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PART A: INTRODUCTION

1. OVERVIEW

Introduction

- 1.1 Islamic banking institutions mobilise a large proportion of their deposits in the form of *mudharabah* (profit-sharing) contract. Under the *mudharabah* contract, depositors (hereinafter known as investment account holders or IAH) agree to participate in the financial activities undertaken by the Islamic banking institutions (as *mudharib*) and share the profit generated from financing and/or investment activities based on an agreed profit-sharing ratio. The IAH shall bear the losses arising from the assets funded under the *mudharabah* contract or commonly know as profit-sharing investment account (PSIA), except in the case of misconduct, negligence or breach of contracted terms by the Islamic banking institutions.
- 1.2 In Malaysia, Islamic banking institutions generally offer two types of PSIA namely, the General Investment Account (GIA) and the Specific Investment Account (SIA). In managing the GIA and SIA, Islamic banking institutions have full discretion to utilise the funds from GIA (also known as unrestricted investment account) for the provision of finance and/or investments, while the financing and/or investment activities funded by SIA (or restricted investment account) are confined to the investment mandate agreed between the Islamic banking institutions and the IAH.
- 1.3 The contractual relationship between the Islamic banking institutions and the IAH under the PSIA requires the IAH to bear the commercial risks associated with the assets funded by the PSIA. Contractually, these risks are akin to equity in nature, and therefore the credit and market risks on the assets funded by the PSIA are excluded from the risk weighted capital ratio (RWCR) calculation. Essentially, Islamic banking institutions are responsible for managing the investment of assets and the **fiduciary duty** to safeguard the

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interest of the IAH through the establishment of sound and prudent policies in the management of assets funded by the PSIA.

- 1.4 In this regard, the Guidelines on the Recognition and Measurement of Profit Sharing Investment Account as Risk Absorbent (the Guidelines) set out the minimum qualifying requirements for Islamic banking institutions to accord PSIA as a risk absorbent mechanism under the RWCR calculation. For the purpose of this Guidelines, PSIA is defined under paragraph 1.9 (iii). This Guidelines complement and consistent with the prudential standards issued by the Islamic Financial Services Board (IFSB), in particular the Capital Adequacy Standard (CAS) and Guiding Principles on Corporate Governance.
- 1.5 Prior to recognising PSIA as a risk absorbent mechanism, Islamic banking institutions must ensure that it has put in place the following requirements:
- (i) Sound governance in the management of assets and risks associated with the PSIA;
 - (ii) Clear, comprehensive and enforceable PSIA contract stipulating the right and liabilities of the IAH and the Islamic banking institutions;
 - (iii) Strong management and information system to enable Islamic banking institutions to undertake diligent management of assets; and
 - (iv) Disclosure of information to enable the IAH to make informed investment decisions.

Displaced Commercial Risk

- 1.6 A distinct feature in Islamic banking is the application of displaced commercial risks (DCR)¹ concept where Islamic banking institutions may forgo a proportion of its income from assets funded by the PSIA and apportion it share to the IAH as part of smoothening returns and to mitigate potential withdrawal of funds by depositors. The mechanism to operationalise this act could be through Profit Equalisation Reserve (PER).

¹ For the purpose of this guidelines, DCR is defined under paragraph 1.9 (i).

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- 1.7 DCR may arise as a result of the rate of return risk. For instance, Islamic banking institutions may invest the IAH funds into long-maturity assets which may yield lower rate of return compared to the prevailing market expectations. Any attempt by the Islamic banking institutions to match the market expectation may result in the application of DCR².
- 1.8 The application of DCR requires Islamic banking institutions to allocate adequate capital to cover credit and market risks exposures arising from the assets funded by the PSIA, which would otherwise be absorbed by the IAH. This measurement of additional risk borne by the Islamic banking institutions arising from the application of DCR is represented by alpha (α), which quantifies the risk to be absorbed by the Islamic banking institutions for the purpose of the RWCR calculation under the Capital Adequacy Framework³.

Definition

- 1.9 For the purpose of the Guidelines, the following terms shall be applicable:
- (i) Displaced Commercial risks (DCR) refer to the risk arising from the assets managed on behalf of the IAH which is effectively transferred to the Islamic banking institutions' own capital where the Islamic banking institutions forgo part or all of its portion of profits on PSIA, in order to increase the rate of return that would otherwise be payable to the IAH⁴.
 - (ii) Alpha (α) represents the proportion of commercial risk to be absorbed by the Islamic banking institutions arising from the application of DCR. Islamic banking institutions that practice the DCR are required to allocate adequate capital to cover the credit and market risks exposures arising from the assets funded by the PSIA, which would otherwise be absorbed by the IAH.

² Example of DCR is provided in **Appendix IV**

³ See **Appendix I** for the computation of risk weighted capital adequacy ratio.

⁴ Capital Adequacy Standard issued by IFSB.

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- (iii) 'Profit Sharing Investment Account' refers to deposit product structured based on *mudharabah* (profit-sharing) contract where IAH and Islamic banking institution agree to share the profit generated from assets funded by PSIA based on an agreed profit-sharing ratio, while losses shall be borne by the IAH.
- (iv) 'Specific Investment Account (SIA)' refers to PSIA deposits where the IAH provide specific investment mandate to the Islamic banking institution to utilise the SIA funds to finance and/or invest in specific income producing assets. This fund is managed separately from other deposit funds of the Islamic banking institution.
- (v) 'General Investment Account (GIA)' refers to a type of PSIA deposits where full discretion is given to the Islamic banking institutions to utilise the GIA to finance and/or invest in income producing assets.

Applicability

- 1.10 The Guidelines shall be applicable to all Islamic banks licensed under the Islamic Banking Act 1983 (IBA) and banking institutions participating in the Islamic Banking Scheme (IBS) licensed under the Banking and Financial Institutions Act (BAFIA) of 1989.

Scope of the Guidelines

- 1.11 The Guidelines shall form part of the Capital Adequacy Framework for Islamic Banks and the Revised Capital Framework for Banking Institutions issued by Bank Negara Malaysia. The types of PSIA covered under the Guidelines limited to the General Investment Account (GIA) and Specific Investment Account (SIA).

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Legal Provision

1.12 The Guidelines are issued pursuant to section 14 and section 53A of the Islamic Banking Act 1983 (IBA); and section 37 and section 126 of the Banking and Financial Institutions Act (BAFIA) 1989. The Guidelines shall be effective from 1 January 2008 and shall be read together with:

- (i) The Islamic Banking Act of 1983 (IBA) or the Banking and Financial Institutions Act (BAFIA) of 1989, whichever is applicable;
- (ii) The Capital Adequacy Framework for Islamic Banks and the Revised Capital Framework for Banking Institutions issued by Bank Negara Malaysia;
- (iii) Other relevant regulations, guidelines or circulars that Bank Negara Malaysia may issue from time to time; and
- (iv) Applicable guidelines issued by other relevant authorities.

General Requirements

1.13 In managing the PSIA, Islamic banking institutions are expected to comply with the following principles:

- (i) Islamic banking institutions shall ensure that the terms and conditions of *mudharabah* contract between Islamic banking institution and IAH must be in accordance with *Shariah* principles and relevant laws, regulations and contracts governing the product. Islamic banking institutions shall also ensure that prohibited and imprudent activities are not undertaken in breach of the terms and conditions of the contract;
- (ii) Islamic banking institutions shall disclose relevant details to the contracted parties such as the type, purpose, terms or period of the contract and profit sharing ratio agreed by the contracted parties; and

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- (iii) Islamic banking institutions shall obtain the consent of the IAH on the practice of smoothening IAH income.

PART B: POLICY REQUIREMENT FOR RECOGNITION OF PSIA AS RISK ABSORBENT

2. POLICY REQUIREMENT

- 2.1 Islamic banking institution must satisfy the requirements of paragraph 3 to 6 for the purpose of recognising PSIA as a risk absorbent. The Board of Directors must provide confirmation in writing to Bank Negara Malaysia that the Islamic banking institution has fulfilled the requirements of the Guidelines prior to the recognition of PSIA as risk absorbent.

3. GOVERNANCE

- 3.1 Islamic banking institutions have a fiduciary duty under the PSIA contract to safeguard the rights and interests of the IAH, whose deposits are exposed to risks (credit and market risks) arising from the financing and/or investment decisions by the Islamic banking institutions. It is the responsibility of the board of directors and senior management to provide sound oversight function to ensure that PSIA deposits are managed in the best interest of the IAH.
- 3.2 The role and responsibilities of the Board in the management of the PSIA are as follows:
- (i) **Approve and review the policies and strategies of the PSIA investments.**

The Board shall approve and review the broad policies and strategies of the investments and the management strategies of the DCR as well as conduct regular review on the policies and performance of the

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assets portfolio funded by the PSIA. The Board should be conversant with the impact of PSIA, taking into account the risk and return appetites of the IAH. The broad policies and strategies shall include, among others the following matters:

- (a) scope of financing and/or investment that can be funded by the PSIA, risk management and valuation on assets funded by PSIA;
- (b) the management of DCR, that shall include the policy and mechanism of the Islamic banking institution's rights to forgo its share of profits to the IAH, limits and tolerance level of DCR; and
- (c) allocation of reserves and provision in accordance with the agreed contractual terms under the PSIA.

(ii) **Perform oversight function on the management of the PSIA**

To safeguard the interests of the IAH, the Board shall ensure **rigorous and diligent oversight policy, process and procedures** over:

- (a) the financing and/or investment activities undertaken by the Islamic banking institution on behalf of the IAH;
- (b) the fiduciary and agency duties performed by the Islamic banking institution is in accordance with the terms and conditions of the *mudharabah* contract between the Islamic banking institution and IAH;
- (c) the allocation of assets and profits between the Islamic banking institution and the IAH; and
- (d) the appropriate level of reserves allocation that is fair to existing or new IAH.

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(iii) **Establish effective governance infrastructure to facilitate effective monitoring and control of PSIA**

An effective governance infrastructure is important to ensure the effectiveness of monitoring and control of the PSIA management. In this regard, the Board shall ensure that the Islamic banking institutions have established:

- (a) adequate internal controls that provide reasonable assurance on the soundness of PSIA operations and its activities are conducted within the internal policy framework approved by the Board, and comply with the relevant regulations governing the PSIA activities;
- (b) a sound risk management policies, processes and infrastructure to identify, measure, monitor and control the various type of risks associated with the assets funded by PSIA; and
- (c) a process on the appointment of competent personnel with the relevant knowledge and expertise to manage the affairs of PSIA.

(iv) **Approve policies on disclosure of information to IAH**

The Board shall approve and conduct regular review of the disclosure policies to ensure reliable, relevant and timely information are disseminated to the IAH to facilitate the evaluation of PSIA performance and the risks associated with the assets portfolio. The disclosure of information to the IAH should also be consistent with the policies, best practices and relevant guidelines issued by Bank Negara Malaysia⁵.

⁵ Detail disclosure requirements are stipulated in the disclosure requirements in paragraph 6 and Appendix III.

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3.3 The role and responsibilities of the senior management in the management of the PSIA are as follows:

(i) **Formulate and implement sound investment strategies, internal control and risk management system to safeguard the rights and interests of the IAH**

Senior management shall formulate and implement sound investment strategies that are consistent with the preferred risk and return appetites of the IAH. Senior management shall ensure that strong internal control and risk management processes, system and infrastructure are adequate to assess, manage, control and monitor risks associated with the assets funded by PSIA, that include among others:

- (a) Framework for risk management with respect to the identification, measurement, monitoring and controlling the risks associated with financing and investment activities;
- (b) Policies governing the identification, management and valuation of assets and income recognition for the purpose of calculating returns on investment and fair valuation on the assets; and
- (c) Reliable management information system for controlling, monitoring and reporting of risk exposures.

(ii) **Establish and implement policy on DCR and monitor performance of assets funded by PSIA vis-à-vis IAH's risk tolerance**

In managing the PSIA, the senior management shall establish an appropriate framework that sets out the risk tolerance level acceptable to the bank's Board that commensurate with the IAH's expected return on the assets portfolio. It is also the responsibility of the senior management to establish adequate and appropriate system and infrastructure to record, monitor and sufficiently reflect the performance of assets funded by the PSIA. For PSIA that are managed on a pool

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basis, Islamic banking institutions are required to develop and implement relevant policies and methodologies that would enable the identification of PSIA funded assets and the calculation of the rate of return generated by these assets.

(iii) **Ensure staff with the right skill set to manage the PSIA**

Senior management shall identify, assign and train the staff with the right skill set to manage, monitor and review the performance of the PSIA assets.

(iv) **Disclose relevant information to assist IAH to make informed decision**

Senior management shall ensure that timely disclosure of relevant information is provided to the IAH. At a minimum, the disclosure of information should include among others, information on the risk and return profiles, product structure, as well as allocation of reserves and investment performance. The information disclosed must be able to assist the IAH in the decision making process⁶.

⁶ Detail disclosure requirements are stipulated in paragraph 6 and **Appendix III**.

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4. TERMS AND CONDITIONS of PSIA CONTRACT

- 4.1 Islamic banking institutions shall ensure that the PSIA contract between the IAH and the bank is comprehensive and enforceable, which would allow the bank to effect and **execute the transfer of risks** and losses effectively. It is the responsibility of Islamic banking institutions to ensure that the IAH, are fully aware and agree to the terms and conditions stipulated under the PSIA contract.
- 4.2 The PSIA contracts' terms and conditions must be transparent, concise and should be crafted in a simple manner that is easily understood by the IAH. In addition to the general requirements of the PSIA contracts, the following conditions must be explicitly disclosed in the contract:
- (i) The rights and liabilities of both parties, in particular with respect to the circumstances where losses are to be borne by the IAH⁷ and the implication on the IAH's contractual rights with regard to the early withdrawal and early redemption; and
 - (ii) The Islamic banking institutions' accountability and responsibility to disclose accurate, relevant and timely information to the IAH on the investment of the PSIA including its performance, investment policies, valuation and frequency of valuation of the PSIA funded assets.

5. TAGGING AND INTERNAL SYSTEM CAPABILITY

- 5.1 For the purpose of recognition and measurement of PSIA as a risk absorbent mechanism, specific identification including tagging of assets shall be established to clearly identify the sources of funding that belongs to GIA, SIA, shareholders fund and other funds. The accurate tagging mechanism would enable Islamic banking institutions to undertake diligent and proper management of assets that are funded by the PSIA.

⁷ Except in the case of negligence, mismanagement, fraud or breach of contract on the part the Islamic banking institutions.

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- 5.2 The tagging mechanism must enable Islamic banking institutions to differentiate the various assets funded by PSIA and other funding sources. As opposed to the pool mechanism, the tagging mechanism enables Islamic banking institutions to provide accurate allocation of income, expenses, profit and loss distribution to the respective fund providers.
- 5.3 The identification of assets funded by PSIA funds may be based on either proportionate tagging (where Islamic banking institutions may utilise the funds from the general pool but must be able to ascertain the proportion of assets funded by the respective funding sources) or matched tagging (where the funds in the general and PSIA pools could be specifically identified)⁸. Islamic banking institutions are allowed to adopt a more effective internal tagging mechanism, subject to prior notification given to Bank Negara Malaysia.

6. DISCLOSURE REQUIREMENT

- 6.1 Disclosures of information on policies, procedures, product design or structures, profit allocation basis and differences between various types of PSIA are important aspect of this guideline to provide clarity and transparency regarding the rates of return and the risks associated with the PSIA. Higher level of disclosure reduces information asymmetry between Islamic banking institutions and IAH which enable IAH to make an informed investment decisions.
- 6.2 The information disclosed should not only allow the IAH to assess the risks and return profile of the PSIA asset portfolio and at the same time should also provide the IAH with ample information to monitor the performance of the PSIA funds, which include among others⁹:
- (i) Policies governing the management of the PSIA funds, including the policy on DCR;

⁸ Examples on mechanism of proportionate and matched tagging are provided in the **Appendix II**.

⁹ See **Appendix III** for the detailed disclosure requirement on PSIA

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- (ii) Methodology in calculating profit attributable for distribution to the IAH and the policy on reserve management;
- (iii) Types of financing and/or investment under the assets portfolio for each PSIA funds;
- (iv) Disclosure of the amount of Profit Equalisation Reserve (PER) provided and the amount of PER being written back during the period by the following categories, if applicable:
 - (a) By types of PSIA;
 - (a) By shareholders' portion and depositors' portion of PER.
- (v) Risks profile and investment strategy of the assets portfolio;
- (vi) Historical performance on PSIA investment returns; and
- (vii) Mechanism for the valuation of underlying assets of PSIA.

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PART C: COMPUTATION OF CAPITAL ADEQUACY RATIO

7. STANDARDISED MEASUREMENT OF RISK ABSORBENT

7.1 With effect from 1 January 2008, Islamic banking institutions are required to observe the following:

- (i) Credit and market risk weighted assets funded by the **Specific Investment Account** (SIA) are allowed to be excluded from the calculation of RWCR¹⁰ provided that the requirements for the recognition of PSIA as risk absorbent stipulated in Part B of the Guidelines are met; and
- (ii) Credit and market risk weighted assets funded by the **General Investment Account** (GIA) are not allowed to be excluded from the calculation of RWCR. Accordingly, Islamic banking institutions are required to apply the **alpha (α) value for GIA to be “1 (one)”**. Islamic banking institutions are required to allocate the necessary capital required for risks arising from the exposure of the assets funded by the GIA. Assessment on the GIA standardised alpha (α) should be carried out on continuous basis. Islamic banking institutions are also expected to maintain sufficient data in respect of the rate of return and DCR application for the purpose of quantifying the risks to be borne by the GIA in the future.

7.1 Notwithstanding of the above, Bank Negara Malaysia has no restrictions for Islamic banking institutions that wish to use internal model in the estimation of alpha (α) for internal risk management purposes. The internal model may be considered by Bank Negara Malaysia for implementation in 2010.

¹⁰ Equivalent to alpha (α) value for SIA of “0 (zero)”.

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PART D: APPENDICES

Appendix I

Appendix I: Computation of Capital Adequacy Ratio

- Under the *mudharabah* contract, the IAH bears the commercial risks associated with the assets funded by the PSIA. The risk weighted assets for both the credit and market risks shall therefore be excluded from the calculation of RWCR for Islamic banking institutions.
- Where PSIA is recognised as risk absorbent, the RWCR of Islamic banking institutions shall be computed as follows:

Modified Formula of RWCR: Incorporating the Risk Nature of *Mudharabah* Deposits

RWCR _{Islamic} =	$\frac{\text{Capital Base}_{\text{Islamic}}}{\text{Total Risk Weighted Assets}^{\text{i}}_{\text{Islamic}}}$ <p style="text-align: center;">Less</p> <p style="text-align: center;">(1-α)ⁱⁱ (Credit and Market Risk Weighted Assets funded by PSIAⁱⁱⁱ)</p> <p style="text-align: center;">Less</p> <p style="text-align: center;">α (proportion of Credit and Market Risk Weighted Assets funded by PSIA in the form of PER)</p>
	<p>ⁱ Total risk weighted assets is the sum of credit risk, market risk and operational risk weighted assets of Islamic banking operations</p> <p>ⁱⁱ (1-α) represents the quantum of PSIA recognised as risk absorbent for RWCR computation purposes and approved by Bank Negara Malaysia.</p> <p>ⁱⁱⁱ PSIA balances include Profit Equalisation Reserves (PER).</p>

- Alpha (α) represents the proportion of commercial risk borne by Islamic banking institutions following the application of DCR. The residual value of (1- α) represents the proportion of the commercial risks required to be absorbed by the IAH.
- Profit Equalisation Reserves (PER) represent a portion of the bank's income appropriated from the gross income and set aside for the purpose of DCR.

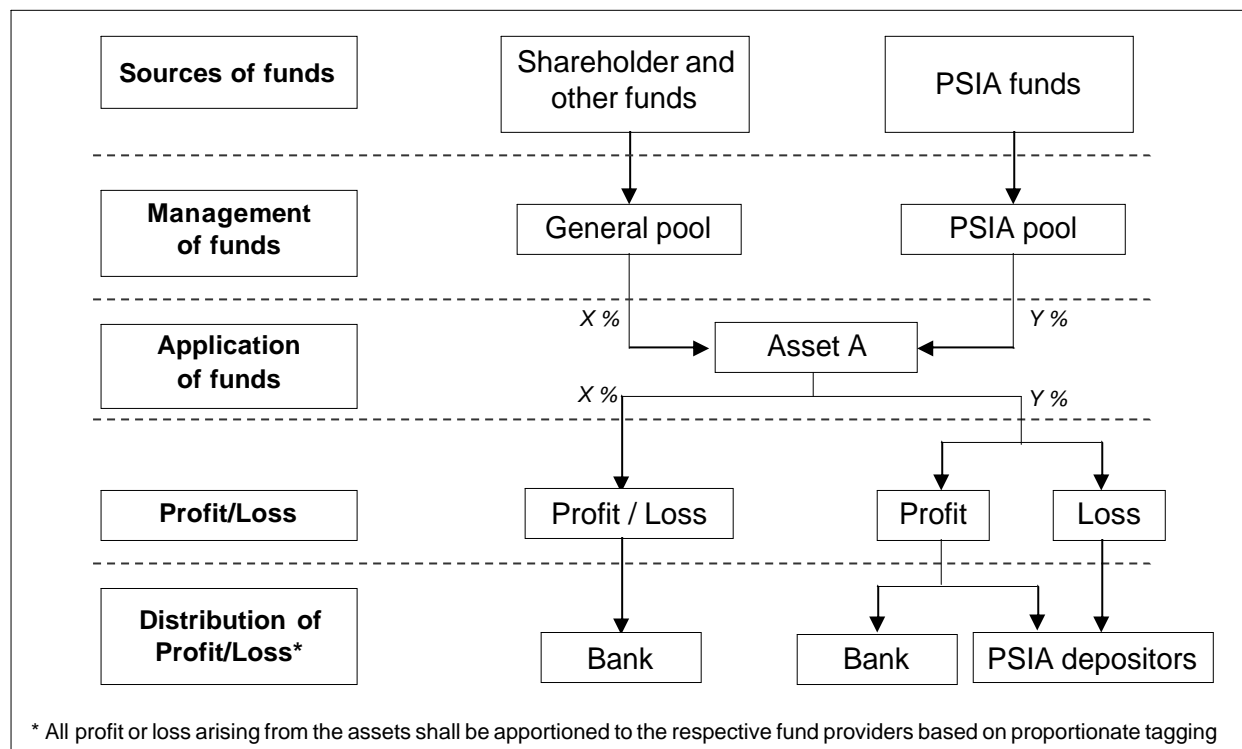
Appendix II

Appendix II: Illustration on Identification of Assets against Funding Sources

Proportionate tagging

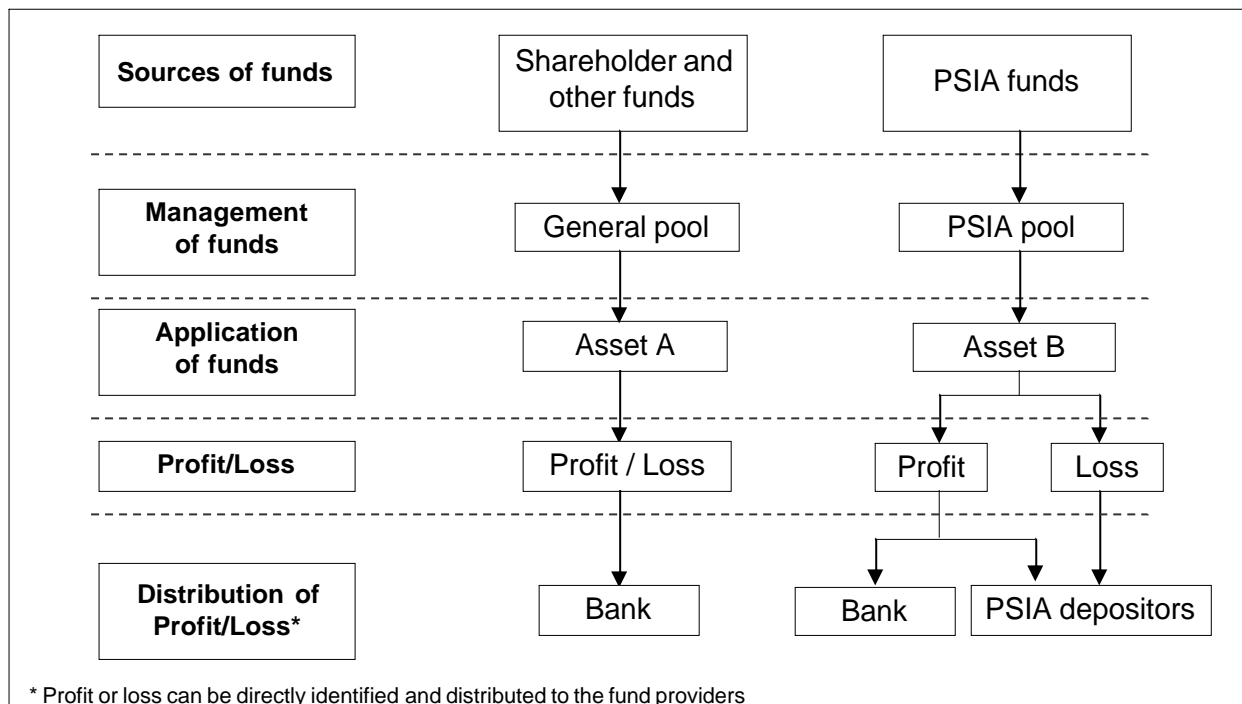
- Under proportionate tagging, Islamic banking institutions may utilise funds from the general pool (i.e. shareholders fund and other funds) with the PSIA funds for the purpose of funding its exposure in different types of Islamic banking assets. However, Islamic banking institutions must have in place the capability to ascertain the proportion of assets that are funded by the respective funds. This is to ensure that proper allocation of revenues, expenses, profit and loss distribution to the respective fund providers.
- The following diagram illustrates an example of mechanism for proportionate tagging between assets and the funding sources.

Diagram 1: Mechanism of proportionate tagging



Matched tagging

3. For 'matched' tagging approach, funds in the general and PSIA pools could be specifically identified and enable Islamic banking institutions to allocate profit or loss to the respective fund providers.
4. An example of mechanism for matched tagging is provided in the following diagram:

Diagram 2: Mechanism of matched tagging

5. The two examples provided above are not exhaustive. Islamic banking institutions may provide a more effective tagging mechanism subject to prior notification to Bank Negara Malaysia.

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Appendix III

Appendix III: Disclosure requirements

(i) Qualitative Disclosure

No.	Description
1.	Written policies applicable to PSIA e.g. range of PSIA available, characteristics of the IAH for whom various PSIA may be appropriate and governance arrangements for PSIA funds.
2.	Product information and the manner in which the products are made available to investors.
3.	Method for calculating profit available for distribution.
4.	Disclosure on policies governing the management of PSIA funds, including the approaches to management of asset portfolio (including policy on DCR), establishment of prudential reserves, investment strategies of the asset portfolio and changes in investment strategies.
5.	Rules governing transfer of funds to or from profit equalisation reserve (PER) where applicable.
6.	Mechanism for the valuation of underlying assets of PSIA.

(ii) Quantitative Disclosure

No.	Description
1.	Amount of assets funded by each type of PSIA (SIA and GIA), types of assets funded by the respective funds, amount invested in each type of assets and the key risk factors of the assets.
2.	Disclosure of the amount of Profit Equalisation Reserve (PER) provided and the amount of PER being written back during the period by the following categories, if applicable: (i) By types of PSIA; (ii) By shareholders' portion and depositors' portion of PER.
3.	Historical performance on PSIA investment returns.

Appendix IV

Appendix IV: Illustration of DCR Application

1. In this example, Islamic banking institutions have invested the IAH funds into long terms assets based on *murabahah* contract. The returns on the *murabahah* assets that are shared between the Islamic banking institution and the IAH are pegged against a fixed profit rate.
2. In situation where there is a sudden rise of market rates, the Islamic banking institutions as a strategy to be competitive may decide to increase the rate of returns payable to IAH to prevent potential withdrawal of funds.
3. The application of DCR would occur when Islamic banking institutions give up its proportion of share of profits and allocate it to IAH in order to increase the rate of return. The rate of return to the IAH is “smoothed” at the expense of profits normally attributable to Islamic banking institutions, as illustrated in following diagram:

Diagram 3: Example of Displaced Commercial Risk

