lessee this right subject to certain conditions (such as a minimum period of notice). In such a case, the lessor is required to refund to the lessee the capital payments (instalments of the purchase price) that were included in the periodic lease rentals (subject to deduction of any amounts due for unpaid rentals). If the value of the repossessed asset is less than the amount to be refunded (before any such deduction), the difference constitutes a loss to the lessor. This exposes the Islamic bank licensee as lessor to a form of market risk<sup>15</sup>.

CA-3.5.10 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 Islamic bank licensee may thus be exposed to market risk, in respect of a potential loss from disposing of the asset for an amount lower than its residual value.

CA-3.5.11 In the case of IMB, the lessor's exposure in such a case described in Paragraph CA-3.5.10 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 residual value of the asset in the lessor's book at the term of a full payout of the IMB (i.e. its residual value as assumed in fixing the lease rentals) would be zero or close to zero.

#### ***Credit Risk –Ijarah and IMB***

**CA-3.5.12** In a binding PL, when an Islamic bank licensee is exposed to default on the lease orderer's obligation to execute the lease contract, the exposure is measured as the amount of the asset's total acquisition cost to the Islamic bank licensee, less the market value of the asset where it is eligible collateral subject to any haircut (see Paragraph CA-4.7.25), and less the amount of any urbun received from the lease orderer. The applicable RW must be based on the standing of the obligor as rated by an ECAI that is approved by the CBB (refer to section CA-4.6), and in the case the obligor is unrated, a RW of 100% applies. The Islamic bank licensee may or may not have the right to recoup from the customer any loss on leasing or disposing of the asset after taking account of the HJ, depending on the terms of the contract.

<sup>15</sup> The contract should include clauses that cover the treatment of destruction or loss of the property without any fault of the tenant. The contract should also elaborate how the bank as a lessor will cover itself in the absence of any Takaful.



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### CA-3.5 Ijarah and Ijarah Muntahia Bittamleek (continued)

#### CA- 3.5.13

In applying the treatment as set out in Paragraph CA-3.5.12, the Islamic bank licensee must ensure that the PL is properly documented and is legally enforceable. In the absence of proper documentation and legal enforceability, the asset is to be treated similarly to one in a non-binding PL which is exposed to market (price) risk, using the measurement approach as set out in Subparagraph CA-3.5.18(a).

#### *Credit Risk - Operating Ijarah*

#### CA-3.5.14

In addition to the credit risk mentioned in Paragraph CA-3.5.12, when the lessee gets the right to use the asset, the lessor is exposed to credit risk for the estimated value of the lease payments in respect of the remaining period of the Ijarah. This exposure is mitigated by the market value of the leased asset where it is eligible collateral (subject to the applicable haircut) if it can be repossessed. The net credit risk exposure is assigned a RW based on the credit standing of the lessee/counterparty as rated by an ECAI that is approved by the CBB. In the case that the lessee is unrated, a RW of 100% applies. See Paragraph CA-4.7.25 for eligible collateral.

#### *Credit Risk - IMB*

#### CA-3.5.15

In addition to credit risk mentioned in Paragraphs CA-3.5.12 and CA-3.5.13, the capital requirement for IMB is based on the following two components:

- (a) Total estimated future Ijara receivable amount over the duration of the lease contract: This exposure is mitigated by the market value of the leased asset (subject to any haircut if it is eligible collateral) if it may be repossessed. The net credit risk exposure must be assigned a RW based on the credit standing of the lessee/counterparty as rated by an ECAI that is approved by the CBB. In cases where the lessee is unrated, a RW of 100% applies. See Paragraph CA-4.7.25 for eligible collateral; and
- (b) Price risk attached to the expected residual value of a leased asset: This exposure is treated under Paragraph CA-3.5.20.





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### CA-3.5 Ijarah and Ijarah Muntahia Bittamleek (continued)

#### *Exclusions from Credit Risk for Ijarah and IMB*

##### CA-3.5.16

The capital requirement must be calculated on the receivable amount, net of:

- (a) Specific provisions;
- (b) Any amount that is secured by eligible collateral (as defined in Paragraph CA-4.7.25); and
- (c) Any amount which is past due by more than 90 days (see Section CA-4.2).

#### *Market Risk – Ijarah and IMB*

##### CA-3.5.17

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

- (a) **Non-binding PL**  
The asset for leasing will be treated as inventory of the Islamic bank licensee and, using the simplified approach, the capital charge applicable to such a market risk exposure is 15% of the amount of the asset's market value); and
- (b) **Binding PL**  
In a binding PL, an Islamic bank licensee is exposed to default on the lease orderer's obligation to lease the asset in its possession. In the event of the lease orderer defaulting on its PL, the Islamic bank licensee will either lease or dispose of the asset to a third party. The Islamic bank licensee will have recourse to any HJ paid by the customer<sup>16</sup>, and (i) may have a right to recoup from the customer any loss on leasing or disposing of the asset after taking account of the HJ, or (ii) may have no such right, depending on the legal situation. In both cases, this risk is mitigated by the asset in possession as well as any HJ paid by the lease orderer.

<sup>16</sup> In the case of HJ, the amount can only be deducted for damages – that is, the difference between the asset acquisition cost and the total of lease rentals (when the asset is leased to a third party) or selling price (when the asset is sold to a third party), whichever is applicable.



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### CA-3.5 Ijarah and Ijarah Muntahia Bittamleek (continued)

CA-3.5.18

In case CA-3.5.17(b)(i), if the down-payment was made as HJ, the Islamic bank licensee 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 must be measured as the amount of the asset's total acquisition cost to the Islamic bank licensee, less the market value of the asset if it may be repossessed and where it is eligible collateral (see Paragraph CA-4.7.25) subject to any haircut, and less the amount of any HJ. The applicable RW must be based on the standing of the customer as rated by an ECAI that is approved by the CBB. In cases where the obligor is unrated, a RW of 100% applies.

CA-3.5.19

In case CA-3.5.17(b)(ii), the Islamic bank licensee has no right to recoup any losses, and the cost of the asset to the Islamic bank licensee constitutes a market risk (as in the case on a non-binding PL), but this market risk exposure is reduced by the amount of any HJ that the Islamic bank licensee has the right to retain.

#### *Market Risk- Operating Ijarah*

CA-3.5.20

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

#### *Market Risk - IMB*

CA-3.5.21

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.



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**CA-3.5 Ijarah and Ijarah Muntahia Bittamleek (continued)**

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

**CA-3.5.22**

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

**Operating Ijara**

Applicable Stage of the Contract	Credit RW	Market Risk Capital Charge
Asset available for lease (prior to signing a lease contract)	Binding PL* Asset acquisition cost less (a) market value of asset fulfilling function of collateral (net of any haircuts), and (b) any HJ multiply by the customer's rating or 100% RW for unrated customer	Non-binding PL 15% capital charge until lessee takes possession
Asset available for lease and the lease rental payments are due from the lessee	Total estimated value of lease receivables for the whole duration of leasing contract is risk-weighted according to the lessee's rating. 100% RW for an unrated lessee less residual value of the leased asset	The residual value is risk-weighted at 100%
Maturity of contract term and the leased asset is returned to the bank	Not applicable	15% capital charge of the carrying value of the asset

\* This credit RW is applicable only when the bank has recourse to any HJ paid by the customer, and (depending on the legal situation) may have a right to recoup from the customer any loss on leasing or disposing of the asset to a third party, after taking account of the HJ. If the bank has no such right, the cost of the asset to the bank constitutes a market risk (as in the case of a non-binding PL), but this market risk exposure is reduced by the amount of any HJ that the bank has the right to retain.



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**CA-3.5 Ijarah and Ijarah Muntahia Bittamleek (continued)**

**CA-3.5.23**

**IMB**

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

\* This credit RW is applicable only when the bank has recourse to any HJ paid by the customer. In the case of HJ (depending on the legal situation), the bank may have a right to recoup from the customer any loss on leasing or disposing of the asset to a third party, after taking account of the HJ, while any excess HJ must be refunded. If the bank has no such right, the cost of the asset to the bank constitutes a market risk (as in the case of a non-binding PL), but this market risk exposure is reduced by the amount of any HJ that the bank has the right to retain.



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## CA-3.6 Musharakah and Diminishing Musharakah

### *Introduction*

- CA-3.6.1 This Section sets out the minimum capital adequacy requirement to cover the risk of loss on invested capital arising from entering into contracts or transactions that are based on the Sharia rules and principles of Musharakah and Diminishing Musharakah where the Islamic bank licensee and their customers/partner(s) contribute to the capital of the partnership and shares its profit or loss.
- CA-3.6.2 This Section is applicable to both (a) Musharakah in which all the partners' share remains constant throughout the contract period; and (b) Diminishing Musharakah in which the share of the Islamic bank licensee is gradually reduced during the tenure of the contract until it is fully sold to the other partner(s).
- CA-3.6.3 Musharakah contracts refer to partnerships in specific transactions or projects. These exclude participation in the share capital (equity) of other enterprises which is covered in Section CA-4.8.
- CA-3.6.4 A Musharakah is an agreement between the Islamic bank licensee 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 bank ("Diminishing Musharakah"). Profits generated by that enterprise or real estate/asset are shared in accordance with the terms of Musharakah agreement whilst losses are shared in proportion to the respective contributor's share of capital.
- CA-3.6.5 An Islamic bank licensee may enter into a Musharakah 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 Musharakah is normally of the diminishing type, in which the customer gradually purchases the Islamic bank licensee's partnership share over the life of the contract. This type of financing is one of the Sharia compliant alternatives to avoid a conventional term loan repayable by instalments, and as such it is exposed to credit risk for the customer's purchase payments as well as to the risk attached to the Islamic bank licensee's share of the underlying assets.



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## CA-3.6 Musharakah and Diminishing Musharakah (continued)

### *Musharakah*

- CA-3.6.6 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. The Islamic bank licensee acts as a partner in a Musharakah contract and is exposed to the risk of losing its capital upon making payment of its share of capital in a Musharakah contract. A Musharakah can expose the Islamic bank licensee either to capital impairment risk or to ‘credit risk’, depending on the structure and purpose of the Musharakah and the types of asset in which the funds are invested. The invested capital is redeemable either by liquidation of the Musharakah 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 Musharakah 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 Musharakah.
- CA-3.6.7 As a partner to a Musharakah contract, the Islamic bank licensee 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 Musharakah contract, whereas losses are to be borne by the Islamic bank licensee and its partners according to their respective ratio of invested capital. Therefore, the Islamic bank licensee 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.
- CA-3.6.7A For the purpose of determining the minimum capital adequacy requirement, this Section makes distinctions between the four main categories of Musharakah as set out below:
- (a) Private commercial enterprise to undertake trading activities in foreign exchange, shares and/or commodities
- This type of Musharakah exposes the Islamic bank licensee to the risk of underlying activities, namely foreign exchange, equities or commodities;



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### CA-3.6 Musharakah and Diminishing Musharakah (continued)

- (b) Private commercial enterprise to undertake a business venture (other than (a))  
This type of Musharakah exposes the Islamic bank licensee 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 Islamic bank licensee serves as the first loss position and its rights and entitlements are subordinated to the claims of secured and unsecured creditors. For further explanation of the nature of risk in such ventures, see Paragraphs CA-4.8.4 to CA-4.8.6; and
- (c) Joint ownership of real estate or movable assets (such as cars) is divided into two sub-categories:
- (i) Musharakah in Ijara contract  
Ownership of such assets can produce rental income for the partnership, through leasing the assets to third parties by means of Ijara contracts. In this case, the risk of the Musharakah investment is essentially that of the underlying Ijara contracts – that is, credit risk mitigated by the collateral represented by the leased assets.
- However, in some cases the lessee is not a third party but the Islamic bank licensee's partner as customer. The existence of such an Ijara sub-contract in addition to a Musharakah exposes the Islamic bank licensee to credit risk in respect of the partner's obligation to service the lease rentals and
- (ii) Musharakah in Murabahah contract  
The Islamic bank licensee is entitled to its share of revenue generated from selling the assets to third parties by means of Murabahah contracts that expose the Islamic bank licensee to credit risk in respect of the Murabahah receivables from the buyer/counterparty.

#### *Diminishing Musharakah*

- CA-3.6.8 The Islamic bank licensee's position in a diminishing Musharakah is set out in Paragraphs CA-4.8.12 to CA-4.8.15.



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## CA-3.6 Musharakah and Diminishing Musharakah (continued)

### *Equity Position Risk - Musharakah*

#### CA-3.6.9

For Musharakah, the equity exposure is measured based on the nature of the underlying investments as follows:

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

#### CA-3.6.10

For private commercial enterprises undertaking trading activities in foreign exchange, shares or commodities, the Musharakah exposures, net of provisions is measured as follows:

- (a) The RW is based on the applicable underlying assets as set out in the market risk section in Chapter CA-5.  
The investment in foreign exchange and trading in gold/silver is measured according to the treatment as set out in Section CA-5.5, which requires 8% capital charge on the greater of either net long or net short positions in foreign exchange and 8% capital charge on the net long position of gold/silver;
- (b) The RW of a Musharakah that invests in quoted shares is measured according to the equity position risk approach, where positions in assets tradable in markets qualify for treatment as equity position risk in the trading book, which incur a total capital charge of 16% as set out in Section CA-5.3; and





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### CA-3.6 Musharakah and Diminishing Musharakah (continued)

(c) Investment in commodities is measured according to either the maturity ladder approach or the simplified approach as set out in Section CA-5.6.

#### CA-3.6.11

For private commercial enterprise undertaking a business venture other than in Paragraph CA-3.6.12), there are two possible methods used to calculate the equity exposures:

- (a) Simple risk-weight method: The RW must be applied to the exposures (net of specific provisions) based on equity exposures in the banking book. The RW under the simple RW method for equity position risk in respect of an equity exposure in a business venture must entail a 400% RW for shares that are not publicly traded less any specific provisions for impairment. If there is a third-party guarantee to make good impairment losses, the RW of the guarantor must be substituted for that of the assets for the amount of any such guarantee; or
- (b) Supervisory slotting method: An Islamic bank licensee is required to map its RW into four supervisory categories as described in Appendix CA-5 (specialised financing) where the RW of each category is as follows:

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

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

For further explanation, also see Paragraphs CA-4.8.7-4.8.11.



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## CA-3.6 Musharakah and Diminishing Musharakah (continued)

### *Joint Ownership of Real Estate and Movable Assets (such as cars)*

#### CA-3.6.12

##### Musharakah in Ijara contract:

Income-producing Musharakah through leasing to third parties by means of Ijara contracts exposes the capital contributor to the risk of that underlying Ijara contract – that is, counterparty risk mitigated by the value of leased assets. This Musharakah investment is assigned a RW based on the credit standing of the counterparty/lessee, as rated by an ECAI that is approved by the CBB, and a 100% RW on the residual value of an Ijara asset (operating lease). In cases where the counterparty is unrated, a RW of 100% applies. (Please refer to the treatment for Ijara as set out in Paragraph CA-3.5.22.)

#### CA-3.6.13

##### Musharakah in Murabahah contract:

Income-producing Musharakah through selling to third parties by means of Murabahah contracts exposes the capital contributor to the risk of that counterparty/buyer. This Musharakah investment is assigned a RW based on the credit standing of the counterparty /buyer, as rated by an ECAI that is approved by the CBB. In cases where the counterparty is unrated, a RW of 100% applies. (Please refer to the treatment for Murabahah as set out in Section CA-3.2.)

### *Equity Position Risk – Diminishing Musharakah*

#### CA-3.6.14

The equity exposure in a Diminishing Musharakah contract, where the Islamic bank licensee has provided funds for the working capital of the partnership and 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. The exposure must be risk weighted according to the nature of the underlying assets as set out in Paragraphs CA-3.6.11 to CA-3.6.14. If a third party guarantee exists, to make good impairment losses, the RW of the guarantor is substituted for that of the assets (if lower) for the amount of any such guarantee. The Islamic bank licensee can use the risk weights under the slotting method (see Paragraph CA-3.6.11) after the required CBB approval, based on the criteria set out in Appendix CA-6.



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### CA-3.6 Musharakah and Diminishing Musharakah (continued)

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

CA-3.6.15

The following table sets out the Musharakah categories that attract capital charges:

Musharakah Category	Credit RW	Market Risk Capital Charge
Private commercial enterprise to undertake trading activities in the foreign exchange, share and/or commodity	Not applicable.	Depends on the underlying asset as set out in the applicable <u>market risk</u> section
Private commercial enterprise to undertake business venture other than trading activities in the foreign exchange, share and/ or commodity	(a) Simple RW 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 is 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	Not applicable
Joint ownership of real estate and movable assets (Musharakah with Ijara sub-contract, Musharakah with Murabahah subcontract)	Based on lessee's (for Ijara sub-contract) or customer's (for Murabahah sub-contract) rating or 100% RW for unrated lessee or customer	Please refer to the <u>market risk</u> capital charge requirements as set out under the sub-contracts

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



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## CA-3.7 Mudarabah

### *Introduction*

- CA-3.7.1 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'a rules and principles of Mudarabah where the Islamic bank licensee assumes the role of capital provider ('rab al mal'). This Section is applicable to both restricted and unrestricted Mudarabah financing.
- CA-3.7.2 A Mudarabah is an agreement between the Islamic bank licensee and a customer whereby the Islamic bank licensee would contribute capital to an enterprise or activity which is to be managed by the customer as the (labour provider or) Mudarib.
- CA-3.7.3 Profits generated by that enterprise or activity are shared in accordance with the terms of the Mudarabah agreement whilst losses are to be borne solely by the Islamic bank licensee unless the losses are due to the Mudarib's misconduct, negligence or breach of contracted terms.
- CA-3.7.4 A Mudarabah financing can be carried out on either:
- A restricted basis, where the capital provider allows the Mudarib to make investments subject to specified investment criteria or certain restrictions such as types of instrument, sector or country exposures, etc.; or
  - An unrestricted basis, where the capital provider allows the Mudarib to invest funds freely based on the latter's skills and expertise.
- CA-3.7.5 As the capital provider, the Islamic bank licensee is exposed to the risk of losing its capital investment ('capital impairment risk') upon making payment of the capital to the Mudarib. 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 Mudarib.
- CA-3.7.6 While it is not permissible for a Mudarib to give a guarantee against losses outlined in Paragraph CA-3.7.5, a guarantee may be given by a third party on the basis of tabarru (donation). In such a case, the amount of the Mudarabah capital so guaranteed may be considered as subject to credit risk with a risk weighting equal to that of the guarantor.
- CA-3.7.7 Guarantees referred to in Paragraph CA-3.7.6 may be given when liquid funds are placed in an Islamic interbank market under a Mudarabah contract.



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## CA-3.7 Mudarabah (continued)

### *Equity Position Risk*

CA-3.7.8 Apart from placements identified in Paragraph CA-3.7.7, Mudarabah contracts are commonly used for the investment purposes mentioned in Paragraph CA-3.7.10.

CA-3.7.9 In assigning the RW, consideration is given to the intent of the Mudarabah investment, and to the nature of the underlying assets. The intent may be:

- (a) The purchase of assets for trading;
- (b) Investing on an equity basis in an ongoing business venture with the intention of holding the investment for an indefinite period, perhaps with a view to eventual sale (e.g. venture capital investments); or
- (c) Project finance. The underlying assets may be tradable assets such as commodities, foreign exchange or securities, or business assets such as real property, plant and equipment, and working capital. Real property and movable property may also be purchased with a view to generating rental income by means of Ijara contracts.

#### CA-3.7.10

For the purpose of calculating the minimum capital requirement, Islamic bank licensees must make distinctions between the three main categories of Mudarabah, as set out in Paragraphs CA-3.7.11 to 3.7.13.

#### *Private Commercial Enterprise to Undertake Trading Activities in Foreign Exchange, Shares or Commodities.*

CA-3.7.11 This type of Mudarabah exposes the Islamic bank licensee to the risk of the underlying activities, namely foreign exchange, equity or commodities.

#### *Private Commercial Enterprise to Undertake a Business Venture (other than outlined in Paragraph CA-3.7.11.)*

CA-3.7.12 This type of Mudarabah exposes the Islamic bank licensee 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 Islamic bank licensee serves as the first loss position and its rights and entitlements are subordinated to the claims of secured and unsecured creditors. For further explanation of the nature of risk in such ventures, see Paragraphs CA-4.8.4 to CA-4.8.6.



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## CA-3.7 Mudarabah (continued)

### *Mudarabah Investments in Project Finance*

CA-3.7.13 An Islamic bank licensee advances funds to a customer who acts as Mudarib in a construction contract for a third-party customer (ultimate customer). The ultimate customer will make progress payments to the Mudarib who, in turn, makes payments to the Islamic bank licensee. The essential role of the Islamic bank licensee in this structure is to provide bridging finance to the Mudarib pending its receipt of the progress payments.

In this type of construction contract Mudarabah investment structure:

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

CA-3.7.14 The Islamic bank licensee is exposed to the risk on the amounts paid to the Mudarib, and as these amounts are made on a profit-sharing and loss-bearing basis they are treated under credit risk as equity positions in the banking book. In principle, the Islamic bank licensee’s credit exposure is to the Mudarib, not to the ultimate customer; however, as described below, a structure may involve the use of a “repayment account” to receive progress payments from the ultimate customer, which transfers much of the credit risk to the latter.

CA-3.7.15 In addition to credit risk (i.e. that the Mudarib has received payment from the ultimate customer but fails to pay the Islamic bank licensee, or that the ultimate customer fails to pay), the Islamic bank licensee is exposed to capital impairment in case the project results in a loss.



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### CA-3.7 Mudarabah (continued)

#### *Direct Payment by Ultimate Customer into a "Repayment Account" Opened with the Bank and Effectively Pledged to the Bank*

CA-3.7.16 Much of the Islamic bank licensee's credit exposure to the Mudarib 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.

CA-3.7.17 In a construction related transaction, 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 Mudarib will be the credit risk of the ultimate customer. However, this does not per se constitute a mitigation of the credit risk of the Islamic bank licensee's exposure to the Mudarib. 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 Islamic bank licensee the amount of that progress payment due is no longer exposed to the risk of unsatisfactory performance by the Mudarib, but only to the latter's failure to pay the Islamic bank licensee (the Mudarib 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 Mudarib – that is, say 100%, rather than 400%. However, if a binding agreement exists between the Islamic bank licensee and the ultimate customer whereby the latter will make the payment into a "repayment account" with the Islamic bank licensee, the latter's credit exposure in respect of the amount due is transferred from the Mudarib to the ultimate customer.

**CA-3.7.18** Other structures may be used which have the effect of modifying the risk exposures of the investors in a Mudarabah. The determination of the risk exposure (nature and amount) must take into account the structure which must be reflected in the application of RW.

#### *Equity Position Risk*

**CA-3.7.19** The equity exposure must be measured based on the nature of the underlying investments:

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



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### CA-3.7 Mudarabah (continued)

#### CA-3.7.20

The Mudarabah exposures, must be measured net of specific provisions.

*Private Commercial Enterprise to Undertake Trading Activities in Foreign Exchange, Shares or Commodities*

#### CA-3.7.21

The RW must be based on the applicable underlying assets as set out in the market risk section in Chapter CA-5. An investment in foreign exchange and trading in gold/silver must be measured according to the treatment set out in Section CA-5.5, which requires an 8% capital charge on the greater of either net long or net short positions and an 8% capital charge on the net position of gold/silver.

The RW of a Mudarabah that invests in quoted shares must be measured according to the equity position risk approach where positions in assets tradable in markets qualifies for treatment as equity position risk in the trading book, which incurs a total capital charge of 16% (equivalent to 200% RW) as set out in Section CA-5.3.

Investment in commodities must be measured according to either the maturity ladder approach or the simplified approach, as set out in Section CA-5.6.

*Private Commercial Enterprise to Undertake a Business Venture (other than Paragraph CA-3.7.21)*

#### CA-3.7.22

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

- a) The simple risk-weight method; and
- (b) The slotting method.

The calculation details are set out in Paragraphs CA-4.8.7 to 4.8.11.





MODULE	CA:	Capital Adequacy
CHAPTER	CA-3:	The Banking Book - Minimum Capital Requirements for Islamic Financing & Investment Assets

## CA-3.7 Mudarabah (continued)

### *Mudarabah Investment in Project Finance*

#### CA-3.7.23

The Islamic bank licensee's overall credit exposure in respect of the Mudarabah in such a case is divided into three parts:

- (a) The amount receivable by the Islamic bank licensee from the Mudarib in respect of progress payments due to the Mudarib from the ultimate customer for work certified as having reached a certain stage of completion: If a binding agreement exists as described in Paragraph CA-3.7.13, whereby the amount will be paid by the ultimate customer into a “repayment account” with the Islamic bank licensee, the RW reflects the credit standing of the ultimate customer. In the absence of such an agreement, the RW reflects the credit standing of the Mudarib (or 100% RW for unrated customer);
- (b) The amount held in the “repayment account” with the Islamic bank licensee, which has a risk weighting of 0%; and
- (c) For any remaining balance of the funds advanced by the Islamic bank licensee to the Mudarib, which incurs a RW of between 300% and 400% under the simple RW method, or between 90% and 270% under the slotting method, unless otherwise rated, the treatment as set out in Paragraph CA-3.7.12 applies.



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### CA-3.7 Mudarabah (continued)

#### *Summary of Capital Requirements for Mudarabah Categories*

#### CA-3.7.24

The Mudarabah categories that attract capital charges of Paragraphs CA-3.7.11 and CA-3.7.12 are:

Mudarabah Category	Credit RW	Market Risk Capital Charge
Private commercial enterprise to undertake trading activities in the foreign exchange, share and/or commodity	Not applicable	Depends on the underlying asset as set out in the applicable <u>market risk</u> section
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% and 270% RW of the contributed amount to the business venture based on the four categories	Not applicable

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



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### CA-3.7 Mudarabah (continued)

#### CA-3.7.25

The applicable stages in a Mudarabah contract in project finance that attract capital charges of Paragraph CA-3.7.13 are:

Applicable Stages in a Contract	Credit RW	Market Risk Capital Charge
Prior to certification, where funds are already advanced by the bank to the Mudarib	Risk weight is based on the rating of either the ultimate customer or the Mudarib (see Paragraph CA-3.7.13). Otherwise, 400% RW is applied to an unrated Mudarib.	Not applicable
After certification, where the amount is receivable by the bank from the Mudarib in respect of progress payment to the Mudarib from the ultimate customer	If a "repayment account" or similar mitigation structure is used, RW is based on the credit standing of the ultimate customer on the amounts receivable by the bank from the Mudarib (or 100% RW for unrated customer).	Not applicable



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**CA-3.8** Sukuk [This Section was moved to Chapter CA-8 in January 2015].



<b>MODULE</b>	<b>CA: Capital Adequacy</b>
<b>CHAPTER</b>	<b>CA-3: The Banking Book - Minimum Capital Requirements for Islamic Financing &amp; Investment Assets</b>

## CA-3.9 Qard Hasan

### *Introduction*

- CA-3.9.1 This Section sets out the minimum capital requirement to cover the risk of losing capital arising from entering into contracts or transactions that are based on the Shari'a rules and principles of Qard.
- CA-3.9.2 Qard is a loan given by an Islamic bank licensee, where the borrower is contractually obliged to repay only the principal amount borrowed.<sup>17</sup> In the contract of Qard, no payment in addition to the principal amount lent may be required, as that would be a form of Riba.
- CA-3.9.3 If a fixed period of repayment is stipulated in the contract, the borrower is liable to pay back the principal amount to the Islamic bank licensee on or before the agreed date of payment. On the other hand, if no period is stipulated in the contract, it is binding upon the borrower to make a repayment of the loaned amount to the lender on demand.

### *Collateralisation*

- CA-3.9.4 As one of the CRM techniques, Islamic bank licensees can secure a pledge of a tangible asset. The collateralisation is not automatically provided in a Qard contract but must be explicitly stated or must be documented in a separate security agreement at or before the time of signing of the Qard contract. The Islamic bank licensee may employ other techniques such as pledge of deposits/PSIA or a third-party financial guarantee.

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<sup>17</sup> As a business entity, banks provide financing to their customers to perform their role as financial intermediary and seek an opportunity to earn profits for their enterprise and for distribution to their shareholders and fund providers. Therefore, most banks will not be providing any significant amount of lending on the basis of Qard, as Shari'a rules and principles require the borrower to pay only the principal amount in that case. Nonetheless, a bank survey has shown that, in several jurisdictions, some banks do provide Qard-based lending for different reasons. These vary widely among banks and may include: (a) lending to some specific type of clients such as the poor, needy or widows, etc. as a part of Corporate Social Responsibility practice; (b) lending out of their Charity Account (built out of their non-permissible income) to small entrepreneurs and new businesses that do not have access to sufficient assets that can be used as collateral; (c) lending as a part of their business product – that is, not out of the Charity Account; (d) providing funding to various microfinance institutions or customers; and (e) lending mainly for marketing or public acceptance purposes, where a small portion of the overall financing portfolio is allocated to support certain activities of underprivileged sections of the population, etc.



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## CA-3.9 Qard (continued)

### *Credit Risk*

CA-3.9.5 Islamic bank licensees are exposed to credit risk in the event that the borrower fails to repay the principal amount in accordance with the agreed terms of the contract. In a fixed-period Qard contract, credit risk exposure commences upon the execution of the contract until the full repayment by the borrower.

**CA-3.9.6** The credit exposure is measured based on account receivable in Qard – that is, the amount due from the customer at the end of the financial period less any provision for doubtful debts.

**CA-3.9.7** The account receivable amount (net of specific provisions) arising from the Qard contract must be assigned a RW based on the credit standing of the borrower, as rated by an ECAI that is approved by the CBB (see Section CA-4.6). In cases where the borrower is unrated, a RW of 100% applies. The RW of a financial guarantor can be substituted for the RW of the borrower provided that the guarantor has a better credit rating than the borrower and that the guarantee is legally enforceable. If an exposure is covered by multiple CRM techniques, the exposure must be segregated into segments covered by each type of CRM technique as specified in Section CA-4.7. For any uncovered exposure, the RW of the underlying counterparty applies.

### *Market Risk*

**CA-3.9.8** In the case where a cash loan is provided by the Islamic bank licensee, there is no element of market risk. If, however, a loan is provided in a currency other than the local currency or in the form of a commodity, the related market risk is applicable, as outlined in Section CA-5.6.



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### CA-3.9 Qard (continued)

#### *Summary of Capital Requirement for Qard-based Lending*

##### CA-3.9.9

The following table sets out capital charges for lending on the basis of Qard:

Exposure	Credit RW	Market Risk Capital Charge
Accounts receivable from customer	Exposure is equal to the amount of loan (less specific provisions) X customer's rating (or 100% RW for unrated customer).	Not applicable*

\*Applicable only if Qard-based lending is made in the foreign currency or in commodities.



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## CA-3.10 Wakalah

### *Introduction*

- CA-3.10.1 This Section sets out the minimum capital adequacy requirement to cover the risk of losing invested capital arising from an Islamic bank licensee entering into asset-side financing contracts or transactions that are based on the Shari'a rules and principles of Wakalah.
- CA-3.10.2 An Islamic bank licensee assumes the role of a principal (Muwakkil) and appoints the customer as agent (Wakil) to carry out a specified set of services or act on its behalf. This Section is applicable to both restricted and unrestricted Wakalah financing.
- CA-3.10.3 Wakalah is a contract of agency whereby one person contracts to perform any work or provide any service on behalf of another person. Businesses rely on a range of individuals to act on their behalf; these include employees, directors, partners, and a range of professional agents. An action performed by an agent on behalf of the principal will be deemed to be an action by the principal. An agent will obtain fees for services rendered according to the contractual reward structure offered by the principal which may incorporate a performance-related element.
- CA-3.10.4 Profits generated are distributed to the Muwakkil less the Wakil fee, in accordance with the terms of the Wakalah agreement. In case the contract includes some "indicative" or "expected" profit rate on the investment, the Wakalah contract can include a clause stipulating that the Wakil's remuneration may be:
- (a) A pre-agreed flat fee; or
  - (b) A certain share of profit added to a pre-agreed flat fee, subject to the terms and conditions.





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### CA-3.10 Wakalah (continued)

- CA-3.10.5 A Wakalah financing can be carried out on either:
- A restricted basis, where the capital provider allows the Wakil to make investments subject to specified investment criteria or certain restrictions such as types of instrument, sector or country exposures etc.; or
  - An unrestricted basis, where the capital provider allows the Wakil to invest funds freely based on the latter's skills and expertise. For interbank Wakalah, the Wakil is permitted by the Muwakkil to invest the investment amount on a discretionary basis, but only in Shari'a-compliant transactions.
- CA-3.10.6 As the Muwakkil, the Islamic bank licensee is exposed to the risk of losing its invested capital – that is, capital impairment risk. Any loss on the investment is to be borne solely by the Muwakkil but is limited to the amount of its capital. Losses that are due to fraud, misconduct, negligence or breach of contractual terms are to be borne by the Wakil. The Wakil shall be entitled to any pre-agreed flat Wakil fee irrespective of whether the actual profit is less than, equal to or greater than any expected profit, and also in the event of a loss.
- CA-3.10.7 However, while it is not permissible for a Wakil to give a guarantee against losses or for any indicative or expected profits, such a guarantee may be given by a third party on the basis of tabarru' (donation). In such a case, the amount of the Wakalah 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 Wakalah contract.
- CA-3.10.8 In the absence of any fraud, misconduct, negligence or breach of contractual terms on the part of Wakil, all the risk of loss on the investment is to be borne by the Muwakkil. Therefore, the Islamic bank licensee is exposed to the skills of the Wakil that manages the investments on behalf of the Islamic bank licensee, as well as to business risks associated with the underlying activities and types of investments or assets of the Wakalah agreement.

#### ***Capital Requirements***

- CA-3.10.9 For the purpose of determining the minimum capital requirements, this section makes distinctions between the following main categories of Wakalah:
- Wakalah investments to undertake trading activities in foreign exchange, shares and/or commodities, including Commodity Murabaha Transactions (CMTs);
  - Wakalah investments with a private commercial enterprise to undertake business activities (other than (a) above); and
  - Wakalah placement in the interbank market.



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### CA-3.10 Wakalah (continued)

**CA-3.10.10** The Wakalah exposures, are measured net of specific provisions as set out below.

*Wakalah Investments to Undertake Trading Activities in Foreign Exchange, Shares and/or Commodities, including CMT*

**CA-3.10.11** The RW is based on the applicable underlying assets as set out in the market risk section in Chapter CA-5. An investment in foreign exchange and trading in gold or silver must be measured according to the treatment as set out in Section CA-5.5, which requires an 8% capital charge on the greater of either net long or net short positions and an 8% capital charge on the net position of gold/silver.

**CA-3.10.12** The RW of a Wakalah for funds that are invested in quoted shares must be measured according to the equity position risk approach, where positions in assets tradable in markets qualify for treatment as equity position risk in the trading book, which incur a total capital charge of 16% (equivalent to 200% RW) as set out in Section CA-5.3.

**CA-3.10.13** Investment in commodities must be measured according to either the maturity ladder approach or the simplified approach as set out in Section CA-5.6.

**CA-3.10.14** If the Wakalah investment is to be utilised by the Wakil (another Islamic bank licensee) for conducting CMT to earn a (fixed rate of) profit, the investing Islamic bank licensee is primarily exposed to the counterparty risk. In that case, the invested amount (net of specific provisions) must be assigned a RW based on the credit standing of the counterparty as rated by an approved ECAI. In cases where the counterparty is unrated, a RW of 100% applies (see Section CA-4.2).



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### CA-3.10 Wakalah (continued)

#### *Wakalah Investments with Private Commercial Enterprise to Undertake Business Activities (other than in Paragraph CA-3.10.11)*

CA-3.10.15

This type of Wakalah investment exposes the Islamic bank licensee to capital impairment risk. Due to this downside risk, the RW is measured according to equity position in the banking book approach. The RW must be applied to the exposures net of specific provision, if any.

CA-3.10.16

As explained in Sections CA-3.6 and 3.7, there are two possible methods used to calculate the equity exposures, that is:  
(a) The simple risk-weight method; and  
(b) The slotting method.

CA-3.10.17

The RW under the simple risk-weighting method (a) entails a RW of 300–400%. Under the slotting method (b), an Islamic bank licensee must map its RW into four supervisory categories as described in Appendix CA-5 (specialised financing) where the RWs of each category are as follows:

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

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

For further explanation, also see Paragraphs CA-4.8.7 to 4.8.11.

#### *Wakalah Placement in the Interbank Market*

CA-3.10.18

An Islamic bank licensee may place liquid funds with a central bank or another Islamic bank licensee on a Wakalah basis in order to obtain a return on those funds. Such placements are considered to be more secure than those identified in Paragraphs CA-3.10.11 to CA-3.10.14, owing to the available credit standing of, and the established relationship with, the counterparty in the interbank market.



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### CA-3.10 Wakalah (continued)

#### CA-3.10.19

A placement of funds made by an Islamic bank licensee with another Islamic bank licensee under a Wakalah agreement (whether on a restricted or unrestricted basis) may be subject to a Shari'a-compliant guarantee from a third party. Such a guarantee can be related to the amount of principal invested, as well as the expected return. In such cases, the capital must 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 Wakil as counterparty. Otherwise, the RW of the Wakil applies. As explained in Section CA-3.11 related to Mudarabah interbank placement, interbank placement received on a Wakalah basis can also be effectively treated as a liability by the Islamic bank licensee receiving the funds. In the absence of any guarantee mentioned earlier, the risk-weighting must be applied based on the credit standing of the counterparty as rated by an approved ECAI, or a RW of 100% for an unrated counterparty.

#### CA-3.10.20

If the funds placed under a Wakalah arrangement are placed in a foreign currency, in addition to the above treatment, capital charge related to foreign exchange risk is applicable as outlined in Section CA-5.5.



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CA-3.10 Wakalah (continued)

*Summary of Capital Requirements for Wakalah Categories*

CA-3.10.21 The following table sets out the Wakalah categories that attract capital charges.

Wakalah Category	Credit RW	Market Risk Capital Charge
Wakalah investments to undertake trading activities in foreign exchange, shares and/ or commodities, including CMT	Not applicable	Depends on the underlying asset as set out in the applicable <u>market risk</u> section. See Section CA-5.5 for Wakalah investments in FX. See Section CA-5.3 for Wakalah Investments in shares. See Section CA-5.6 for Wakalah Investments in commodities. See Section CA-3.11 for Wakalah investments in CMT.
Wakalah investments with private commercial enterprise to undertake business activities, other than above categories	(a) Simple risk-weight method 300–400% RW of the placed amount less any specific provisions Or: (b) Slotting method Between 90% and 270% RW of the contributed amount to the business venture based on the four categories	Not applicable
Wakalah placement in the interbank market	Risk-weighting can be applied based on the credit standing of the counterparty* as rated by the approved ECAI, or a RW of 100% for an unrated counterparty.	Not applicable**

\*In the case of a third-party guarantee, the capital must 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 Wakil as counterparty. Otherwise, the RW of the Wakil applies.

\*\*If funds are invested in foreign exchange, foreign exchange risk will also be applicable as per Section CA-5.5.



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### CA-3.11 Commodity Murabahah Transactions (CMT)

CA-3.11.1 This Section sets out the minimum capital requirements to cover the credit and market risks arising from financing contracts that are based on the Shari'a rules and principles of CMTs, either in the interbank market or to other customers.

CA-3.11.2 Islamic bank licensees can be involved in CMT-based financing in the following forms:<sup>18</sup>

- (a) CMT for interbank operations for managing short-term liquidity surplus (i.e. selling and buying of Shari'a-compliant commodities through Murabahah transactions, which is commonly termed "placement" in conventional institutions) or where the counterparty is the central bank or monetary authority offering a Shari'a-compliant lender of last resort and/or a standing facility for effective liquidity management. Such placement/financing is referred to as "commodity Murabahah for liquid funds (CMLF)"; or<sup>19</sup>
- (b) CMT for providing financing to a counterparty by a longer-term commodity Murabahah where the counterparty immediately sells the commodities on the spot market is referred to as "commodity Murabahah financing (CMF)".

CA-3.11.3 CMLF is a tool for liquidity management for Islamic bank licensees in order for them to invest their surplus liquid funds on a short-term basis with other market players, within or outside the jurisdiction. In this type of transaction, the RW will be influenced by the credit standing of the counterparty receiving the funds and the duration of the placement.

#### *Capital Requirements*

CA-3.11.4 It is crucial for Islamic bank licensees to recognise and evaluate the overlapping nature and transformation of risks that exist between various types of risk. Since the dynamism of risk exposure through the phases of CMT is unique, Islamic bank licensees should break down the contractual timeline for CMT while managing the risks in each phase.

<sup>18</sup> Please see IFSB GN-2 (Guidance Note on CMT, issued in December 2010) for details on various risk management and capital adequacy aspects of CMT that can be conducted on both sides of the balance sheet.

<sup>19</sup> CMLF is also referred to as "commodity Murabahah investment" by some banks in the industry. Strictly speaking, Murabahah should not be classified as an investment, since in fact it is a type of receivable.



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### CA-3.11 Commodity Murabahah Transactions (continued)

CA-3.11.5 An Islamic bank licensee may be exposed to market risk through any fluctuation in the price of the underlying commodity that comes into its possession for a longer duration than normal – for example, when a customer refuses to honour his commitment to buy or when the agreement is non-binding. With CMLF and CMF on the asset side, market risk transforms into credit risk; that is, market risk is applicable before selling the commodities to the counterparty, while upon their being sold to the counterparty on deferred payment terms the market risk converts into credit risk. In view of the market practice relating to CMT whereby the commodities are sold instantaneously after being bought on the basis of a binding promise, there would be no market risk. On the other hand, if an Islamic bank licensee holds title to the commodities for any length of time in the CMT transaction, a market risk exposure will be present. Placement of funds in currencies other than the local currency will also expose the Islamic bank licensee to foreign exchange risk.

#### *Credit Risk*

CA-3.11.6

As in both CMLF and CMF, a binding promise from the customer exists to purchase the commodity; an Islamic bank licensee is exposed to default on the customer's obligation to purchase. In the event of default by the customer, the Islamic bank licensee disposes of the asset to a third party; that is, the credit risk is mitigated by the asset in possession as collateral, net of any haircut. The exposure must be measured as the amount of the total acquisition cost to the Islamic bank licensee for the purchase of commodities, less the market value of the commodities as collateral, subject to any haircut and specific provisions, if any. The RW of the counterparty must be applicable to the resultant receivables,<sup>20</sup> and would be based on credit ratings issued by a recognised ECAI.<sup>21</sup> In the case of an unrated counterparty, the applicable RW will be 100%.

CA-3.11.7

In applying the RWs outlined above, an Islamic bank licensee must ensure that the contracts for the transactions are properly documented and legally enforceable in a court of law. In the absence of these features, the commodities are exposed to market risk.

<sup>20</sup> In CMLF and CMF on the asset side, the bank is exposed to market risk in the interval before it sells the commodities to the counterparty, and subsequently to credit risk (accounts receivable risk), which is applicable after the bank sells those commodities to the counterparty.

<sup>21</sup> If the credit exposure is funded and denominated in local currency and the counterparty is a domestic sovereign, a 0% risk weight shall be applied. Otherwise, a higher risk weight as suggested by the credit rating of the foreign sovereign is applicable.



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### CA-3.11 Commodity Murabahah Transactions (continued)

#### *Market Risk*

CA-3.11.8

In the presence of a binding promise to purchase from the counterparty (Paragraph CA-3.2.6) and legally enforceable contract documentation, no capital charge is applicable for market risk. Otherwise, a capital charge for commodities risk is applicable, and must be measured by using either the maturity ladder approach or the simplified approach as set out in Section CA-5.6.

CA-3.11.9

In case the exposure is denominated in a foreign currency, a capital charge on the foreign currency exposure must be calculated as outlined in Section CA-5.5.

#### *Summary of Capital Requirements*

CA-3.11.10

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

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

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





MODULE	CA: Capital Adequacy
CHAPTER	CA-4: Credit Risk – The Standardised Approach

## CA-4.1 Introduction

CA-4.1.1 Credit risk exposures in Islamic financing arise in connection with accounts receivable in Murabaha contracts, counterparty risk in Salam contracts, accounts receivable and counterparty risk in Istisn'a contracts and lease payments receivable in Ijarah contracts, and Sukuk held to maturity in the banking book. Credit risk is measured according to the Standardised Approach as outlined in this Module, except for certain exposures arising from investments by means of Musharaka or Mudaraba contracts in assets in the banking book. The latter are to be treated as giving rise to credit risk (in the form of capital impairment risk), and are to be risk-weighted applying the supervisory slotting criteria for exposures in the nature of specialised financing and the risk weights applicable to equities for other equity exposures as detailed in the Musharaka and Mudaraba sections of Chapter CA-3.

CA-4.1.2 Broadly, the assignment of Risk Weights (RWs) takes into consideration the following:

- (a) The credit risk rating of an obligor or other counterparty, or a security, based on external credit assessment institutions (ECAI) ratings<sup>22</sup>. In determining the risk weights in the standardised approach, Islamic bank licensees must use assessments by only those external credit assessment institutions which are recognised as eligible for capital purposes by CBB in accordance with the criteria defined in Section CA-4.6;
- (b) Credit risk mitigation techniques adopted by the Islamic bank licensees;
- (c) Types of the underlying assets that are sold and collateralised or leased by the Islamic bank licensees; and
- (d) The amount of specific provisions made for the overdue portion of accounts receivable or lease payments receivable.

### CA-4.1.3

**Exposures must be risk-weighted net of specific provisions and may take eligible collateral into account where the risk weight of the collateral is lower than that of the counterparty or obligor.**

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<sup>22</sup> The notations follow the methodology used by one institution, 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. The ratings used throughout this document, therefore, do not express any preferences or determinations on external assessment institutions by the CBB.



<b>MODULE</b>	<b>CA: Capital Adequacy</b>
<b>CHAPTER</b>	<b>CA-4: Credit Risk – The Standardised Approach</b>

## CA-4.2 Segregation of Claims

### *Claims on Sovereigns*

#### CA-4.2.1

Claims on governments of GCC member states (hereinafter referred to as GCC) and their central banks are normally risk weighted at 0%. Claims on other sovereigns and their central banks are given a preferential risk weighting of 0% where such claims are denominated and funded in the relevant domestic currency of that sovereign/central bank (e.g. if a Bahraini bank has a claim on government of Australia and the loan is denominated and funded in Australian dollar, it will be risk weighted at 0%). Such preferential risk weight for claims on GCC/other sovereigns and their central banks are allowed only if the relevant supervisor also allows 0% risk weighting to claims on its sovereign and central bank.

#### CA-4.2.2

Claims on sovereigns other than those referred to in Paragraph CA-4.2.1 must be assigned risk weights as follows:

Credit Assessment	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated
Risk Weight	0%	20%	50%	100%	150%	100%

### *Claims on International Organisations*

#### CA-4.2.3

Claims on the Bank for International Settlements, the International Monetary Fund and the European Central Bank receive a 0% risk weight.



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## CA-4.2 Segregation of Claims (continued)

### *Claims on Non-central Government Public Sectors Entities (PSEs)*

**CA-4.2.4** Any claims on the Bahraini PSEs listed in Appendix CA-8 are treated as claims on the government of Bahrain and are eligible for 0% risk weighting.

**CA-4.2.4A** In addition to the Bahraini PSEs listed in Appendix CA-8, existing exposures to the following entities which have been removed from the list of PSEs as of 1<sup>st</sup> March 2016, will be grandfathered and will remain eligible for 0% risk weighting until the final maturity or sale of such exposure:

- (a) Durrat Khaleej Al Bahrain Company;
- (b) Hawar Island Development Company;
- (c) Lulu Tourism Company; and
- (d) Al Awali Real Estate Company.

**CA-4.2.4B** Any new claims to the entities listed under Paragraph CA-4.2.4A are subject to the normal risk weights as outlined in this Section.

**CA-4.2.5** Where other supervisors also treat claims on named PSEs as claims on their sovereigns, claims to those PSEs are treated as claims on the respective sovereigns as outlined in Paragraphs CA-4.2.1 and CA-4.2.2. These PSEs must be shown on a list maintained by the concerned central bank or financial regulator. Where PSE's are not on such a list, they must be subject to the treatment outlined in Paragraph CA-4.2.6.



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## CA-4.2 Segregation of Claims (continued)

### CA-4.2.6

Claims on all other (foreign) PSEs (i.e. not having sovereign treatment) denominated and funded in the home currency of the sovereign must be risk weighted as allowed by their home country supervisors, provided the sovereign carries rating BBB- or above. Claims on PSEs with no explicit home country weighting or to PSEs in countries of BB+ sovereign rating and below are subject to ECAI ratings as per the following table:

Credit Assessment	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated
Risk Weight	20%	50%	100%	100%	150%	100%

### CA-4.2.7

Claims on commercial companies owned by governments must be risk weighted as normal commercial entities unless they are in the domestic currency and covered by a government guarantee in the domestic currency that satisfies the conditions in Section CA-4.7 in which case they may take the risk weight of the concerned government.

#### *Claims on Multilateral Development Banks (MDBs)*

### CA-4.2.8

MDBs currently eligible for a 0% risk weight are: the World Bank Group comprised of the International Bank for Reconstruction and Development (IBRD) and the International Finance Corporation (IFC), the Asian Development Bank (ADB), the African Development Bank (AfDB), the European Bank for Reconstruction and Development (EBRD), the Inter-American Development Bank (IADB), the European Investment Bank (EIB), the European Investment Fund (EIF), the Nordic Investment Bank (NIB), the Caribbean Development Bank (CDB), the Islamic Development Bank (IDB) and the Islamic Corporation for the Insurance of Investment and Export Credit (ICIEC), Arab Monetary Fund (AMF), the Council of Europe Development Bank (CEDB), the Arab Bank for Economic Development in Africa (ABEDA), Council of European Resettlement Fund (CERF) and the Kuwait Fund for Arab Economic Development (KFAED).



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## CA-4.2 Segregation of Claims (continued)

### CA-4.2.9

The claims on MDBs, which do not qualify for the 0% risk weighting above, must be assigned risk weights as follows:

Banks Credit Quality Grades	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Un-rated
Risk weights	20%	50%	50%	100%	150%	50%

### *Claims on Islamic Banks and Conventional Banks*

### CA-4.2.10

Claims on banks must be risk weighted as given in the following table. No claim on an unrated bank may receive a risk weight lower than that applied to claims on its sovereign of incorporation (see guidance in Paragraph CA-4.2.11A for self-liquidating letters of credit).

Banks Credit Quality Grades	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Un-rated
Standard risk weights	20%	50%	50%	100%	150%	50%
Preferential risk weight	20%	20%	20%	50%	150%	20%

### CA-4.2.11

Short-term claims on locally incorporated banks must be assigned a risk weighting of 20% where such claims on the banks are of an original maturity of 3 months or less denominated and funded in either BD or US\$. A preferential risk weight that is one category more favourable than the standard risk weighting must be assigned to claims on foreign banks licensed in Bahrain of an original maturity of 3 months or less denominated and funded in the relevant domestic currency (other than claims on banks that are rated below B-). Such preferential risk weight for short-term claims on banks licensed in other jurisdictions will be allowed only if the relevant supervisor also allows this preferential risk weighting to short-term claims on its banks.

### CA-4.2.11A

Self-liquidating letters of credit issued or confirmed by an unrated bank are allowed a risk weighting of 20% without reference to the risk weight of the sovereign of incorporation. All other claims will be subject to the 'sovereign floor' of the country of incorporation of the concerned issuing or confirming bank. See also Paragraph CA-4.5.5.



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## CA-4.2 Segregation of Claims (continued)

**CA-4.2.12** Claims with an (contractual) original maturity under 3 months that are expected to be rolled over (i.e. where the effective maturity is longer than 3 months) do not qualify for a preferential treatment for capital adequacy purposes.

### *Claims on Investment Firms*

**CA-4.2.13** Claims on category one and category two investment firms which are licensed by the CBB are treated as claims on banks for risk weighting purposes but without the use of preferential risk weight for short-term claims. Claims on category three investment firms licensed by the CBB must be treated as claims on corporates for risk weighting purposes. Claims on investment firms in other jurisdictions will be treated as claims on corporates for risk weighting purposes. However, if the bank can demonstrate that the concerned investment firm is subject to an equivalent capital adequacy regime to this Module and is treated as a bank for risk weighting purposes by its home regulator, then claims on such investment firms must be treated as claims on banks.

### *Claims on Corporates, including Insurance Companies*

**CA-4.2.14** Risk weighting for corporates including insurance companies is as follows:

Credit assessment	AAA to AA-	A+ to A-	BBB+ to BB-	Below BB-	Unrated
Risk weight	20%	50%	100%	150%	100%

**CA-4.2.15** Risk weighting for unrated (corporate) claims will not be given a preferential RW to the concerned sovereign. Credit facilities to small/medium enterprises may be placed in the regulatory retail portfolio in limited cases described below.

### *Risk Weights Based on Underlying Assets*

**CA-4.2.16** The RW of a debtor, counterparty or other obligor is adjusted if the underlying assets are retail or real estate financed under Murabaha, Ijara, IMB, Istisna' or diminishing Musharakah, as set out in Paragraphs CA-4.2.17 to CA-4.2.20.



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## CA-4.2 Segregation of Claims (continued)

### *Claims Included in the Regulatory Retail Portfolios*

CA-4.2.17

Retail claims that are included in the regulatory retail portfolio must be risk weighted at 75%, except as provided in Paragraph CA-4.2.21 for the past due receivables.

CA- 4.2.18

To be included in the regulatory retail portfolio, claims must meet the following criteria:

- (a) Orientation – the exposure is to an individual person or persons or to a small business. A small business is a Bahrain-based business with annual turnover below BD 2mn;
- (b) Product – The exposure takes the form of any of the following: revolving credits and lines of credit (including credit cards and running finance), personal term finance and leases (e.g. instalment finance, auto finance and leases, student and educational finance, personal finance) and small business facilities and commitments. Islamic products which involve securities (such as Musharakah, Mudarabah, Sukuks and equities), whether listed or not, are specifically excluded from this category. Mortgage finance will be excluded if they qualify for treatment as claims secured by residential property (see below). Finance for purchase of shares are also excluded from the regulatory retail portfolios;
- (c) Granularity – The regulatory retail portfolio is sufficiently diversified to a degree that it reduces the risks in the portfolio, warranting a 75% risk weight. No aggregate exposure to one counterpart<sup>23</sup> can exceed 0.2% of the overall regulatory retail portfolio; and
- (d) The aggregate receivables (accounts receivable in Murabaha and Istisna, lease payments receivable in IMB, and share purchase plus lease receivables in diminishing Musharakah) due from a single counterparty or person(s) must not exceed BD250,000.

### *Claims Secured by Residential Real Estate (RRE)*

CA-4.2.19

Financing facilities fully secured by first mortgages on RRE that is or will be occupied by the borrower, or that is leased, carry a risk weighting of 75%.

<sup>23</sup> Aggregated exposure means gross amount (i.e. not taking any credit risk mitigation into account) of all forms of debt exposures (e.g. finances or commitments) that individually satisfy the three other criteria. In addition, “to one counterpart” means one or several entities that may be considered as a single beneficiary (e.g. in the case of a small business that is affiliated to another small business, the limit would apply to the bank’s aggregated exposure on both businesses).



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## CA-4.2 Segregation of Claims (continued)

### CA-4.2.19A

The RW for RRE may be reduced to 35% subject to meeting all of the criteria below:

- (a) The RRE is to be utilised for residential purposes only;
- (b) The subject matter of RRE must be pledged as collateral (or serve as quasi-collateral) to the Islamic bank licensee in the case of Murabaha, IMB or diminishing Musharakah;
- (c) There exists a legal infrastructure in the jurisdiction whereby the Islamic bank licensee can enforce the repossession and liquidation of the RRE; and
- (d) The Islamic bank licensee must obtain a satisfactory legal opinion that foreclosure or repossession as mentioned in (c) above is possible without any impediment.

### CA-4.2.19B

The RW for residential mortgage exposure granted under the Social Housing Schemes of the Kingdom of Bahrain may be reduced to 25% subject to meeting conditions, (a) and (b) in CA-4.2.19A. The reduced risk weight is subject to ensuring the compliance with the requirements for timely recognition of expected credit loss (ECL) as per the Credit Risk Management Module (Module CM).





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## CA-4.2 Segregation of Claims (continued)

### *Claims Secured by Commercial Real Estate*

#### CA-4.2.20

Financing facilities secured by mortgages on commercial real estate are subject to a minimum of 100% risk weight but may be subject to higher risk weights depending on the financing structure (see CA-3). If the borrower is rated below BB-, the risk-weight corresponding to the rating must be applied.

### *Past Due Receivables*

#### CA-4.2.21

In the event that accounts receivable or lease payments receivable become past due, the exposure must be risk-weighted in accordance with the following table. The exposures should be risk weighted net of specific provisions (see Paragraph CA-4.3.5 for exposures risk-weighted under Supervisory Slotting Criteria).

Type	RW	% of Specific Provisions for Past Due Receivables
Unsecured exposure (other than a qualifying residential mortgage finance facility) that is 90 days or more past due, net of specific provisions	150%	Less than 20% of the outstanding receivables.
	100%	At least 20% of the outstanding receivables.
Exposure secured by RRE	100%	For receivables that are 90 days or more past due.



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## CA-4.2 Segregation of Claims (continued)

**CA-4.2.22** For the purposes of defining the secured portion of a past due receivable, eligible collateral and guarantees will be the same as for credit risk mitigation purposes.

**CA-4.2.23** Past due retail receivables are to be excluded from the overall regulatory retail portfolio when assessing the granularity criterion, for risk-weighting purposes.

### *Investments in Equities and Funds (not including Real Estate)*

**CA-4.2.24** Investments in listed equities below the thresholds mentioned in Chapter CA-2 must be risk weighted at 100% while unlisted equities must be risk weighted at 150% provided they are not subject to other treatments described in this paragraph and in CA-4.2.25-26 below. The amount of any significant investments in commercial entities above the 15% and 60% Total Capital materiality thresholds (see Paragraph CA-2.4.25) must be weighted at 800%. Significant investments in the common shares of unconsolidated financial institutions and Mortgage Servicing Rights and Deferred Tax Assets arising from temporary differences must be risk weighted at 250% if they have not already been deducted from CET1 as required by Paragraphs CA-2.4.15 to CA-2.4.24. For risk-weighting of Sukuk, refer to Chapter CA-8.

**CA-4.2.25** Investments in funds (e.g. mutual funds, Collective Investment Undertakings etc.) must be risk weighted as follows:

- (a) If the instrument (e.g. units) is rated, it should be risk-weighted according to its external rating (for risk-weighting, it must be treated as a “claim on corporate”);
- (b) If not rated, such investment should be treated as an equity investment and risk weighted accordingly (i.e. 100% for listed and 150% for unlisted);
- (c) The Islamic bank licensee can apply to CBB for using the look-through approach for such investments if it can demonstrate that the look-through approach is more appropriate to the circumstances of the Islamic bank licensee;
- (d) If there are no voting rights attached to investment in funds, the investment will not be subjected to consolidation, deduction or additional risk-weighting requirements (in respect of large exposure and significant investment limits);
- (e) For the purpose of determining “large exposure limit” for investment in funds, the look-through approach should be used (even if the look-through approach is not used to risk weight the investment).



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## CA-4.2 Segregation of Claims (continued)

CA-4.2.26 CBB may require an Islamic bank licensee to adopt the ‘Simple Risk Weight Method’ for equities (Section CA-4.4) if the CBB considers that Islamic bank licensee’s equity portfolio is significant.

### *Large Exposures over the Limits in Module CM*

CA-4.2.26A The amount of any large exposures exceeding the limits set in Chapter CM-4 must be weighted at 800%.

### *Holdings of Real Estate*

CA-4.2.27 See Chapter CA-9 for full details. All direct holdings of real estate by Islamic bank licensees (i.e. owned directly by the Islamic bank licensee on balance sheet) must be risk-weighted at 200%. Premises occupied by the Islamic bank licensee must be risk-weighted at 100%. Investments in Real Estate Companies (e.g. by way of investments in the common equity of subsidiaries or associates or other arrangements such as trusts, funds or REITs) must be risk-weighted at 300% or 400% as outlined in Chapter 9 of this Module. Such equity investments will be subject to the materiality thresholds for commercial companies described in Paragraph CA-2.4.25 and therefore any holdings which amount to 15% or more of Total Capital will be subject to a 800% risk weight.

### *Other Assets*

CA-4.2.28 Gold bullion held in own vaults or on an allocated basis to the extent backed by bullion liabilities must be treated as cash and therefore risk-weighted at 0%. In addition, cash items in the process of collection must be risk-weighted at 20%. The standard risk weight for all other assets will be 100%. Investments in regulatory capital instruments issued by banks or investment firms must be risk weighted at a minimum of 100%, unless they are deducted from the regulatory capital according to the corresponding deduction approach in Section CA-2.4 of this Module.



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## CA-4.2 Segregation of Claims (continued)

### *Underwriting of Non-trading Book Items*

#### CA-4.2.29

Underwritings of capital instruments issued by other banking, financial or insurance entities are covered in Subparagraph CA-2.4.16(c) and CA-2.4.20(c). The large exposures limits of Chapter CM-4 apply for underwritings. This means the 800% risk weights apply for underwritings in excess of the limits set in Chapter CM-4. The risk weights below apply for exposures within the limits of Chapter CM-4. Where an Islamic bank licensee has acquired assets on its balance sheet in the banking book which it is intending to place with third parties under a formal arrangement, the following risk weightings apply for no more than 90 days. Once the underwriting period has expired, the usual risk weights must apply.

- (a) For holdings of private equity (within large exposures limits), a risk weighting of 100% applies instead of the usual 150% (see Paragraph CA-4.2.24); and
- (b) For holdings of real estate (within large exposures limits), a risk weight of 200% applies instead of the usual 300% or 400% risk weight (see Paragraph CA-4.2.27).

#### CA-4.2.30

Netting arrangements between financing assets and deposits will be permitted subject to the satisfaction of conditions in this Paragraph. The net exposure can be used for capital adequacy purposes if the Islamic bank licensee has a legally enforceable arrangement for netting or offsetting the financing assets and the deposits, irrespective of whether the counterparty is insolvent or bankrupt. The Islamic bank licensee must have a robust system of monitoring those financing assets and deposits with the counterparty that is subject to the netting arrangements. In using the net exposure for the calculation of capital adequacy, financing assets must be treated as exposures and deposits as collateral in the comprehensive approach (as per the formula provided in Paragraph CA-4.7.23). A zero haircut is applicable, except in the case of a currency mismatch.



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### CA-4.3 Supervisory Slotting Criteria

[This section was deleted in January 2015.]



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## CA-4.4 Simple Risk Weight Method

CA-4.4.1 As stated in Paragraph CA-4.2.26, the CBB may require an Islamic bank licensee to adopt the simple risk weight method for equities if the CBB considers that the Islamic bank licensee's equity portfolio is significant.

**CA-4.4.2** The RW under the simple risk weight method for equity position risk in respect of an equity exposure must be 300% for listed and 400% for unlisted less any specific provisions for impairment. If there is a third party guarantee to make good impairment losses, the RW of the guarantor must be substituted for that of the assets for the amount of any such guarantee.



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## CA-4.5 Risk Weighting – Off-balance Sheet Items

CA-4.5.1 Off-balance sheet items must be converted into credit exposure equivalents using credit conversion factors (CCFs).

CA-4.5.2 Commitments with an original maturity of up to one year and commitments with an original maturity of over one year will receive a CCF of 20% and 50%, respectively.

CA-4.5.3 Any commitments that are unconditionally cancellable at any time by the Islamic bank licensee without prior notice, or that are subject to automatic cancellation due to deterioration in a borrowers' creditworthiness, must receive a 0% CCF.

CA-4.5.4 A CCF of 100% must be applied to the lending of other banks' securities or the posting of securities as collateral by banks.

CA-4.5.5 For short-term self-liquidating trade letters of credit arising from the movement of goods a 20% CCF must be applied to both issuing or confirming banks. See also Paragraph CA-4.2.11A.

CA-4.5.6 An import or export financing, which is based on Murabahah where the underlying goods/shipment are collateralised and insured, must attract a 20% credit conversion factor to the Islamic bank licensees that issues or confirms the letter of credit. This treatment of collateral assumes there are no obstacles to the exercise of rights over it by the issuer or confirmer (see Pledge of assets as collateral as detailed below under Credit Risk Mitigation).

CA-4.5.7 Direct credit substitutes, e.g. general guarantees of indebtedness (including standby letters of credit serving as financial guarantees for finance and securities) and acceptances (including endorsements with the character of acceptances) must be applied a CCF of 100%.

CA-4.5.8 Shari'a compliant sale and repurchase agreements, securitised lending/borrowing and asset sales with recourse, where the credit risk remains with the Islamic bank licensee, must be applied a CCF of 100%.

CA-4.5.9 Forward asset purchases, forward deposits and partly-paid shares and securities, which represent commitments with certain drawdown must be applied a CCF of 100%.

CA-4.5.10 Certain transaction-related contingent items (e.g. performance bonds, bid bonds, and warranties) must be applied a CCF of 50%.



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## CA-4.5 Risk Weighting – Off-balance Sheet Items (continued)

**CA-4.5.11** Note issuance facilities and revolving underwriting facilities must be applied a CCF of 50%.

**CA-4.5.12** Islamic bank licensees must closely monitor securities, commodities, and foreign exchange transactions that have failed, starting the first day they fail. A capital charge to failed transactions must be calculated in accordance with CBB guidelines set forth in Appendix CA-4 – ‘Capital treatment for failed trades and non DvP transactions’.

CA-4.5.13 With regard to unsettled securities, commodities, and foreign exchange transactions, Islamic bank licensees are encouraged to develop, implement and improve systems for tracking and monitoring the credit risk exposure arising from unsettled transactions as appropriate for producing management information that facilitates action on a timely basis.

**CA-4.5.14** When transactions mentioned in Paragraph CA-4.5.12 are not processed through a delivery-versus-payment (DvP) or payment-versus-payment (PvP) mechanism, Islamic bank licensees must calculate a capital charge as set forth in Appendix CA-4.

CA-4.5.15 Shari’a-compliant over-the-counter (OTC) hedging contracts expose an Islamic bank licensee to counterparty credit risk (CCR). CCR refers to the risk that the counterparty to a transaction could default before the final settlement of the transaction’s cash flows. An economic loss would occur if the transactions, or portfolio of transactions, with the counterparty had a positive economic value at the time of default. Unlike an Islamic bank licensee’s exposure to credit risk through a financing arrangement, where the exposure to credit risk is unilateral and only the Islamic bank licensee financing the transaction faces the risk of loss, CCR involves a bilateral risk of loss; that is, the market value of the transaction can be positive or negative on either counterparty to the transaction, depending on the movements in the market prices of the underlying variables.

**CA-4.5.16** A credit equivalent for Shari’a-compliant hedging techniques can be derived using the Current Exposure Method.<sup>24</sup> The credit equivalent exposure is based on the positive mark-to-market replacement cost of the contract. An add-on factor must be added to cover for potential future credit exposure. (See Appendix CA-2 for full details. Also see Paragraph CA-4.7.20 for conditions for applying 0% RW to such contracts.)

<sup>24</sup> Current exposure is the larger of zero or the market value of a transaction, or portfolio of transactions with a counterparty that would be lost upon the default of the counterparty, assuming no recovery on the value of those transactions in bankruptcy. Current exposure is often also called replacement cost (see Appendix CA-2 for details).





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## CA-4.6 External Credit Assessments

### *The Recognition Process and Eligibility Criteria*

CA-4.6.1 CBB will assess all External Credit Assessment Institutions (ECAI) according to the six criteria below. Any failings, in whole or in part, to satisfy these to the fullest extent will result in the respective ECAI's methodology and associated resultant rating not being accepted by the CBB:

- (a) **Objectivity:** The methodology for assigning credit assessments must be rigorous, systematic, and subject to some form of validation based on historical experience. Moreover, assessments must be subject to ongoing review and responsive to changes in financial condition. Before being recognized by the CBB, an assessment methodology for each market segment, including rigorous back testing, must have been established for an absolute minimum of one year and with a preference of three years;
- (b) **Independence:** An ECAI must show independence and should not be subject to political or economic pressures that may influence the rating. The assessment process should be as free as possible from any constraints that could arise in situations where the composition of the board of directors, political pressure, the shareholder structure of the assessment institution or any other aspect could be seen as creating a conflict of interest;
- (c) **International access/Transparency:** The individual assessments, the key elements underlining the assessments and whether the issuer participated in the assessment process should be publicly available on a non-selective basis, unless they are private assessments. In addition, the general procedures, methodologies and assumptions for arriving at assessments used by the ECAI should be publicly available;
- (d) **Disclosure:** An ECAI should disclose the following information: its code of conduct; the general nature of its compensation arrangements with assessed entities; its assessment methodologies, including the definition of default, the time horizon, and the meaning of each rating; the actual default rates experienced in each assessment category; and the transitions of the assessments, e.g. the likelihood of AA ratings becoming A over time;
- (e) **Resources:** An ECAI must have sufficient resources to carry out high quality credit assessments. These resources should allow for substantial ongoing contact with senior and operational levels within the entities assessed in order to add value to the credit assessments. Such assessments will be based on methodologies combining qualitative and quantitative approaches; and
- (f) **Credibility:** Credibility, to a certain extent, can derive from the criteria above. In addition, the reliance on an ECAI's external credit assessments by independent parties (investors, insurers, trading partners) may be evidence of the credibility of the assessments of an ECAI. The credibility of an ECAI will also be based on the existence of internal procedures to prevent the misuse of confidential information. In order to be eligible for recognition, an ECAI does not have to assess firms in more than one country.



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## CA-4.6 External Credit Assessments (continued)

CA-4.6.2 The CBB recognises Standard and Poor’s, Moody’s, Fitch IBCA, Capital Intelligence and the Islamic International Rating Agency as eligible ECAIs. With respect to the possible recognition of other rating agencies as eligible ECAIs, CBB will update this paragraph subject to the rating agencies satisfying the eligibility requirements. (See Appendix CA-7 for mapping of eligible ECAIs).

**CA-4.6.3** Islamic bank licensees must use the chosen ECAIs and their ratings consistently for each type of claim, for both risk weighting and risk management purposes. Islamic bank licensees will not be allowed to “cherry-pick” the assessments provided by different eligible ECAIs and to arbitrarily change the use of ECAIs.

**CA-4.6.4** Islamic bank licensees must disclose in their annual reports the ECAIs that they use for the risk weighting of their assets by type of claims, the risk weights associated with the particular rating grades as determined by the CBB through the mapping process as well as the aggregated risk-weighted assets for each risk weight based on the assessments of each eligible ECAI.

### *Multiple Assessments*

**CA-4.6.5** If there are two assessments by eligible ECAIs chosen by an Islamic bank licensee which map into different risk weights, the higher risk weight must be applied.

**CA-4.6.6** If there are three or more assessments by eligible ECAIs chosen by an Islamic bank licensee which map into different risk weights, the assessments corresponding to the two lowest risk weights must be referred to and the higher of those two risk weights must be applied.

### *Issuer Versus Issues Assessment*

CA-4.6.7 Where a bank invests in a particular issue that has an issue-specific assessment, the risk weight of the claim will be based on this assessment. Where the bank’s claim is not an investment in a specific assessed issue, the following general principles apply:

- (a) In circumstances where the borrower has a specific assessment for an issued debt — but the bank’s claim is not an investment in this particular debt — a high quality credit assessment (one which maps into a risk weight lower than that which applies to an unrated claim) on that specific debt may only be applied to the bank’s un-assessed claim if this claim ranks pari passu or senior to the claim with an assessment in all respects. If not, the credit assessment cannot be used and the un-assessed claim will receive the risk weight for unrated claims; and



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## CA-4.6 External Credit Assessments (continued)

- (b) In circumstances where the borrower has an issuer assessment, this assessment typically applies to senior unsecured claims on that issuer. Consequently, only senior claims on that issuer will benefit from a high quality issuer assessment. Other un-assessed claims of a highly assessed issuer will be treated as unrated. If either the issuer or a single issue has a low quality assessment (mapping into a risk weight equal to or higher than that which applies to unrated claims), an un-assessed claim on the same counterparty will be assigned the same risk weight as is applicable to the low quality assessment.

### CA-4.6.8

Whether the Islamic bank licensee intends to rely on an issuer- or an issue-specific assessment, the assessment must take into account and reflect the entire amount of credit risk exposure the Islamic bank licensee has with regard to all payments owed to it.<sup>25</sup>

### CA-4.6.9

In order to avoid any double counting of credit enhancement factors, no recognition of credit risk mitigation techniques will be taken into account if the credit enhancement is already reflected in the issue specific rating (see Paragraph CA-4.7.3).

### *Domestic Currency and Foreign Currency Assessments*

### CA-4.6.10

Where unrated exposures are risk weighted based on the rating of an equivalent exposure to that borrower, the general rule is that foreign currency ratings must be used for exposures in foreign currency. Domestic currency ratings, if separate, must only be used to risk weight claims denominated in the domestic currency.

### CA-4.6.11

However, when an exposure arises through an Islamic bank licensee's participation in a credit facility that has been extended, or has been guaranteed against convertibility and transfer risk, by certain MDBs, its convertibility and transfer risk can be considered by CBB, on a case by case basis, to be effectively mitigated. To qualify, MDBs must have preferred creditor status recognised in the market and be included in MDB's qualifying for 0% risk rate under Paragraph CA-4.2.8. In such cases, for risk weighting purposes, the borrower's domestic currency rating may be used instead of its foreign currency rating. In the case of a guarantee against convertibility and transfer risk, the local currency rating can be used only for the portion that has been guaranteed. The portion of the loan not benefiting from such a guarantee will be risk-weighted based on the foreign currency rating.

<sup>25</sup> For example, if a bank is owed both principal and interest, the assessment must fully take into account and reflect the credit risk associated with repayment of both principal and interest.



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## CA-4.6 External Credit Assessments (continued)

### *Short-term/Long-term Assessments*

#### CA-4.6.12

For risk-weighting purposes, short-term assessments are deemed to be issue-specific. They can only be used to derive risk weights for claims arising from the rated facility. They cannot be generalised to other short-term claims, except under the conditions of Paragraph CA-4.6.14. In no event can a short-term rating be used to support a risk weight for an unrated long-term claim. Short-term assessments may only be used for short-term claims against banks and corporates. The table below provides a framework for banks' exposures to specific short-term facilities, such as a particular issuance of commercial paper: For any Sharia 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 must be applied.

Credit assessment	A-1/P-1 <sup>26</sup>	A-2/P-2	A-3/P-3	Others <sup>27</sup>
Risk weight	20%	50%	100%	150%

#### CA-4.6.13

If a short-term rated facility attracts a 50% risk-weight, unrated short-term claims cannot attract a risk weight lower than 100%. If an issuer has a short-term facility with an assessment that warrants a risk weight of 150%, all unrated claims, whether long-term or short-term, must also receive a 150% risk weight, unless the Islamic bank licensee uses recognised credit risk mitigation techniques for such claims.

#### CA-4.6.14

For short-term claims on Islamic bank licensees, the interaction with specific short-term assessments is expected to be the following:

- The general preferential treatment for short-term claims, as defined under Paragraphs CA-4.2.11 and CA-4.2.12, applies to all claims on Islamic bank licensees of up to three months original maturity when there is no specific short-term claim assessment;
- When there is a short-term assessment and such an assessment maps into a risk weight that is more favourable (i.e. lower) or identical to that derived from the general preferential treatment, the short-term assessment should be used for the specific claim only. Other short-term claims would benefit from the general preferential treatment; and
- When a specific short-term assessment for a short term claim on an Islamic bank licensee maps into a less favourable (higher) risk weight, the general short-term preferential treatment for inter-bank claims cannot be used. All unrated short-term claims should receive the same risk weighting as that implied by the specific short-term assessment.

<sup>26</sup> The notations follow the methodology used by Standard & Poor's and by Moody's Investors Service. The A-1 rating of Standard & Poor's includes both A-1+ and A-1-.

<sup>27</sup> This category includes all non-prime and B or C ratings.



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## CA-4.6 External Credit Assessments (continued)

CA-4.6.15 When a short-term assessment is to be used, the institution making the assessment needs to meet all of the eligibility criteria for recognising ECAIs as presented in Paragraph CA-4.6.1 in terms of its short-term assessment.

### *Level of Application of the Assessment*

**CA-4.6.16** External assessments for one entity within a corporate group must not be used to risk weight other entities within the same group.

### *Unsolicited Ratings*

CA-4.6.17 Unsolicited ratings should be treated as unrated exposures.



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## CA-4.7 Credit Risk Mitigation

### *Overarching Issues*

CA-4.7.1 The exposure in respect of an obligor or other, counterparty can be further adjusted or reduced by taking into account the credit risk mitigation (CRM) techniques employed by Islamic banks (off-balance sheet items will first be converted into on-balance sheet equivalents prior to the CRM being applied).

**CA-4.7.2 The effects of CRM will not be double counted. Therefore, no additional recognition of CRM for regulatory capital purposes is applicable on claims for which an issue-specific rating is used that already reflects that CRM.**

CA-4.7.3 While the use of CRM techniques reduces or transfers credit risk, it simultaneously may increase other risks (residual risks). Residual risks include legal, operational, liquidity and market risks. Therefore, it is imperative that Islamic bank licensees employ robust procedures and processes to control these risks, including strategy; consideration of the underlying credit; valuation; policies and procedures; systems; control of roll-off risks; and management of concentration risk arising from the Islamic bank licensee's use of CRM techniques and its interaction with the Islamic bank licensee's overall credit risk profile. Where these risks are not adequately controlled, the CBB may impose additional capital charges or take supervisory actions.

**CA-4.7.4 The collateral used as a part of CRM must be compliant with Shari'a requirements. The collateralisation<sup>28</sup> must be properly documented in a security agreement or in the body of a contract to the extent permissible by Shari'a and must be binding on all parties and legally enforceable in the relevant jurisdictions. The Islamic bank licensee must ensure that the CRM documentation is legally enforceable and must carry out periodic reviews to confirm its enforceability at all times. The Islamic bank licensee cannot recognise a commitment to provide collateral or a guarantee as an eligible CRM unless such a commitment is actually executed.**

**CA-4.7.5 There should be a negligible positive correlation, if any, between the value of collateral and the credit quality of a counterparty. Consequently, securities issued by a counterparty or its related entities are not eligible as collateral.**

**CA-4.7.6 For a collateralised transaction – such as Shari'a-compliant alternatives to repo/reverse repo or borrowing/lending of Sukuk and Islamic securities – capital requirements must be applicable on either side of the transaction.**

<sup>28</sup> Generally, in banks such collateralisation takes place under the concept of “Rahn” or “Kafalah”.



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## CA-4.7 Credit Risk Mitigation (continued)

### *Guarantees*

#### CA-4.7.7

Capital relief for the use of a guarantee is given when the following conditions are satisfied:

- (a) The guarantee represents the Islamic bank licensee's direct claim on the guarantor, and it must be explicitly referenced to specific exposures or a pool of exposures so that the extent of the cover is clearly defined and incontrovertible;
- (b) The guarantee is irrevocable and does not allow the guarantor to unilaterally cancel the guarantee after creation of the receivables;
- (c) 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;
- (d) The Islamic bank licensee 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;
- (e) The guarantee is an explicitly documented and legally enforceable obligation assumed by the guarantor in all relevant jurisdictions. There must be a well-founded legal basis to reach this conclusion; and
- (f) The guarantee covers all types of expected payments made under the contract in the event that the original counterparty defaults.

#### CA-4.7.8

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

#### CA-4.7.9

Takaful is not allowed as a credit risk mitigation technique.

### *Leased Assets Used as Collateral*

#### CA-4.7.10

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



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## CA-4.7 Credit Risk Mitigation (continued)

### *Pledge of Assets as Collateral*

#### CA-4.7.11

The pledged asset must be a Shari'a-compliant asset of monetary value that can be lawfully owned, and is saleable, specifiable, deliverable and free of encumbrance. The pledge must be legally enforceable. The asset pledged may either be the underlying asset, or any other eligible financial collateral owned by the customer (see Paragraph CA-4.7.25). The pledge of an asset owned by a third party is subject to the owner's consent to the pledge. Murabaha facilities secured by real estate are covered separately in Paragraphs CA-4.2.19 to CA-4.2.20.

#### CA-4.7.12

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

#### CA-4.7.13

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





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## CA-4.7 Credit Risk Mitigation (continued)

### *Types of Eligible Collateral and Credit Risk Mitigants*

#### CA-4.7.14

The types of collateral are eligible for relief in respect of the CRM techniques outlined in Paragraphs CA-4.7.7 to CA-4.7.13 include:

- (a) Cash on deposit<sup>29</sup> with the Islamic bank licensee which is incurring the exposure;
- (b) Sukuk rated by an external rating agency which is issued by:
  - (i) Sovereigns and PSEs (treated as sovereigns) with a minimum rating of BB-; or
  - (ii) Issuers other than the above and other than the concerned Islamic bank licensee, with a minimum rating of BBB- or A-3/ P-3;
- (c) Unrated Sukuk but which fulfil each of the following criteria:
  - (i) Issued by a bank other than the concerned Islamic bank licensee or a sovereign;
  - (ii) Listed on a recognised exchange;
  - (iii) All other rated issues by the issuing Islamic bank or conventional bank must be rated at least BBB - or A-3/P-3 by a recognised ECAI, as determined by the CBB;
  - (iv) The Islamic bank 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 Islamic bank licensee must show that these Sukuk are liquid in a two-way market;
- (d) Shari'a compliant equities and units in Islamic collective investment undertakings that are listed in a main index excluding those issued by the concerned bank (which are subject to the treatments for holdings of own instruments outlined in Paragraph CA-2.4.12);
- (e) Shari'a compliant 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) Islamic banks or conventional banks; and
  - (vi) Corporate entities (including Takaful and Shari'a compliant securities firms) either by the parent, subsidiary and/or affiliates, of a minimum rating of A-; and

<sup>29</sup> Must be supported by an agreement or documentation that gives the bank the right of set-off against the amount of receivables due. The treatment of netting of such deposits are outlined in Paragraph CA-4.2.30.



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#### CA-4.7 Credit Risk Mitigation (continued)

- (f) Certain physical assets fulfilling the function of collateral, as stated in Paragraph CA-4.7.10 (See also section CA-3.5).

**CA-4.7.14A** Credit default guarantee provided by Tamkeen is recognised as an eligible credit risk mitigant.

**CA-4.7.15** Any portion of the exposure which is not collateralised must be assigned the RW of the counterparty.

**CA-4.7.16** Capital relief against the collateral can be granted based on either the simple or the comprehensive approach as described below in reducing the risk exposures in the banking book. Islamic bank licensees must approach the CBB for approval before using the comprehensive approach. Islamic bank licensees can use partial collateralisation in both approaches. Maturity mismatches between exposure and collateral will only be allowed under the comprehensive approach.

##### *The Simple Approach*

**CA-4.7.17** The Islamic bank licensee can substitute the RW of the collateral for the RW of the counterparty for the collateralised portion of the exposure, subject to the collateral being pledged for at least the duration of the contract. The minimum RW of the collateralised portion is not lower than 20% (with a limited exception in Paragraph CA-4.7.19B).

**CA-4.7.18** The uncollateralised portion of the exposure continues to be assigned the RW of the counterparty.

**CA-4.7.19** A 0% RW is applied to the collateralised portion under the simplified method where the exposure and the collateral are denominated in the same currency, and the collateral consists of any of the following:

- (a) Cash or cash equivalents;
- (b) A deposit with the Islamic bank licensee; or
- (c) Sovereign/ PSE securities eligible for a 0% RW, and the market value of such securities has been discounted by 20%.



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## CA-4.7 Credit Risk Mitigation (continued)

### *Shari'a Compliant Hedging Instruments*

#### CA-4.7.20

Shari'a-compliant hedging instruments which are normally traded OTC can be given a RW of 0% provided the conditions set out in the following are met. (In case these conditions are not fulfilled, see Paragraphs CA-4.5.10 and CA-4.5.11 for calculating the credit equivalent using the Current Exposure Method).

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

### *The Comprehensive Approach*

#### CA-4.7.21

In the comprehensive approach, the exposure to a counterparty is adjusted based on the collateral used without the 20% floor of the simple approach. The Islamic bank licensee must adjust both the amount of the exposure to the counterparty and the value of the collateral shown in Paragraph CA-4.7.25, using haircuts and add-ons in order to reflect variations in the value of both the exposure and the collateral due to market movements. The resultant volatility-adjusted amount of exposure and collateral is used for the calculation of capital requirements for the underlying risk exposure. In most cases, the adjusted exposure is higher than the unadjusted exposure after application of the add-on and adjusted collateral is lower than the unadjusted collateral after application of the haircut, unless either of them is cash. An additional downward adjustment for collateral must be made if the underlying currencies of exposure and collateral are not denominated in the same currency, so as to take account of foreign exchange fluctuations in the future.

#### CA-4.7.22

Risk-weighted assets must be calculated by calculating the difference between the volatility adjusted exposure and the volatility-adjusted collateral and multiplying this adjusted exposure by the RW of the counterparty.<sup>30</sup>

<sup>30</sup> This calculation will be carried out when the volatility-adjusted exposure amount is greater than the volatility-adjusted collateral amount, including any additional adjustment for foreign exchange risk.



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## CA-4.7 Credit Risk Mitigation (continued)

**CA-4.7.23** The formula for calculation of the adjusted exposure after incorporating risk mitigation using the comprehensive approach is as follows:

- $E^* = \max \{0, [E \times (1 + H_e) - C \times (1 - H_c - H_{fx})]\}$ , where:  
 $E^*$  = Adjusted exposure amount after risk mitigation  
 $E$  = Exposure amount  
 $H_e$  = Applicable add-on for exposure  
 $C$  = The current value of underlying collateral  
 $H_c$  = Applicable haircut for collateral  
 $H_{fx}$  = Applicable haircut for foreign exchange exposure, in case exposure and collateral have dissimilar currencies

**CA-4.7.24** If more than one asset is involved in a collateralised transaction, the haircut on the basket ( $H$ ) will be a weighted sum of applicable haircuts to each asset ( $H_i$ ), with asset weights ( $a_i$ ) measured by units of currency – that is,  $H = \sum a_i H_i$ .

### *The Standard Supervisory Haircuts and Add-Ons*

**CA-4.7.25** Both the amount of exposure to counterparty and the value of collateral received are adjusted by using standard supervisory add-ons and haircuts as set out below with the exception of any exposures collateralised by own securities which are subject to treatment under Subparagraph CA-4.7.14(d) (and Chapter CA-2 as applicable):



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#### CA-4.7 Credit Risk Mitigation (continued)

Types of Collateral*	Residual Maturity (yrs)	Haircuts (%)	
		Sovereigns <sup>31</sup>	Others
Cash on deposit	All	0	0
Sukuk	≤ 1	0.5	1
Long-term: AAA to AA- and	> 1 to ≤ 5	2	4
Short-term: A-1	> 5	4	8
Sukuk	≤ 1	1	2
Long-term: A+ to BBB- and	> 1 to ≤ 5	3	6
Short-term: A-2 to A-3	> 5	6	12
Sukuk	All	15	15
Long-term: BB+ to BB-			
Sukuk (unrated)	All	25	25
Equities (listed and included in main index)	All	15	15
Equities (listed but not included in main index)	All	25	25
Units in collective investment schemes	All	Depending on the underlying assets as above	Depending on the underlying assets as above
Certain physical assets fulfilling the role of collateral in accordance with CA-4.7.10 (except real estate - see CA-4.2.19 to CA-4.2.20)	All	≥30	≥30

\* Collateral denominated in a different currency will also be subject to an additional 8% haircut to cater for foreign exchange risk (see Paragraph CA-4.7.26).

<sup>31</sup> Includes PSEs and MDBs



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## CA-4.7 Credit Risk Mitigation (continued)

### CA-4.7.26

The standard haircut for currency risk where exposure and collateral are denominated in different currencies is 8% (also based on a 10-business day holding period and daily mark-to-market). For transactions in which the Islamic bank licensee lends non-eligible instruments (e.g. non- investment grade securities), the haircut to be applied on the exposure must be the same as the one for equity traded on a recognised exchange that is not part of a main index.

### *Maturity Mismatch*

### CA-4.7.27

A maturity mismatch is a situation where the residual maturity of the CRM is less than that of the underlying credit exposure. In the case of a maturity mismatch with the CRM having a maturity of less than one year, the CRM is not recognised. This means that a CRM with a maturity mismatch is only permitted where its original maturity is at least one year. The simple approach must not be used for CRM with maturity mismatches.

### CA-4.7.28

The following adjustment must be applied for a CRM with a maturity mismatch:

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

$P_a$  = adjusted value of risk mitigation

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

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

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

### *Credit Risk Mitigation for Mudarabah Classified as Equity Exposures*

### CA-4.7.29

A placement of funds made under a Mudarabah contract may be subject to a Shari'a-compliant guarantee from a third party. Such a guarantee relates only to the Mudarabah capital, not to the return. In such cases, the capital must 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 Mudarib as a counterparty. Otherwise, the RW of the Mudarib must apply; that is, a RW for "equity exposure in banking book" applies, as per Paragraphs CA-4.8.16 to 4.8.18.



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## CA-4.7 Credit Risk Mitigation (continued)

CA-4.7.30 In a Mudarabah investment in project finance, collateralisation of the progress payments made by the ultimate customers (e.g. by means of a "repayment account" – see Paragraph CA-4.8.18) can be used to mitigate the exposure to unsatisfactory performance by the Mudarib.

CA-4.7.31 An Islamic bank licensee may also place liquid funds with a central bank or another Islamic bank licensee on a short-term Mudarabah basis in order to obtain a return on those funds. Such placements serve as an interbank market transaction with maturities ranging from overnight up to three months, but the funds may be withdrawn on demand before the maturity date, in which case the return is calculated proportionately on the basis of duration and amount. Although from a juristic point of view the amounts so placed do not constitute debts, since (in the absence of misconduct or negligence) Mudarabah capital does not constitute a liability for the Mudarib, in practice the operation of this interbank market requires that the Mudarib should effectively treat them as liabilities. Hence, an Islamic bank licensee placing funds on this basis may treat them as cash equivalents and, for risk-weighting purposes, apply the RW applicable to the Mudarib as counterparty.

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

CA-4.7.32

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



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## CA-4.8 Exposures in Investments Made under Profit-Sharing Modes

CA-4.8.1 An Islamic bank licensee may provide financing and hold investments made under profit- and loss-sharing modes (Musharakah) or profit-sharing and loss-bearing modes (Mudarabah) which may be used, inter alia, to invest in the following:

- (a) A commercial enterprise to undertake a business venture (with the intention of holding the investment for an indefinite period or with a view to eventual sale, such as venture capital investments or privately held equity);
- (b) Diminishing Musharakah in which the share of the Islamic bank licensee can be gradually reduced during the tenure of the contract until the asset is fully sold to the partner(s);
- (c) An equity investment in a company or an Islamic collective investment scheme not held for short-term resale or trading purposes<sup>32</sup>;
- (d) A specific project; or
- (e) A joint ownership of real assets or movable assets (such as cars) on a Musharakah basis for onward lease or sale on an Ijara or a Mudarabah basis, respectively (i.e. Musharakah with an Ijara or Mudarabah sub-contract).

CA-4.8.2 This Section covers exposures of the Islamic bank licensees mentioned in Paragraph CA-4.8.1 that are held not for trading but for the purpose of earning investment returns from medium- to long-term financing (i.e. held in the "banking book"). Such investments are:

- (a) Not held with the intent of trading or short-term resale benefiting from actual or expected price movements (as in Subparagraph CA-4.8.1(a));
- (b) Not marked-to-market on a daily basis;
- (c) Not actively monitored with reference to market sources; and
- (d) Exposed to credit risk in the form of capital impairment risk.

### *Commercial Enterprise to Undertake a Business Venture*

#### CA-4.8.3

In assigning the RW, consideration is given to the intent of the profit-sharing investment, and to the nature of the underlying assets. For the purpose of determining minimum capital requirements, the RW is applied based on Paragraphs CA-4.8.4 to CA-4.8.22.

<sup>32</sup> Banking book investments would not normally include investments in listed common shares or listed Islamic collective investment schemes, which would instead be held in the trading book.





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## CA-4.8 Exposures in Investments made under Profit-Sharing Modes (Continued)

CA-4.8.4 Financing on a Musharakah or Mudarabah basis of a commercial enterprise to undertake a business venture can expose an Islamic bank licensee to capital impairment risk as well as credit risk, to an extent that depends on the structure and purpose of the financing and the types of assets in which the funds are invested. Commonly, an Islamic bank licensee would invest in a commercial enterprise with the intention of holding the investment for an indefinite period or with a view to eventual sale (as in the case of venture capital or private equity investments). As an equity investor, the Islamic bank licensee's rights and entitlements are subordinated to the claims of secured and unsecured creditors.

CA-4.8.5 Capital impairment risk is the risk of losing the amount invested in an enterprise or in the ownership of an asset. Such impairments may arise for two kinds of reasons:

- (a) The investee may be unprofitable, so that the Islamic bank licensee as investor fails to recover its investment; and
- (b) The Musharakah partner or Mudarib may fail either:
  - (i) To pay the Islamic bank licensee's share in the profit on a periodical basis, as contractually agreed; or
  - (ii) To settle the Islamic bank licensee's entitlement to its share of the capital and the profits at the time of redemption. The former kind of reason is an impairment of capital without any credit default being involved; whereas the latter, being a failure of the partner to meet its contractual obligations, is a type of credit default.

CA-4.8.6 Bearing in mind the relatively risky nature of financing based on profit-sharing modes, the CBB sets out some prudential conditions on Islamic bank licensees that invest IAH funds in such financing either directly or by commingling the funds of IAH with those of shareholders in such financing (see module CM). Unrestricted investment account holders (UIAH) typically have a small risk appetite and are content with an investment which has a relatively low risk and low returns.

**CA-4.8.7** The RW for investments in commercial enterprises is calculated according to either of the following methods:

- (a) Simple risk-weight method (see also Section CA-4.4), treating the investment as an equity exposure held in the banking book; or
- (b) Supervisory slotting method, considering the investment as a type of specialised financing.



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**CA-4.8 Exposures in Investments made under Profit-Sharing Modes (Continued)**

*Simple Risk Weight Method*

**CA-4.8.8** For Musharakah or Mudarabah investments in commercial enterprises whose common shares are listed on a recognised security exchange, a 300% RW must be applied. For Musharakah or Mudarabah investments in all other enterprises, a 400% RW is applicable.

CA-4.8.9 [This Paragraph has been left blank.]

CA-4.8.10 [This Paragraph has been left blank.]

*Supervisory Slotting Method*

**CA-4.8.11** In project finance, the CBB may permit an Islamic bank licensee to employ an alternative approach, namely the supervisory slotting criteria. Under this method, an Islamic bank licensee is required to map its internal risk grades into four supervisory categories for specialised financing, as described in Appendix CA-5. Each of these categories is associated with a specific RW, as given in the following. These RWs include an additional fixed factor of 20% RW to cater for the potential decline in the Mudarabah’s or Musharakah’s net asset value.

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

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## CA-4.8 Exposures in Investments made under Profit-Sharing Modes (Continued)

### CA-4.8.12

The Islamic bank licensee's position in a diminishing Musharakah entails two kinds of exposures:

- (a) The amounts due from the partner to buy out the agreed shares of the investment on the agreed dates are subject to credit risk in respect of the partner's ability and willingness to pay.<sup>33</sup> The Islamic bank licensee's selling price for each share of ownership being transferred is based either on the fair value of that share at the date of the partial transfer of ownership (which exposes the Islamic bank licensee to capital gains or losses and hence to capital impairment risk) or at a price agreed upon at the time of entering into the contract. The Islamic bank licensee's credit risk exposure in respect of the Musharakah investment 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. If there is a third-party guarantee to make good impairment losses, the RW of the guarantor is substituted for that of the outstanding balance of the Musharakah investment for the amount of any such guarantee; and
- (b) As a joint-owner, the Islamic bank licensee is entitled to its share of income generated from its share of the underlying assets of the Musharakah, such as Ijara lease rentals (e.g. when a home purchase plan is provided by an Islamic bank licensee on the basis of diminishing Musharakah). The rental payable by the partner/customer as Ijara lessee is adjusted periodically to reflect the Islamic bank licensee's remaining ownership share in the asset. The Islamic bank licensee is exposed to credit risk in respect of non-payment of the rentals receivable from the partner/customer.

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<sup>33</sup> Diminishing Musharakah contracts typically contain a clause whereby, in the event of a default by the partner in making a due payment, the bank has the right to terminate the contract and to exercise a put option requiring the partner to buy out the whole of the bank's remaining share of the investment. However, a financially distressed partner will most likely be unable to do so.



MODULE	CA: Capital Adequacy
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#### CA-4.8 Exposures in Investments made under Profit-Sharing Modes (Continued)

##### CA-4.8.13

Based on Paragraph CA-4.8.13, when a diminishing Musharakah contract is related to a specific fixed asset/real estate leased to a customer under an Ijara contract, the Islamic bank licensee's credit exposure is similar to an exposure under a Musharakah with an Ijara sub-contract. In this case, the Musharakah investment is assigned a RW based on the credit standing of the counterparty/lessee, as rated by an ECAI that is approved by the CBB, and 100% RW on residual value of an asset. In case the counterparty is unrated, a RW of 100% applies.

##### CA-4.8.14

If the exposure under the diminishing Musharakah contract consists of working capital finance in the customer's business venture, the Islamic bank licensee must measure its credit risk similarly to an equity exposure held in the banking book, as set out in Paragraphs CA-4.8.4 to CA-4.8.11 (Commercial enterprise to undertake a business venture). This treatment is, however, subject to the consideration of any third-party guarantee to make good impairment losses. In that case, the RW of the guarantor is substituted for that of the outstanding balance of the Musharakah investment for the amount of any such guarantee. Moreover, subject to obtaining prior approval from the CBB, an Islamic bank licensee can use the supervisory slotting method, based on the criteria set out in Appendix CA-6 (diminishing Musharakah).



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(Continued)

*Equity Investments in a Company or an Islamic Collective Investment Scheme Not Held for Short-term Resale or Trading Purposes*

CA-4.8.15

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

*A Specified Project*

CA-4.8.16

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



MODULE	CA: Capital Adequacy
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## CA-4.8 Exposures in Investments made under Profit-Sharing Modes (Continued)

CA-4.8.17 Where Paragraph CA-4.8.17 applies, the Islamic bank licensee is exposed to the risk on the amounts advanced to the Mudarib under the Mudarabah contract, but this risk would be mitigated by the amounts received from the ultimate customer into the "repayment account" which are effectively collateralised. Under the Mudarabah contract the amounts advanced by the Islamic bank licensee to the Mudarib would normally be treated under credit risk as "equity positions in the banking book", the use of the structure involving a "repayment account", whereby the ultimate customer makes payments into such an account with the Islamic bank licensee instead of making payments directly to the Mudarib, has the effect of substituting the credit risk of the ultimate customer for that of the Mudarib to the extent of the collateralised balance of the "repayment account".

CA-4.8.18 In addition to credit risk (i.e. in the absence of a repayment account, the risk that the Mudarib has received payment from the ultimate customer but fails to pay the Islamic bank licensee, or, if the repayment account is used, that the ultimate customer fails to pay), the Islamic bank licensee is exposed to capital impairment in the event that the project results in a loss. The proposed RW and impact of credit risk mitigation are explained in Section CA-4.7.

### *Musharakah with Ijara or Murabaha Sub-contract*

CA-4.8.19

An Islamic bank licensee can establish joint ownership of tangible fixed assets (such as cars, machinery, etc.) with a customer on a Musharakah basis, the assets being leased or sold on an Ijara or a Murabaha basis, respectively. In these cases, the "look-through" principle (whereby the RW is that of the underlying contract) applies.



MODULE	CA: Capital Adequacy
CHAPTER	CA-4: Credit Risk – The Standardised Approach

#### CA-4.8 Exposures in Investments made under Profit-Sharing Modes (Continued)

##### CA-4.8.20

In the case of Ijara, ownership of such assets can produce rental income for the partnership, through leasing the assets to third parties by means of Ijara contracts. In this case, the risk of the Musharakah investment is that of the underlying Ijara contracts – that is, credit risk mitigated by the "quasi-collateral"<sup>34</sup> represented by the leased assets. In the event the asset is leased to the Islamic bank licensee's partner as a customer instead of to a third party, the credit risk relates to the partner's obligation to pay the lease rentals. This Musharakah investment is assigned a RW based on the credit standing of the counterparty/lessee, as rated by a CBB-approved ECAI, plus a 100% RW on the residual value of the Ijara asset. In the event the counterparty is unrated, a RW of 100% applies.

##### CA-4.8.21

In the case of Murabaha, the Islamic bank licensee is entitled to its share of income (mark-up) generated from selling the assets to third parties. The Islamic bank licensee as a capital contributor is exposed to credit risk in respect of the Murabaha receivables from the buyer/counterparty. This Musharakah investment must be assigned a RW based on the credit standing of the counterparty/buyer, as rated by a CBB-approved ECAI. In the event the counterparty is unrated, a RW of 100% applies.

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<sup>34</sup> Strictly speaking, Ijara assets do not provide collateral to the lessor, as the latter owns the assets, but can repossess them in the event of default by the lessee. This provides what may be called "quasi-collateral".