



BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

Mudarabah

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BNM/RH/STD 028-8	Islamic Banking and Takaful Department	<i>Mudarabah</i>
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PART A OVERVIEW

1. Introduction

- 1.1 Compliance with Shariah requirement is a prerequisite in ensuring the legitimacy and integrity of Islamic financial products and services. In meeting this expectation, it is essential for an Islamic financial institution (IFI) to establish the necessary operational framework and infrastructure to ensure that the conduct of Islamic financial transactions is consistent with Shariah.
- 1.2 The Shariah contract-based regulatory policy is intended to promote transparency and consistency of Shariah contract application which would enhance the contracts' certainty and strengthen Shariah compliance by IFIs.
- 1.3 The Shariah contract-based regulatory policy consists of two components, namely the Shariah and the operational requirements. The Shariah requirements highlight the salient features and essential conditions of a specific contract. The latter outlines the core principles underpinning good governance and oversight, proper product structuring, effective risk management, sound financial disclosure and fair business and market conduct. The operational requirements aim to complement and promote sound application of the Shariah principles.
- 1.4 *Mudarabah* is a contract based on a fiduciary relationship between a capital provider (*rabbul mal*) and an entrepreneur (*mudarib*). Under a *mudarabah*, any profit generated from the capital is shared while financial losses are borne by the *rabbul mal*.

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2. Policy objectives

- 2.1 This policy document aims to:
- (a) provide reference on the Shariah rulings associated with *mudarabah*;
 - (b) set out key operational requirements with regard to the implementation of *mudarabah*; and
 - (c) promote end-to-end compliance with Shariah requirements which include adherence to sound banking practices and safeguarding customers' interest.

3. Scope of policy document

- 3.1 Part B provides mandatory Shariah requirements to ensure the validity of *mudarabah* and its optional practices.
- 3.2 Parts C and D provide operational requirements on governance and oversight, structuring, risk management, financial reporting and business and market conduct. Part C provides the operational requirements on the *mudarabah* where the IFI is a *mudarib* and/or the *rabbul mal* of the *mudarabah* venture, while Part D provides specific operational requirements where the IFI is the *rabbul mal*.

4. Applicability

- 4.1 This policy document is applicable to:
- (a) all IFIs as defined in paragraph 7.2. Notwithstanding this, licensed takaful operators under the Islamic Financial Services Act 2013 (IFSA) shall only apply Part B of this policy document.
 - (b) all financial products and services structured on *mudarabah*, except for:
 - (i) sukuk, collective investment schemes and equities; and
 - (ii) interbank investments¹, which are excluded from Part D.

¹ *Islamic Negotiable Instruments (INIs) based on mudarabah are also excluded.*

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5. Legal provisions

5.1 The requirements in this policy document are:

- (a) specified pursuant to sections 29(1) and (2), 57(1), 135(1) and 277 of the Islamic Financial Services Act 2013 (IFSA); and
- (b) specified pursuant to sections 41(1) and 126 and issued as a direction pursuant to section 129(3) of the Development Financial Institutions Act 2002 (DFIA).

6. Effective date

6.1 This policy document comes into effect as follows:

- (a) Part B, immediately upon issuance of this policy document; and
- (b) Part C and D, on 1 June 2016.

7. Interpretation

7.1 The terms and expressions used in this policy document shall have the same meanings as assigned under the Financial Services Act 2013 (FSA), IFSA and DFIA, as the case may be, unless otherwise defined in this policy document.

7.2 For the purpose of this policy document:

“S” denotes a standard, requirement or specification that must be complied with. Failure to comply may result in one or more enforcement actions;

“G” denotes guidance which consist information, advice or recommendation intended to promote common understanding and sound industry practices which are encouraged to be adopted;

“Islamic financial institution” or “IFI” means:

- (a) a licensed Islamic bank under the IFSA;
- (b) a licensed takaful operator under the IFSA;
- (c) a licensed bank and licensed investment bank under the FSA approved under section 15(1)(a) of the FSA to carry on Islamic banking business;

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and

- (d) a prescribed institution under the DFIA approved under section 129(1) of the DFIA to carry on Islamic banking business or Islamic financial business.

7.3 A glossary of terms used in the policy document is set out in Appendix 2.

8. Related Shariah rulings and policy documents

8.1 This policy document must be read together with but not limited to such Shariah rulings and policy documents as specified in Appendix 3.

9. Policy documents superseded

9.1 This policy document supersedes the requirements for *mudarabah* in the:

- (a) Guidelines on *Musharakah* and *Mudarabah* contracts for Islamic Banking Institutions issued on 15 September 2007 as at the effective date of part C and D of this policy document; and
- (b) *Shariah Standard on Mudarabah* issued on 22 October 2012.

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PART B SHARIAH REQUIREMENTS AND OPTIONAL PRACTICES

10. Definition

S 10.1 *Mudarabah*² is a contract between a capital provider (*rabbul mal*) and an entrepreneur (*mudarib*) under which the *rabbul mal* provides capital to be managed by the *mudarib* and any profit generated from the capital is shared between the *rabbul mal* and the *mudarib* according to a mutually agreed profit sharing ratio (PSR) whilst financial losses are borne by the *rabbul mal* provided that such losses are not due to the *mudarib*'s misconduct (*ta`addi*), negligence (*taqsir*) or breach of specified terms (*mukhalafah al-shurut*).

11. Nature

S 11.1 *Mudarabah* is a contract based on a fiduciary relationship (*aqd al-amanah*). Under this principle, a *mudarib* manages the *mudarabah* asset in trust and is not liable for the impairment of the asset except for impairment which is a result of the *mudarib*'s misconduct (*ta`addi*), negligence (*taqsir*) or breach of specified terms (*mukhalafah al-shurut*).

S 11.2 Any of the contracting parties has the right to terminate the contract unilaterally except in the following conditions:

- (a) the *mudarib* has commenced the work relating to the management of the capital of the *rabbul mal*; or
- (b) the contracting parties have agreed to enter into a *mudarabah* contract for a specified time; or
- (c) the contracting parties have agreed not to terminate the *mudarabah* contract within a specified time.

² The terms *muqaradah* and *qirad* are synonymous to *mudarabah*.

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G 11.3 A *mudarabah* is categorized into two types:

(a) Unrestricted *Mudarabah* (*Mudarabah Mutlaqah*).

An unrestricted *mudarabah* is a contract in which the *rabbul mal* permits the *mudarib* to manage the *mudarabah* capital without any specific restriction.

(b) Restricted *Mudarabah* (*Mudarabah Muqayyadah*)

A restricted *mudarabah* is a contract in which the *rabbul mal* imposes specific restrictions on the *mudarabah* terms. The *rabbul mal* may specify conditions restricting *the mudarib* such as the determination of location, period for investment, type of project and commingling of funds.

G 11.4 The contracting parties may mutually agree to change the type of *mudarabah* they have entered into to another type of *mudarabah* at any point in time.

COMPONENTS OF *MUDARABAH*

12. Contracting parties

S 12.1 The contracting parties in a *mudarabah* are a *rabbul mal* and a *mudarib*.

S 12.2 Both the *rabbul mal* and the *mudarib* must be a natural person or a legal entity who shall have legal capacity³ to enter into the *mudarabah* contract including the capacity to perform agency (*wakalah*) contract either as a principal or as an agent.

G 12.3 The contracting parties in the *mudarabah* contract may involve more than one *mudarib* or *rabbul mal*.

³ The legal capacity of a person, from Shariah perspective, is defined as capacity to assume rights and responsibilities; and capacity to give legal effect to his action. Among the important conditions are that the person must possess sound mind and the capacity to distinguish between what is harmful or beneficial to one's interests. Legal capacity of a legal entity is defined as eligibility of an entity to acquire rights and assume responsibilities. In Malaysia, the legal capacity is governed under the Contracts Act 1950 and the Age of Majority Act 1971.

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- G 12.4 In the case of the *mudarabah* involving more than one *rabbul mal*, an agreement among the *rabbul mal* may be established whereby:
- (a) an existing *rabbul mal* agrees to relinquish his right over a certain portion of the profit if he withdraws from the *mudarabah* prior to its maturity date; and
 - (b) a new *rabbul mal* agrees to assume liability in respect of the *mudarabah* which is already in operation prior to his participation.

S 12.5 Any terms or conditions in the *mudarabah* contract has been mutually agreed between the *rabbul mal* and *mudarib*, and does not contravene the Shariah shall be binding on both parties.

13. Offer (*ijab*) and acceptance (*qabul*)

S 13.1 A *mudarabah* contract shall be entered into by an offer and acceptance between a *rabbul mal* and a *mudarib*.

G 13.2 The offer and acceptance may be expressed verbally, in writing or any other methods which could be evidenced by appropriate documentation or record.

14. Management

S 14.1 A *mudarib* shall have the right to manage a *mudarabah* venture.

S 14.2 The *mudarib* is responsible to ensure proper management of the *mudarabah* venture and acts in the interests of the *rabbul mal*.

S 14.3 The *mudarib*'s mandate shall be provided under the terms and conditions of the contract.

G 14.4 The *mudarib* may assign the *mudarabah* capital under his management to another *mudarib* in another *mudarabah* (*mudarib yudarib*) or to an agent (*wakil*) subject to the condition that the consent of the *rabbul mal* is obtained.

S 14.5 A *rabbul mal* shall not be involved in managing the *mudarabah* venture but shall have a right of access to reasonable information regarding the *mudarabah* venture.

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15. Capital

- S 15.1 Capital is an asset provided by a *rabbul mal* to a *mudarib* for the purpose of a *mudarabah* venture.
- S 15.2 The capital of *mudarabah* (the capital) shall be provided by the *rabbul mal* and managed by the *mudarib*.
- S 15.3 The capital shall be identifiable, readily available and accessible for the *mudarib* to commence business activities.
- G 15.4 The capital may be in the form of cash or in-kind, including intangible assets.
- S 15.5 Where the capital is in-kind, it shall be valued in monetary terms either by agreement between the contracting parties or by a third party, which may include experts, valuers, or any qualified person, at the time of entering into a *mudarabah* contract.
- S 15.6 Where the capital is denominated in a different currency, it shall be valued based on a specific currency as agreed by the contracting parties at the time of entering into the *mudarabah* contract.
- S 15.7 All forms of debts shall not qualify as capital, including all account receivables and payments due to the *rabbul mal* either from the *mudarib* or a third party.
- S 15.8 All remaining capital shall be returned to the *rabbul mal*, if any, upon dissolution or termination of the *mudarabah* contract.
- S 15.9 Any amount of capital due to the *rabbul mal* under paragraph 15.8 and profit, if any, shall be deemed as a liability due to the *rabbul mal*.
- S 15.10 The *mudarib* shall not guarantee the capital except in the case of his misconduct (*ta`addi*), negligence (*taqsir*) or breach of specified terms (*mukhalafah al-shurut*).
- G 15.11 The *mudarabah* contract may provide for the gradual withdrawal of capital

by the *rabbul mal* during the tenure of the *mudarabah* contract unless stated otherwise.

- G 15.12 Subject to paragraph 15.13, the *mudarib* may with the consent of the *rabbul mal* commingle the capital with other investment funds
- S 15.13 The *mudarib* shall observe the agreed terms and conditions of the respective contract.
- G 15.14 The *mudarib* may inject his own funds into the capital subject to the consent of the *rabbul mal* and hence a *musyarakah* contract is formed between the *mudarib* (as partner under *musyarakah*) and the *mudarabah* venture.
- G 15.15 The *mudarabah* expenditure may be charged to the capital.
- S 15.16 The *mudarabah* expenditure shall be direct expenses that are identifiable and measurable with regard to a specific investment activity⁴.
- G 15.17 The capital may be fully or partially disbursed as per the terms of the *mudarabah* contract.
- G 15.18 Where a *rabbul mal* fails to provide capital as agreed under a *mudarabah* contract (defaulting *rabbul mal*) –
- (a) In the case where the defaulting *rabbul mal* has not paid the capital within the time stipulated in the *mudarabah* contract, the contracting parties may unilaterally terminate the contract. If the *mudarib* has commenced work, the *rabbul mal* has to reimburse the *mudarib* for any *mudarabah* expenditure incurred and pay the *mudarib* fair and reasonable wages or fees;
 - (b) In the case of the *mudarabah* contract involves one *mudarib* and one *rabbul mal* with staggered capital payment which the defaulting *rabbul mal* has made partial capital payment, the contracting parties may,

⁴ Investment activity in the context of this paragraph refers to Shariah compliant profit generating activities which may include Shariah compliant provision of finance provided by *mudarib* using *mudarabah* fund.

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subject to the terms and conditions of the *mudarabah* contract, -

- (i) revise the *mudarabah* contract based on the actual capital paid by the defaulting *rabbul mal*; or
- (ii) terminate the *mudarabah* contract and consequently:
 - (a) the *mudarib* shall return the capital contributed to the defaulting *rabbul mal* if any and share the profits with the defaulting *rabbul mal*, if any; and
 - (b) the defaulting *rabbul mal* shall bear the *mudarabah* expenditure incurred by the *mudarib*. If the justified *mudarabah* expenditure⁵ incurred exceeds the actual capital contribution, such liability shall be borne by the defaulting *rabbul mal* up to the limit of the total capital amount committed under the *mudarabah* contract.
- (c) in the case of the *mudarabah* contract involves one *mudarib* and multiple *rabbul mal* with single capital payment by each *rabbul mal*, and where one or more *rabbul mal* failed to pay, the *mudarib* may terminate the *mudarabah* contract with the defaulting *rabbul mal* who failed to pay and may based on agreed terms impose on him to indemnify the *mudarabah* venture for any expenses incurred due to his default.
- (d) in the case of the *mudarabah* contract involves one *mudarib* and multiple *rabbul mal* with staggered capital payment by each or some of the *rabbul mal* and where one or more *rabbul mal* failed to make the subsequent capital payment, the non-defaulting contracting parties shall have the following remedies including:
 - (i) requiring the defaulting *rabbul mal* to sell his interest to the other

⁵ Explanation on *mudarabah* expenditure is provided under paragraph 15.16.

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rabbul mal or to a third party;

- (ii) the non-defaulting contracting parties may agree to revise *the mudarabah* contract based on actual capital paid; or
- (iii) the non-defaulting contracting parties may terminate the *mudarabah* contract with the defaulting *rabbul mal* and may, based on agreed terms, require him to indemnify the *mudarabah* venture for any expenses incurred due to his default.

16. Profit

- S 16.1 Profit sharing is the primary motive of a *mudarabah* contract and therefore it is a fundamental component of the contract.
- G 16.2 A *mudarabah* profit (the profit) is the value created over and above the capital which is determined based on a methodology acceptable by market conventions or practices.
- S 16.3 A *mudarib* shall not guarantee any profit.
- S 16.4 A *rabbul mal* and a *mudarib* shall share profit based on a ratio mutually agreed between them.
- S 16.5 The PSR shall be determined at the time of entering into a *mudarabah* contract.
- G 16.6 The PSR may be revised during the tenure of the *mudarabah* contract.
- S 16.7 Subject to paragraph 16.6, a revision of the PSR shall be mutually agreed by the *rabbul mal* and the *mudarib*.
- S 16.8 The *mudarabah* contract shall not stipulate a pre-determined fixed amount of profit to one contracting party which deprives the profit share of the other contracting party.
- S 16.9 The profit shall not be fixed in the form of a certain percentage of the capital.

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- G 16.10 Notwithstanding paragraph 16.9, the ex-post performance profit amount (based on the PSR which had been mutually agreed upon between the *rabbul mal* and the *mudarib*) may be translated into a fixed percentage yield of the capital.
- G 16.11 In a multi-tiered *mudarabah*, two or more profit sharing arrangements may be agreed upon. In the first tier, a *rabbul mal* and a *mudarib* may agree on a certain PSR. Whilst in the second tier, the *rabbul mal* (*mudarib* in the first tier *mudarabah*) and the other *mudarib* may agree on another PSR. Such arrangement may apply to the following tier respectively. The profit generated in each tier shall be shared according to the respective PSR.
- S 16.12 Pursuant to paragraph 15.14, where a *mudarib* commingles or injects his own fund to a *mudarabah* venture, the *mudarib* is entitled to the profit based on his capital contribution in the commingled fund and the remaining profit shall then be distributed based on PSR in the *mudarabah* contract.
- G 16.13 The *rabbul mal* and the *mudarib* may agree on a PSR based on a specified profit threshold. In the event that:
- (a) the actual profit is equivalent or below the threshold, the profit shall be shared based on the agreed PSR.
 - (b) the actual profit exceeds the threshold, the excess amount may be:
 - (i) distributed based on a different PSR agreed by the parties; or
 - (ii) paid to any of the contracting parties as agreed
- G 16.14 The PSR may be varied to correspond with different periods of investment, different amount of the capital or pre-mature withdrawal of the capital, provided that the conditions for the variation have been agreed upon by the contracting parties at the time of entering into the *mudarabah* contract.
- s 16.15 In a single *mudarabah* contract involving more than one *mudarib*, a common PSR is agreed between the *rabbul mal* and all the *mudarib*. All *mudarib* shall share the *mudarib*'s profit portion as per the agreed terms.

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s 16.16 Profit shall be recognized based on the following methodology:

- (a) realized basis by actual liquidation of assets of the *mudarabah* partnership (*al-tandid al-haqiqi*); or
- (b) constructive basis according to acceptable profit recognition method which may include valuation according to acceptable market methodology, independent valuation or valuation based on estimated figures (*al-tandid al-hukmi*).

G 16.17 In the case of the profit recognized based on constructive basis, a profit reserve may be created.

s 16.18 In the case of the profit recognized based on constructive basis, a final consolidation and adjustment shall be undertaken to determine the actual profit, either:

- (a) at the end of a certain period; or
- (b) at the point of actual profit realization.

s 16.19 The profit shall be distributed upon the maturity of a *mudarabah* venture or at an agreed period.

s 16.20 Unrealized gains recognized during the *mudarabah* tenure shall be recognized as the profit and be included in the profit and loss calculation for the *mudarabah*.

s 16.21 A *mudarib* is only entitled to the profit for works which are integral to the *mudarabah* venture and shall not earn any additional fee for such works.

G 16.22 A *rabbul mal* may commission a *mudarib* for a fee to perform works apart from the works integral to a *mudarabah* venture.

G 16.23 The parties to the contract may agree to set aside the profit as a reserve or for any other purpose.

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- S 16.24 In relation to paragraph 16.23, the reserve shall only be created from the profit.
- S 16.25 In the case where profit reserved is utilised to cover depletion of the capital, only the profit portion of a *rabbul mal* in the reserve shall be utilised⁶.
- G 16.26 The contracting parties may agree to a condition whereby a *rabbul mal* may be subject to lower or no profit payment if the capital is withdrawn before the maturity of the *mudarabah* venture.

17. Loss

- S 17.1 Loss⁷ shall be borne by a *rabbul mal* up to the capital value.
- S 17.2 A *mudarib* shall not be liable for any impairment of asset unless such loss is due to the *mudarib*'s misconduct (*ta`addi*), negligence (*taqsir*) or breach of specified terms (*mukhalafah al-shurut*) of the contract.
- S 17.3 Notwithstanding paragraph 17.2, in the case of any loss, the *mudarib* shall furnish the reason for the occurrence of the loss.
- S 17.4 In the case of multiple *rabbul mal* in a single *mudarabah*, the loss shall be borne by each *rabbul mal* proportionate to his capital contribution.
- S 17.5 In the case where a *mudarib* commingles or injects his own fund to a *mudarabah* venture, the loss shall be borne based on the proportion of the *mudarib*'s capital contribution in the commingled fund.

⁶ This requirement is specified to prevent implication of capital guarantee by *mudarib*.

⁷ A loss is depletion from the value of capital.

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ARRANGEMENT OF *MUDARABAH* WITH OTHER CONTRACTS OR CONCEPTS

18. Arrangement for guarantee

S 18.1 Subject to paragraph 15.10, a *mudarib* shall not guarantee the capital and/or profit.

G 18.2 Notwithstanding paragraph 18.1, the following measures may be exercised:

(a) a *rabbul mal* may take a collateral from the *mudarib*, provided that the collateral could only be liquidated in the event of a misconduct (*ta`addi*) or negligence (*taqsir*) or breach of terms (*mukhalafah al-shurut*) of a contract by the *mudarib*; or

(b) the *rabbul mal* may require the *mudarib* to arrange for an independent third party guarantee.

S 18.3 Pursuant to paragraph 18.2(b), the following requirements shall be observed:

(a) the guarantee shall be executed in a separate contract;

(b) the guarantee shall be utilised to cover any loss or depletion of the capital; and

(c) the third party guarantor shall be independent from the *mudarib* such that it shall not be a related party where:

(i) the *mudarib* has majority ownership and/or has control over the third party guarantor; or

(ii) the third party guarantor owns or has control over the *mudarib*.

19. Arrangement of a *mudarabah* with a *wadiah*, a *wakalah* or a *musyarakah*

G 19.1 Contracting parties may agree to an arrangement whereby a certain amount of fund is assigned as a *mudarabah* capital and another portion of the fund is assigned under *wadi'ah*, *wakalah* or *musyarakah* contracts.

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s 19.2 Pursuant to paragraph 19.1, the contracting parties shall observe the requirements of the *mudarabah* on the part of fund assigned under the *mudarabah* and shall observe the requirements of the *wadiah*, *wakalah* or *musyarakah* on the part of fund assigned under the respective contract.

20. Arrangement of a *mudarabah* with a *hibah*

G 20.1 A *mudarib* may provide a *hibah* to a *rabbul mal*.

s 20.2 Pursuant to paragraph 20.1, provision of a *hibah* shall observe the following conditions:

- (a) the *hibah* shall not be sourced from the capital or the *rabbul mal's* portion of profit; and
- (b) provision of the *hibah* shall not amount to a guarantee of capital and/or profit by the *mudarib*.

21. Arrangement of a *mudarabah* with a promise (*wa'd*)

G 21.1 A *mudarabah* contract may be arranged with a promise (*wa'd*) where:

- (a) a *mudarib* undertakes to purchase a *mudarabah* asset upon the occurrence of a specified event as stipulated in the *mudarabah* contract; or
- (b) an agent (*wakil*) appointed by a *mudarib* undertakes to purchase a *mudarabah* asset upon the occurrence of a specified event as stipulated in the *mudarabah* contract.

G 21.2 The *rabbul mal* may request the *mudarib* to give a promise (*wa'd*) to purchase the *mudarabah* asset over an agreed period of time at market value, fair value or any price to be agreed by the parties at the time of purchase.

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DISSOLUTION

22. Dissolution of *mudarabah*

s 22.1 A *mudarabah* contract is dissolved under the following circumstances:

- (a) unilateral termination by any of the parties in the absence of any prohibitive circumstances as per paragraph 11.2;
- (b) unilateral termination by any of the parties due to misconduct (*ta`addi*), negligence (*taqsir*) or breach of specified terms (*mukhalafah al-shurut*) of contract by the other;
- (c) mutual agreement to terminate the *mudarabah* contract between the parties;
- (d) the *mudarabah* contract expires upon the maturity date agreed by the parties;
- (e) demise or dissolution of either a *mudarib* or a *rabbul mal*;
- (f) loss of legal capacity; or
- (g) invalidity of the *mudarabah*.

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PART C OPERATIONAL REQUIREMENTS

23. Background

23.1 Part C outlines the expectations for the establishments of policies and procedures for a *mudarabah* venture where an IFI⁸ is the *rabbul mal* and/or the *mudarib*. It covers requirements to enable effective governance and oversight, sound risk management, proper product structuring and appropriate financial disclosure and reporting of a *mudarabah* venture. It also highlights expectations on IFIs' business and market conduct. The policy intent of these operational requirements is to provide adequate safeguards for stakeholders' interests, promote effective implementation of business and risk management strategies and drive the development and establishment of the necessary systems, processes and control measures.

24. Governance and oversight

Principle 1: The IFI shall establish sound governance and oversight structure to ensure that *mudarabah* ventures are conducted based on sound practices and comply with Shariah requirements.

s 24.1 This policy document complements the *Guidelines on Corporate Governance for Licensed Islamic Banks* and *Guidelines on Corporate Governance for Development Financial Institutions*.

s 24.2 While the broad governance and oversight principles can be applied, specific requirements are needed to manage the distinct risks and the unique nature of a *mudarabah* venture. An IFI shall have sufficient understanding of its risk profile and availability of resources with the appropriate knowledge and skill set.

⁸ *Illustration on the differences in the role of IFI is given in the Appendix 4.*

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s 24.3 The IFI shall identify areas for further enhancements which include the establishment of additional roles of the board of directors, board committee, Shariah committee, senior management and the dedicated function or unit⁹.

Board of Directors

s 24.4 The board of directors (the Board) shall establish a sound governance structure to facilitate an effective oversight function on the management of a *mudarabah* venture. The adequacy of governance structure shall commensurate with the nature, complexity and risk profile of the *mudarabah* venture.

s 24.5 The roles and responsibilities of the Board with respect to the *mudarabah* venture shall include the following:

- (a) setting the IFI's business strategy and risk appetite with regard to the *mudarabah* venture;
- (b) approving and overseeing policies and procedures for effective risk management to ensure compliance with the relevant law and regulations;
- (c) ensuring that a comprehensive and effective Shariah governance framework is in place;
- (d) ensuring that the IFI has adequate and qualified personnel with sufficient knowledge and competency on the concept, application and risks associated with the *mudarabah* venture; and
- (e) ensuring that independent reviews are conducted regularly to assess compliance with the policy documents issued by the Bank and internal policies established by the IFI.

Board Committee

s 24.6 Key responsibilities of the board committee shall include conducting oversight to ensure that a *mudarabah* venture is managed effectively,

⁹ *Dedicated function or unit as per paragraph 30.2.*

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assisting the Board in performing its oversight function and providing recommendations in respect of the management, operations and performance of the *mudarabah* venture.

s 24.7 The board committee shall consist of members who are qualified with sufficient knowledge, competency and understanding of the risks associated with the *mudarabah* venture.

Shariah Committee

s 24.8 The Shariah committee shall perform the following to ensure that all activities associated with a *mudarabah* venture undertaken by the IFI are conducted in line with Shariah requirements:

- (a) endorse that the Shariah requirements are appropriately applied in the relevant policies and procedures governing the *mudarabah* venture;
- (b) deliberate and endorse that the terms and conditions stipulated in legal documentation and other documents¹⁰ are in compliance with Shariah;
- (c) ensure Shariah review and Shariah audit are conducted, identify issues and propose appropriate corrective measures; and
- (d) advise and provide clarification on relevant Shariah rulings, decisions or guidelines on Shariah matters issued by the Bank and, if relevant, any other authorities.

Senior Management

s 24.9 The roles and responsibilities of the senior management with regards to the *mudarabah* venture shall include the following:

- (a) developing and implementing business strategies, internal control and risk management requirements in line with IFI's business objectives;
- (b) establishing policies, processes and procedures with regard to proper management of the *mudarabah* venture;
- (c) implementing relevant internal systems, infrastructure and adequate

¹⁰ Such as information published in promotional materials, product manuals or other publications.

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mechanisms to identify, measure, control and monitor risk inherent in the *mudarabah* venture;

- (d) ensuring that the IFI monitors and has proper and adequate reporting of the *mudarabah* venture operations and performance;
- (e) identifying, assigning and training of key personnel with the appropriate skill set for the *mudarabah* venture and ensuring that the roles and responsibilities are properly delegated to the relevant functions within the IFI;
- (f) undertaking regular reviews and monitoring compliance with the approved policies; and
- (g) ensuring timely disclosure of relevant information to the Board and the Shariah committee.

25. Structuring

Principle 2: The IFI shall ensure that structuring and implementation of *mudarabah* venture is supported by comprehensive policies and procedures, processes, adequate infrastructure and robust documentation.

Principle 3: The IFI shall ensure a sound structuring of *mudarabah* venture which includes conducting end-to-end process to match the risk and reward profile between sources and usage of funds.

Shariah Compliance

s 25.1 An IFI shall be responsible for ensuring:

- (a) the overall operations a of *mudarabah* venture are in compliance with Shariah requirements;
- (b) the product structure, strategies, terms of agreement, asset portfolio¹¹ and type of business involved¹² are endorsed by the Shariah committee; and
- (c) the opinion of the Shariah Advisory Council (SAC) of the Bank is

¹¹ Such as the underlying asset portfolio for a *Mudarabah Investment Account*.

¹² Such as the business or services conducted by the customer as *mudarib* in a *mudarabah* venture.

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sought to resolve issues pertaining to Shariah matters as outlined in the *Shariah Governance Framework for Islamic Financial Institutions*.

s 25.2 The IFI shall establish an effective framework that is supported by adequate policies and procedures and competent personnel to ensure that the *mudarabah* venture continues to adhere to Shariah requirements.

Contracting Parties¹³

s 25.3 An IFI shall undertake an assessment on the suitability of the contracting parties before entering into a *mudarabah* venture.

s 25.4 The contracting parties' roles and responsibilities shall be stipulated clearly in the legal documentations.

G 25.5 The contracting parties in a *mudarabah* venture may involve more than one *rabbul mal* which could exist under the following structures:

- (a) a “single” PSR structure which creates a *mudarabah* venture between a group of *rabbul mal* with a *mudarib*; or
- (b) a “multiple” PSR structure which creates a *mudarabah* venture between each *rabbul mal* with a *mudarib*.

Illustration of these structures is given in Appendix 6.

Management of *mudarabah* venture

s 25.6 As per paragraph 14.5, a *mudarabah* venture shall only be managed by the *mudarib* while the *rabbul mal* shall have access to information. In this regard, the *rabbul mal* shall not:

- (a) be involved in the decision making in respect of the *mudarabah* venture;
- (b) influence decision making in core business areas of the *mudarabah* venture¹⁴; and

¹³ Refer to the *rabbul mal* and the *mudarib* unless defined otherwise.

¹⁴ E.g. a *rabbul mal* providing advisory services directly contributing to major decision making for the *mudarabah*

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(c) be involved in the day-to-day management of the *mudarabah* venture.

Capital

- s 25.7 An IFI shall determine the value of capital¹⁵ upon the execution of a *mudarabah* contract.
- s 25.8 Notwithstanding the type of capital allowed under paragraph 15.4, the capital shall only be in the form of cash. The capital shall be identifiable, readily available and accessible at the date of commencement of the *mudarabah* venture. The capital shall not be in the following forms:
- (a) debt or receivables owing to the *rabbul mal*; and
 - (b) encumbered assets¹⁶.
- s 25.9 Upon disbursement of the capital, the *rabbul mal* shall assume its rights and liabilities of the *mudarabah* venture up to the limit of the amount of capital disbursed or contributed.
- s 25.10 In the event where there is commingling of funds by a *mudarib* as mentioned in paragraph 15.12, the IFI shall ensure the following:
- (a) identification of funding purpose and assets is clearly stated in the terms and conditions;
 - (b) proper tagging of assets (either dedicated or proportionate) at all times using an appropriate mechanism by the *mudarib* such as separate record keeping;
 - (c) proper valuation of underlying assets under the *mudarabah* venture is carried out periodically; and
 - (d) the *rabbul mal* has the rights¹⁷ on the underlying assets funded by the *rabbul-mal* at all times, including upon exit and upon the *mudarib*'s winding-up.

venture.

¹⁵ To be received by the IFI as a *mudarib* or to be contributed by the IFI as a *rabbul mal*.

¹⁶ E.g. assets pledged as collateral.

¹⁷ Rights as stipulated in the legal documentations.

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s 25.11 Any subsequent commingling of funds arising from the injection of the *mudarib's* own funds into the *mudarabah* venture shall:

- (a) not nullify the *mudarabah* contract between the *rabbul mal* and the *mudarib*;
- (b) continue to cause application of this policy document for the *mudarabah* contract;
- (c) cause requirements of the *musyarakah* to apply for the *musyarakah* between the *mudarib* and the *mudarabah* venture; and
- (d) require proper distribution of profit and loss. This is illustrated in Appendix 7.

s 25.12 The IFI shall observe the applicable prudential limits and requirements based on the type of *mudarabah* funds used as specified in the relevant policy documents as per Appendix 10.

Profit

s 25.13 The PSR shall be mutually agreed between a *rabbul mal* and a *mudarib* and stipulated clearly in a *mudarabah* contract at the time of entering into the contract.

G 25.14 In determining the appropriate PSR, the IFI may consider the following factors:

- (a) estimated return on the *mudarabah* venture;
- (b) benchmark rate of return of equivalent product, underlying asset or business segment; and
- (c) estimated management or operational costs incurred by the *mudarib* in managing the *mudarabah* venture.

s 25.15 Notwithstanding the requirements in paragraph 16.16, the profit shall be recognized and measured based on the applicable Malaysian Financial Reporting Standards (MFRS).

s 25.16 As required under paragraph 16.18, an IFI shall conduct and, in the case

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where the IFI is the *rabbul mal*, ensure that the *mudarib* conducts an assessment at the end of a certain period of the *mudarabah* venture or upon actual realisation of profit to arrive at the actual amount of profit. A final adjustment in accordance with MFRS shall be undertaken to the amounts already recognized, to reflect the actual profit of the *mudarabah* venture.

- S 25.17 The methodology used for determining the profit distribution shall be objective, transparent and acceptable to all contracting parties. Only direct expenses shall be deducted in calculating the profit, defined¹⁸ as expenses which are:
- (a) identifiable and measurable; and
 - (b) compulsory and incurred in order to complete specific activities in the *mudarabah* venture.
- S 25.18 The contracting parties shall determine the time period or date for the profit distribution of the *mudarabah* venture.

Loss

- S 25.19 Pursuant to paragraph 17.1, any loss shall be recognized and measured based on the applicable MFRS.
- S 25.20 Expectations and requirements on the *mudarib* shall be sufficiently provided in the terms and conditions to ensure proper conduct of the *mudarib* and to protect the interests of the *rabbul mal* in the event of loss.
- S 25.21 The *mudarib* shall be fully liable if it is proven that the loss is due to his misconduct (*ta'addi*), negligence (*taqsir*) or breach of specified terms (*mukhalafah al-shurut*).
- S 25.22 If the loss is not attributed to misconduct, negligence or breach of specified

¹⁸ As per definition under the policy document on Rate of Return.

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terms of the *mudarib*, the loss shall be borne by the *rabbul mal* up to the amount of capital contributed.

S 25.23 Application of any mechanism which will effectively cause the *mudarib* to guarantee the principal amount upfront¹⁹ is prohibited.

Guarantee or Collateral

S 25.24 For the purpose of paragraph 18.2 (b), an independent third party guarantee shall exclude the following parties:

- (a) for corporate guarantors:
 - (i) entities²⁰ with control over the *mudarib*; or
 - (ii) entities controlled by the *mudarib* as defined in the MFRS²¹.
- (b) for individual guarantors:
 - (i) employee (and his close relatives) of the *mudarib*; or
 - (ii) controlling shareholder (and his close relatives) of the *mudarib*.

Exit²² from venture

S 25.25 An IFI shall clearly stipulate the terms and conditions of an exit of a *mudarabah* venture, which includes the:

- (a) tenure of the *mudarabah* venture;
- (b) time or intervals allowed for the purpose of withdrawal or redemption;
- (c) qualifying criteria for an exit before maturity;
- (d) methodology for valuation of underlying assets and calculation of profit and loss upon the exit;
- (e) potential amount payable or to be received, including compensation or damages incurred; and
- (f) operational procedures for the exit including submission of relevant

¹⁹ E.g. upfront waiver on loss absorption or wa'd to purchase assets or rights at price equivalent to capital provided.

²⁰ E.g. parent company.

²¹ Namely, MFRS 127 Separate Financial Statements.

²² May be in the form of dissolution, termination, withdrawal or redemption of the *mudarabah* capital.

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documents, notice period, number of days taken to process the transaction and settlement period.

Documentation

- s 25.26 An IFI shall develop comprehensive and legally enforceable documentation for a *mudarabah* venture which are in compliance with Shariah and regulatory requirements.
- s 25.27 At a minimum, the legal documentations shall clearly stipulate the following:
- (a) the purpose of the *mudarabah* venture;
 - (b) the contractual relationship between the various parties;
 - (c) the rights, roles and responsibilities of the parties to the *mudarabah* venture;
 - (d) the amount of capital contributed by the *rabbul mal*;
 - (e) the PSR;
 - (f) the loss that shall be borne by the relevant contracting parties;
 - (g) the calculation methodologies and timing for profit distribution;
 - (h) the tenure of the *mudarabah* venture;
 - (i) the pricing or valuation method of underlying assets;
 - (j) requirements on the reporting of the *mudarabah* venture's performance which includes the frequency and the information to be reported;
 - (k) details on the collateral and guarantees including rights over assets, if any;
 - (l) the terms and mechanism of exit; and
 - (m) the terms, fees and charges to be borne by the relevant contracting parties where applicable.
- s 25.28 The use of Arabic terminology in the documents shall be sufficiently clarified or translated to facilitate understanding of the contracting parties.
- s 25.29 Where there is an arrangement of *mudarabah* with other Shariah contracts, the IFI shall ensure that the documentation involved is separated and

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executed in a sequence that is consistent with Shariah requirements.

26. Risk management

Principle 4: The IFI shall institute and implement sound and integrated risk management system to effectively manage risks throughout the life cycle of the *mudarabah* ventures.

- G 26.1 A *mudarabah* venture may expose a *rabbul mal* to various types of risks, such as equity, market, liquidity, credit and operational risks. These risks, which appear at various stages of transactions, may change in nature and may necessitate a comprehensive and sound risk management infrastructure, reporting and control framework.
- s 26.2 An IFI shall establish comprehensive risk management policies and procedures, systems and internal control to address risks in line with its risk appetite, throughout the life cycle of a *mudarabah* venture and shall include the following:
- (a) the identification and monitoring of risks;
 - (b) the appropriate valuation and calculation methodology for underlying assets and distribution of profit;
 - (c) the risk exposure limits;
 - (d) the risk mitigation techniques; and
 - (e) the monitoring and reporting mechanisms.
- s 26.3 Internally, the IFI shall clearly specify and communicate the policies, procedures and limits to all its relevant functions.
- s 26.4 The IFI shall establish a systematic process to review and update its policies, procedures, internal limits and shall ensure consistency with the risk appetite of the IFI and material changes within the industry.
- s 26.5 The IFI shall have in place a rigorous stress testing framework on the

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mudarabah venture.

- S 26.6 In structuring the products based on *mudarabah* contract, the IFI shall ensure appropriateness of product structure against the intended risk and reward profile^{23,24}.

27. Financial disclosure

Principle 5: The IFI shall provide adequate disclosure and transparency to facilitate stakeholders' understanding and assessment of *mudarabah* ventures.

- S 27.1 An IFI shall maintain accounting records and other records in a timely manner which will sufficiently enable the preparation and reporting of financial statements that give a true and fair view.
- S 27.2 Requirements stipulated in the *Guidelines on Financial Reporting for Islamic Banking Institutions, Guidelines on Financial Reporting for Development Financial Institutions, Capital Adequacy Framework for Islamic Banks – Disclosure Requirements (Pillar 3)* issued by the Bank and all applicable MFRS shall be observed by the IFI.
- S 27.3 Specific governance and oversight function²⁵ in place for a *mudarabah* venture, if any, shall be disclosed.

²³ For example, IFI as a *mudharib* shall structure an Investment Account product which is commensurate with the objective as well as targeted risk and return profile of the particular investment account.

²⁴ For example, IFI as *rabbul mal* shall consider, among other matters, whether the *mudarabah* requires a Special Purpose Vehicle or any other specific arrangements.

²⁵ E.g. board observer in respective *mudarabah* venture and their roles

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28. Business and market conduct

Principle 6: The IFI shall undertake *mudarabah* ventures in a fair and transparent manner in line with Shariah to protect stakeholders' interests.

s 28.1 An IFI shall give due regard to the interests of contracting parties²⁶ in its policies and procedures to ensure that a *mudarabah* venture is conducted in a fair, transparent, responsible and professional manner.

Fair dealings

s 28.2 The internal policies and procedures of an IFI on business and market conduct for a *mudarabah* venture shall reflect fair dealing practices to the contracting parties, including:

- (a) the suitability assessment;
- (b) the information provided which shall be accurate, clear and not misleading;
- (c) the fees and charges (if any); and
- (d) reasonable care is taken to ensure suitability of advice and recommendations, if any.

s 28.3 All conflicts of interests including those that will potentially occur under a *mudarabah* venture shall be disclosed to the contracting parties by the IFI.

s 28.4 The IFI shall ensure fairness in the terms of the *mudarabah* contract including in any amendments to the *mudarabah* contract during renegotiation or extension of tenure.

Disclosure of information

s 28.5 At the pre-contractual stage, an IFI shall provide adequate and relevant information to the potential contracting parties in the marketing and promotional materials, product disclosure sheet and any other relevant

²⁶ For purposes of paragraph 28, contracting parties refer to the *rabbul mal* when the IFI is the *mudarib* or the *mudarib* when the IFI is the *rabbul mal*.

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materials with regard to a *mudarabah* venture. The information shall include:

- (a) a comprehensive description of the *mudarabah* venture, which includes;
 - (i) the contractual relationship between the *mudarib* and the *rabbul mal*;
 - (ii) the concept of profit sharing between the *mudarib* and the *rabbul mal* and loss bearing by the *rabbul mal*;
- (b) an overview of the transaction's structure;
- (c) the roles, responsibilities, rights and obligations of the contracting parties;
- (d) the key terms and conditions of the *mudarabah* contract; and
- (e) the requirements, if any, for guarantee and/or collateral (including the rights and obligation of contracting parties on the collateral pledged).

In relation to the product disclosure sheet, the IFI is also required to observe the minimum information to be disclosed in the product disclosure sheet as prescribed in the *Guidelines on Product Transparency and Disclosure*.

- s 28.6 The IFI shall facilitate the contracting parties' understanding of the concept of a *mudarabah* contract.

- s 28.7 At the point of entering into the contract, the IFI shall disclose the salient features of the *mudarabah* venture in the legal documentation to facilitate the contracting parties' understanding of the terms and conditions of the *mudarabah* contract.

- s 28.8 The IFI shall provide appropriate disclosure to the contracting parties during the tenure of the *mudarabah* venture such as providing timely notice of changes to terms and conditions, features, rights and obligations as well as fees and charges (if applicable).

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PART D SPECIFIC OPERATIONAL REQUIREMENTS FOR IFI AS CAPITAL PROVIDER

29. Background

s 29.1 In addition to the general operational requirements in Part C, an IFI is subject to the specific operational requirements under this Part D for a *mudarabah* venture which consists of products or services structured using a *mudarabah* contract where the IFI is the *rabbul ma*²⁷. The IFI shall refer to the Investment Account policy document for specific operational requirements for a *mudarabah* contract where the IFI is the *mudarib*.

30. Governance and oversight

s 30.1 Sound governance and oversight function requirements for *mudarabah* ventures shall reside within both the IFI and the *mudarabah* venture.

IFI's level

Dedicated function or unit at operational level

s 30.2 An IFI shall set up a dedicated function or unit specifically for *mudarabah* ventures within the IFI with the relevant skills and expertise to provide oversight on the *mudarabah* ventures.

s 30.3 The roles and responsibilities of the dedicated function or unit include:

- (a) conducting appraisal of proposals received from a potential *mudarib* and recommending a *mudarabah* venture to the relevant management committee if it is deemed viable;
- (b) monitoring the progress of the *mudarabah* venture, regular on-site²⁸ visits, on-going collection of relevant information and conducting analysis on impact to the *mudarabah* venture;
- (c) ensuring that risk management policies and internal control to manage exposures are adhered to; and

²⁷ Recorded as assets in the books of the IFI.

²⁸ Includes on-site visit for Shariah compliance purposes.

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- (d) promptly alerting the senior management if abnormalities are detected and preparing progress reports to the management on a periodical basis.
- s 30.4 The dedicated function or unit shall consist of personnel with the appropriate expertise, knowledge and competencies in the *mudarabah* venture.
- G 30.5 The IFI may appoint an external party to complement the operations of the dedicated function or unit²⁹ in areas or business activities where the IFI does not possess such expertise.
- s 30.6 For such appointment under paragraph 30.5, the IFI must ensure that:
- (a) the external party has the credibility, capacity, sufficient knowledge and expertise in the areas or business activities involved;
 - (b) there is no conflict of interest between the external party and the IFI;
 - (c) there is no conflict of interest between the external party and the *mudarib*; and
 - (d) appropriate legal documentation governing the transactions between the IFI and the external party to ensure enforceability of provisions such as liabilities, roles and responsibilities and confidentiality.

Dedicated Structure at Board and Senior Management level

- s 30.7 Where the exposure³⁰ to *mudarabah* ventures reaches 25% of the total capital³¹, an IFI shall establish dedicated oversight committees as follows to enable higher level of focus and in-depth deliberation;
- (a) Board Investment Risk Committee (BIRC) at board level; and
 - (b) Investment Committee (IC) at management level.
- s 30.8 The BIRC shall oversee the senior management's activities in managing

²⁹ Includes advisory, assessment, monitoring, review or any other processes necessary in managing the *mudarabah* venture.

³⁰ Includes non-sale based contracts where IFIs may be exposed to capital loss e.g. *Musharakah* venture.

³¹ As defined under the *Capital Adequacy Framework for Islamic Banks (Capital Components)*.

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risks related to *mudarabah* ventures and to ensure that the risk management processes are in place and functioning effectively. The roles and responsibilities of the BIRC includes:

- (a) reviewing and ensuring the effectiveness of policies and the risk management framework;
- (b) recommending to the Board for new or a change in investment strategy;
- (c) setting an authorisation limit for investments; and
- (d) overseeing the IC.

s 30.9 The IC shall be responsible to oversee the performance and ensure effective management of *mudarabah* ventures. The roles and responsibilities of the IC includes:

- (a) overseeing the progress of investment activities;
- (b) approving investment application;
- (c) recommending investment proposals and strategies to BIRC; and
- (d) performing an oversight function and approving investment to ensure that the investment is within the IFI's limit or strategy set.

The dedicated structure and details of the respective roles and responsibilities are given in Appendix 8.

s 30.10 The membership of the BIRC is limited to non-executive directors with at least three members and chaired by an independent director.

s 30.11 The IFI shall ensure that at least one member in the BIRC and the IC has the expertise and experience³² in the main business segments³³ relating to *mudarabah* ventures.

³² For example, if the IFI is involved mainly in properties, there must be at least a committee member who has experience in the real estate industry such as involvement in property development companies. In this regard, experience merely as a banker in real estate or mortgage financing may not be adequate.

³³ If the IFI is involved in more than one business segment at a time, the IFI shall apply judgment in identifying the main business segments that require the existence of a specific committee member with the relevant expertise.

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- G 30.12 Notwithstanding the requirements to establish a BIRC under subparagraph 30.7(a), the IFI may leverage on the existing board committee such as Board Risk Management Committee (BRMC) to undertake the functions of the BIRC.
- S 30.13 If the approach under paragraph 30.12 is adopted, the IFI shall ensure that:
- (a) mechanisms are in place to enhance the competency and credibility of the board committee members, including ensuring that at least one member in the existing board committee has the expertise and knowledge in the main business segments relating to the *mudarabah* venture; and
 - (b) the amount of losses or impairment of the *mudarabah* venture is low or insignificant³⁴ at all times.

***Mudarabah* Venture's level**

Observer

- S 30.14 For an IFI as a *rabbul mal*, the IFI shall ensure that effective mechanisms are in place to monitor and assess whether the *mudarib* is executing his duties effectively, diligently and in accordance with the stipulated terms and conditions of the *mudarabah* contract.
- S 30.15 The IFI shall establish appropriate safeguard measures to ensure effective governance and oversight at the venture level.
- G 30.16 The safeguard measures may include the appointment of a suitable observer with the necessary skills and experience at the *mudarabah* venture's board, management or project level. This is to ensure that the IFI has access to timely information, enhanced understanding of issues and is able to closely monitor the *mudarib*'s conduct in executing fiduciary duties both at the highest as well as at the working level in the *mudarabah* venture.

³⁴ For example, losses or impairment is not more than 5% of total *mudarabah* venture exposure.

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s 30.17 Where an observer is appointed for a complex structure such as a *mudarabah* venture involving multi-tiered SPV or indirect exposures, such appointment shall be made at the entity that conducts the actual business activity and/or the entity which has control over the actual business activity. Illustration of a complex structure is given in Appendix 9.

s 30.18 The IFI shall establish policies and procedures on the appointment of the observers which includes the eligibility criteria, conduct, roles and responsibilities and the review mechanism to enable the observer to discharge his duties effectively.

s 30.19 The appointed observer shall:

- (a) possess skill and in-depth knowledge of the nature of the business of the *mudarabah* venture;
- (b) possess the necessary qualifications, experience and qualities that enable him to discharge his duties effectively;
- (c) possess the maturity to understand the deliberations carried on in the *mudarabah* venture, especially those appointed at the Board level; and
- (d) must be “fit and proper” to hold the post which encompass:
 - (i) his probity, diligence, competence and soundness of judgment;
 - (ii) his reputation, character, integrity and honesty; and
 - (iii) any history of offence(s) involving fraud, dishonesty, violence, incompetence or malpractice, including any engagement in deceitful, oppressive or improper business practices or any practices which would discredit him.

G 30.20 The appointed observer may be an employee of the IFI, an employee of an entity within the IFI’s group of companies or an external party as the subject matter expert from the relevant industry.

s 30.21 The appointment of the observer shall be subject to the following conditions:

- (a) no conflict of interest between the observer and the IFI that may jeopardize the IFI’s interest. In particular, the IFI is not allowed to

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appoint its Board member as a board observer in the *mudarabah* venture;

- (b) no conflict of interest between the observer and the *mudarib* which may cause the oversight function to be ineffective;
- (c) the appointment terms shall define the rights and responsibilities of the observer including duties to the IFI, the prohibited conduct and the disclosure requirements;
- (d) if the observer is an external party to the IFI:
 - (i) the IFI must have in place an assessment process in appointing an external party as an observer to ensure that he has the credibility, knowledge and expertise in the areas or business activities involved; and
 - (ii) the external party shall provide a written undertaking to the IFI on the obligation to comply with the secrecy provision stipulated in section 145 of IFSA, section 133 of FSA or section 119 of DFIA, as the case may be.

s 30.22 The roles and responsibilities of the observer shall include the following:

- (a) reporting the progress and performance of the *mudarabah* venture to the IFI in a timely manner;
- (b) safeguarding the IFI's interest;
- (c) obtaining necessary information in order to validate any issues faced by the *mudarib*; and
- (d) maintaining a high level of integrity and avoiding any transactions with the *mudarib* or any other parties for personal benefit or gain.

s 30.23 The IFI shall have the following policy in place to ensure the effectiveness of the observer's function:

- (a) the *mudarabah* venture is recognized as one of his core job functions;
- (b) establish an internal limit on the number of invested entities for which each individual is allowed to be an observer e.g. each observer is limited to only two ventures at any time;
- (c) any assignment of an alternate observer shall be limited to only one

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other specified³⁵ person, who shall also be subject to the terms and conditions of the appointment of an observer; and

- (d) any fees or remuneration payable to the observer for conducting this function cannot be sourced from the *mudarabah*.

s 30.24 The IFI shall immediately relinquish the observer's function upon disposal of the IFI's interest in the *mudarabah* venture.

s 30.25 The IFI shall ensure the independence of all functions at the IFI and venture level are preserved at all times to enable checks and balances e.g. the board and project level observer shall not be the same person and the head of the dedicated unit or function shall not be the board observer.

31. Structuring

Sources of funds

s 31.1 An IFI's capital contribution under a *mudarabah* venture shall be subjected to the following requirements:

- (a) funding from Unrestricted Investment Account (UA)³⁶ and Restricted Investment Account (RA) are allowed provided that the requirements as per the policy document on Investment Account³⁷ are adhered to. In addition, any utilization of UA fund shall be subject to conditions that would significantly mitigate³⁸ liquidity risks;
- (b) funding from shareholders' funds are allowed subject to the following:
- (i) the IFI maintains adequate capital as required under the *Capital Adequacy Framework for Islamic Banks (Capital Components)*; and
- (ii) the IFI clearly establishes its risk appetite for *mudarabah*

³⁵ Specified means an alternate observer who shall be made permanent throughout the assignment and not be replaced by any other person.

³⁶ For the purpose of funding real estate business, UA is eligible as source of fund subject to conditions specified in paragraph 7.6 of Guidelines on Property Development and Property Investment Activities by Islamic Banks.

³⁷ UA and RA refer to URIA and RIA, respectively in the policy document on Investment Account

³⁸ This may include mechanisms such as matching of tenure between source and usage of funds, allowing redemptions only upon liquidation of underlying assets or replacement of investors other than the IFI.

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ventures and establishes an internal limit on the use of shareholders' funds which commensurate with its risk appetite; and

(c) funding from deposits are not allowed.

s 31.2 Where the mechanism of matching tenure under subparagraph 31.1(a) is used to significantly mitigate liquidity risk, any extension to the tenure of the *mudarabah* venture shall also be supported by an extension of redemption period for the UA and RA funds.

Usage of funds

s 31.3 In utilising funds for purposes of a *mudarabah* venture, an IFI shall assess the business venture viability and risk profile *i.e.* cash flow and risk and reward, in line with the IFI's risk appetite and sources of funds.

Contracting parties

s 31.4 The terms and conditions for the appointment of a *mudarib* shall include clarification of the liabilities to be borne by the *mudarib*.

s 31.5 An IFI shall assess the need for safety measures to ensure that any assignment of a *mudarabah* venture by a *mudarib* to another *mudarib* *i.e.* second *mudarib* will not impose additional risk to the *mudarabah* venture.

s 31.6 For purposes of paragraph 31.5, the IFI shall:

- (a) stipulate criteria or conditions of the *mudarib* in the agreement to ensure proper selection, effective management and proper conduct of the second *mudarib*;
- (b) have mechanisms in place to ensure that there is no conflict of interest between the *mudarib* and the second *mudarib*;
- (c) ensure that the following *mudarabah* contracts are executed separately and shall not negate individual responsibility under each contract:
 - (i) the *mudarabah* contract between the IFI and the *mudarib*; and

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- (ii) the *mudarabah* contract between the *mudarib* and the second *mudarib*;
 - (d) ensure that the terms in the contract between the *mudarib* and the second *mudarib* includes:
 - (i) the roles and responsibilities of the second *mudarib* including reporting obligation, frequency and furnishing detailed reports on any occurrence of loss;
 - (ii) the liabilities to be held by the second *mudarib*; and
 - (e) assess areas where expectations or requirements as imposed by the IFI on the *mudarib* should be similarly imposed on the second *mudarib*.
- s 31.7 The IFI shall have a mechanism in place to ensure that there is no conflict of interest between the *mudarib* and any parties appointed for business dealings.

Capital

- s 31.8 An IFI shall provide capital only in cash³⁹ to a *mudarib*. In addition, the capital provided shall not be via acquisition of shares⁴⁰ of the *mudarib* or the *mudarabah* venture.
- s 31.9 In addition to the requirements in paragraph 25.10, when there is commingling of the *mudarabah* capital with the *mudarib*'s other funds, the IFI shall ensure that the terms and conditions as well as any other measures taken are legally enforceable and effective in ensuring the IFI's rights on the underlying assets under the *mudarabah* venture.
- G 31.10 The capital may be fully or partially disbursed as per the terms of a *mudarabah* contract and additional capital injection is allowed within the tenure of the *mudarabah* venture, subject to mutual agreement between the IFI and the *mudarib*.

³⁹ Capital in-kind is not allowed.

⁴⁰ Where IFI subscribes to the shares issued by the *mudarib*.

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Profit

- S 31.11 The methodology used for determining the calculation and distribution of profit shall be objective, transparent and acceptable to all contracting parties.
- G 31.12 With regard to the final adjustment to the profit or loss calculation of a *mudarabah* venture as mentioned in paragraph 25.16, an IFI may wish to identify measures to prevent complications of the profit being over-distributed, before such adjustments are made between the IFI and the *mudarib*.

Loss

- S 31.13 An IFI shall have effective processes in place to ensure that the *mudarib* provides justification and a detailed report on any occurrence of loss, underperformance against projected returns or derailment from expected performance in a timely manner to the IFI.
- S 31.14 In order to mitigate risks, the IFI shall only provide restricted *mudarabah* funding to the *mudarib*. Under this arrangement, the IFI shall identify specific requirements such as details on the business scope, specific assets involved, milestones and deliverables by the *mudarib*.
- G 31.15 The IFI may set criteria⁴¹ on misconduct and negligence in the *mudarabah* venture terms and conditions to provide clarity, encourage proper conduct of the *mudarib* and to protect the interests of the IFI in the event of loss.
- S 31.16 The *mudarabah* venture shall be separated from the *mudarib*'s other businesses. The venture shall be structured via a separate entity e.g. an SPV if the business falls under the following circumstances:
- (a) existence of high-risk activities; where the *mudarib* has other high-risk

⁴¹ Such as setting expectations on maintaining proper books and records, transparency, disclosure of information.

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business activities which may affect the *mudarabah* venture. Examples of ventures that are considered as high-risk are:

- (i) products that are still at the exploratory or prototype stage e.g. pharmaceuticals; or
 - (ii) industries with a high rate of obsolescence e.g. technology sector; or
- (b) inability to practise effective management; where the IFI is unable to appoint observer(s) or unable to operationalize the use of the designated account⁴² under the non-SPV set-up.

S 31.17 The IFI shall assess whether the *mudarabah* venture should be segregated from the IFI and structured under a separate entity such as an SPV. The factors to be considered include:

- (a) activities and level of risk involved such as the examples in subparagraph 31.16(a); and
- (b) the need to limit risks or claims on the IFI or potential legal impact to the IFI.

S 31.18 If the *mudarabah* venture is structured in the form of a separate entity, it shall be:

- (a) a limited liability entity (e.g. established under the Companies Act 1965); and
- (b) for single-purpose only, which shall be determined by the IFI.

G 31.19 While requirements in paragraphs 14.5 and 25.6 limit the IFI's involvement in the *mudarabah* venture, the IFI may identify covenants necessary to protect the IFI's interest to be included in the legal documentation and agreed at the time of entering into the contract. For example:

- (a) negative covenants preventing certain actions and conduct by the *mudarib* or positive covenants that requires the *mudarib* to conduct

⁴² As per paragraph 32.7.

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specified actions; and/or

- (b) prior notification needed to be given to the IFI on specific decisions or actions taken by the *mudarib*.

Tenure

s 31.20 An IFI shall determine a fixed tenure⁴³ for a *mudarabah* venture. Any decision to extend the tenure of the *mudarabah* venture shall be supported by justifiable reasons such as delay in construction or significant change in market conditions and after conducting appropriate renegotiation and reassessment such as the cost benefit analysis.

Guarantee or collateral

s 31.21 For purposes of meeting the requirements under paragraph 18.2, an IFI shall conduct assessment on:

- (a) the need for collateral or guarantee and its intended purpose⁴⁴;
- (b) the value of assets acceptable as collateral;
- (c) acceptability of collateral and eligibility of guarantors, which includes:
 - (i) existing legal impediments on collateral such as encumbered assets;
 - (ii) financial strength of the guarantors; and
 - (iii) third parties' eligibility as guarantors as per paragraph 25.26.

s 31.22 The IFI shall ensure legal enforceability of any collateral or guarantee documentation.

Exit⁴⁵ from venture

s 31.23 As part of the measures to mitigate risks, an IFI shall identify potential exit options in order to immediately cut loss, taking into consideration the overall impact to the IFI which may include potential compensation or damages

⁴³ Takes into consideration the appropriate tenure to maximise returns.

⁴⁴ To cover losses due to misconduct, breach of contract or negligence or to cover losses due to any other reasons.

⁴⁵ May be in the form of dissolution, termination, redemption or withdrawal of the *mudarabah* capital.

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payable to a *mudarib*.

32. Risk management

- S 32.1 An effective risk management framework shall consist of three main stages prevalent in a *mudarabah* venture:
- (a) the pre-contractual stage;
 - (b) the during or on-going stage; and
 - (c) the exit stage.

Pre-contractual stage

- G 32.2 At the pre-contractual stage, the risk management objective is to enable sufficiency of information for decision making purposes before embarking on a *mudarabah* venture.

Feasibility assessment

- S 32.3 An IFI shall ensure that the objectives and criteria of potential *mudarabah* ventures are in line with the IFI's investment strategy.
- S 32.4 The IFI shall ensure that a comprehensive and robust feasibility and due-diligence framework is in place to facilitate effective decision making, which includes the following:
- (a) the assessment methodologies employed are suitable for the type of products, services and business segments under the *mudarabah* venture e.g. the use of an assessment framework under a similar business segment for sale-based financing⁴⁶ may not be exactly suitable for a *mudarabah* venture due to differences in the nature of funding;
 - (b) the assessment shall be based on empirical evidence based on both quantitative and qualitative analysis. Should there be any data limitations, the IFI shall identify other means to support the

⁴⁶ Such as *murabahah* financing.

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assessment such as using relevant data as proxies. Where judgment is significantly involved, the IFI shall have in place the parameters for the application of judgment in the assessment process e.g. identifying appropriate personnel or committee that can exercise such judgment;

- (c) salient risks and important features affecting the prospects of the *mudarabah* venture have been taken into consideration. Salient risks such as investment, market, operational (which includes legal risk and Shariah non-compliance risk), liquidity and credit risks shall be assessed appropriately. All relevant factors affecting these risks shall be identified and assessed including:
- (i) the credibility, capability, track record⁴⁷ and experience of the *mudarib* including any other parties involved in the *mudarabah* venture such as a second *mudarib*, agents, contractors and suppliers. This also includes assessment of potential conflict of interest amongst the parties involved;
 - (ii) the transaction or venture characteristics such as marketability of products or services which are influenced by several factors including the type and design of the products or services, consumer demand, location, promotional strategies and competition;
 - (iii) the expected selling price, costs involved, expected cash-flow and any potential changes affecting the *mudarabah* venture; and
 - (iv) the enforceability of legal requirements, Shariah-compliance of the business activities as well as economic and regulatory changes;
- (d) robust methodologies are applied in assessing projection of returns, costs involved and cash-flows, taking into consideration stressed conditions such as potential changes in the costs of materials, delay in sales, increase in labour costs or delay in delivery. For this purpose, the IFI shall ensure that sound assumptions based on objective

⁴⁷ Such as performance and financial track record.

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evidence are used in arriving at the projections. In addition, the IFI shall be more conservative in their projection of returns when the actual cash-in flow is based on bullet projection of repayments due to uncertainty in business and market conditions;

- (e) the information used for assessment purposes are current, relevant and obtained from reliable sources; and
 - (f) the assessment process is conducted by parties⁴⁸ with appropriate knowledge and expertise in the relevant business activity and no conflict of interest with the potential *mudarib*. Where external parties are involved, the IFI shall also have in place the policies and procedures which includes the criteria on the selection of suitable external parties.
- G 32.5 In addition to the assessment usually applied for sale-based financing, the IFI may wish to apply an appropriate business courtship⁴⁹ arrangement with the potential *mudarib* before embarking in a *mudarabah* venture. This will involve arrangement for getting to know the *mudarib* more thoroughly over a certain period of time involving close monitoring, information collection and familiarisation process before entering into the *mudarabah* venture.
- s 32.6 The IFI shall ensure that the rights to fully access the books and records of the *mudarib* and any information that would potentially affect the *mudarabah* venture shall be clearly stipulated by the terms and conditions.
- s 32.7 The IFI shall establish designated account(s) for the *mudarabah* venture where all financial transactions shall be maintained to enable close monitoring and supervision of transactions made by the *mudarabah* venture.
- s 32.8 Any credit facilities other than the capital contributions made under the

⁴⁸ The party conducting the assessment may be internal or external party.

⁴⁹ A period of time where an IFI engages and seeks for more information to better understand the business e.g. request for periodic performance overtime without any obligation.

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mudarabah venture, extended by the IFI shall be made on an arm's length basis whereby the terms and conditions for these facilities should not be more favourable than those granted to other obligors with similar background and creditworthiness.

- s 32.9 The IFI shall assess potential exit strategies for the proposed *mudarabah* venture and potential compensation or damages of all contracting parties.
- s 32.10 The legal mechanism on exit strategies shall be specifically and appropriately documented in the *mudarabah* contract to ensure a smooth exit.
- s 32.11 The IFI shall classify the *mudarabah* venture as impaired or loss-making in accordance with the applicable MFRS.
- G 32.12 For the purposes of internal assessment, the IFI may use relevant indicators⁵⁰ to monitor and classify a *mudarabah* venture according to its level of performance.

During or on-going stage

Active monitoring and continued assessment

- G 32.13 The risk management objectives at this stage are intended to ensure continuous monitoring in achieving long term strategy and value creation.
- s 32.14 An IFI shall ensure continuous monitoring on a *mudarabah* venture through adequate and robust risk reporting, risk monitoring and risk control framework with the aim to reduce the IFI's overall risk exposure and safeguard the IFI's investment portfolio. Any gaps or inappropriate risk exposures must be reported immediately.

⁵⁰ E.g. specified series of reduction or significant percentage of reduction in returns projection.

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s 32.15 The IFI shall have in place early-warning mechanism with pre-identified trigger events to facilitate prompt decision making upon any alarming performance of the *mudarabah* venture.

s 32.16 In respect of the *mudarabah* venture's performance reporting, the IFI shall conduct the following:

- (a) identify information required from the *mudarib* or other contracting parties, if any, including:
 - (i) periodical management and financial accounts of the *mudarabah* venture;
 - (ii) key performance indicators;
 - (iii) risk management practices;
 - (iv) minutes of the board of director's meetings; and
 - (v) significant activities or changes⁵¹ that have material effect on the performance of the *mudarabah* venture;
- (b) *mudarib* provides periodical reports in a timely manner; and
- (c) validate the reports received to mitigate the risk of potential manipulation on the performance results leading to understatements of *mudarabah* earnings. This may include validation of the reported earnings or losses, calculation of profits and valuation of underlying assets.

s 32.17 The IFI shall conduct assessment periodically on the projected returns of the *mudarabah* venture or upon the occurrence of material changes affecting the *mudarabah* venture. The frequency for such periodic assessment shall commensurate with the level of risk and complexity of the *mudarabah* venture.

s 32.18 The IFI shall have in place a sound valuation methodology that provides the

⁵¹ Such as change in management (e.g. resignation or election of new board of directors), change in key contractual parties (e.g. change of agent, contractor, supplier or other outsourcing party), and regulatory changes in business requirements (e.g. health and safety regulations and product bans).

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possible loss estimates for the *mudarabah* venture.

- s 32.19 The IFI shall establish a process to collect and analyse data and information on the *mudarabah* venture.
- s 32.20 If a third party is appointed to conduct any activity⁵² for the *mudarabah* venture, the IFI shall ensure that the *mudharib* conducts the following:
- (a) undertake proper selection process;
 - (b) monitor the effectiveness of functions and conduct of the third party;
 - (c) disclose information⁵³ about the third party; and
 - (d) ensure an exit mechanism is in place⁵⁴.
- G 32.21 Legal documentation may contain clauses that will enable the IFI to take actions against the *mudharib*'s failure to prepare timely periodical reports within a reasonable period.
- s 32.22 An effective asset-liability management shall be established to manage mismatch in returns and cash flows of the *mudarabah* venture and the IFI's source of funding.
- G 32.23 The contracting parties may appoint an independent third party to carry out valuations on the *mudarabah* venture to ensure transparency and objectivity in the valuation and distribution of the profits.

Underperforming mudarabah venture

- s 32.24 If a *mudarabah* venture is or is expected to be underperforming, the IFI shall conduct a detailed assessment on whether the *mudarabah* venture would continue to be viable.

⁵² E.g. sub-contracting, management of inventories.

⁵³ E.g. performance history, financial strength and company reputation.

⁵⁴ E.g. able to replace third party should the arrangement fail to deliver results.

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- s 32.25 The viability assessment shall take into consideration the following;
- (a) the possibilities for improvement on the issues and factors that lead to the underperformance;
 - (b) the feasibility of improvement plans proposed by the *mudarib*, such as change in the management, operational processes and period for turnaround;
 - (c) the appropriateness of the revised projection of returns and assumptions used to support such projection;
 - (d) the additional funding required; and
 - (e) whether the *mudarabah* venture's level of risk and reward are still within the IFI's risk appetite.
- s 32.26 After conducting the viability assessment of the *mudarabah* venture, any decision not to exit shall be:
- (a) based on plausible grounds, such as to minimise losses or high potential to recover the profits and capital;
 - (b) time-barred, whereby the IFI shall identify a fixed period for the *mudarib* to turnaround the *mudarabah* venture; and
 - (c) followed by the identification of clear strategies, measures and action plans⁵⁵ by the IFI.
- s 32.27 Risk monitoring, assessment and control functions shall be strengthened⁵⁶ if the underperforming *mudarabah* venture is to be continued.

Exit Stage

- s 32.28 Processes and procedures on the exit mechanism shall be clearly stipulated and communicated to the relevant functions or departments in an IFI in order to ensure effective and efficient execution of exit.
- s 32.29 An assessment on the impact of each exit options shall be conducted by the

⁵⁵ Which may include renegotiating the terms of the *mudarabah* venture.

⁵⁶ An example of a turnaround process flow for a *musyarakah* venture is stipulated in Appendix 11.

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IFI to determine the best value realisation.

s 32.30 The IFI shall obtain legal opinion that the exit mechanism can be executed without any legal impediments.

s 32.31 In the event the IFI exits from the *mudarabah* venture, an assessment on any potential damages payable to the *mudarib* or any other parties involved shall be conducted.

33. Financial disclosure

s 33.1 The financial disclosure⁵⁷ for a *mudarabah* venture shall include the following:

- (a) the value of the *mudarabah* venture:
 - (i) the initial capital contribution;
 - (ii) the outstanding or recoverable value⁵⁸ by sector including any losses incurred or provisions made during the period; and
- (b) the composition of aggregate sources of funds.

s 33.2 Any potential consolidation⁵⁹ in the financial statements of an IFI arising from the *mudarabah* venture shall be notified to the Bank in advance.

34. Business and market conduct

s 34.1 An IFI shall not disclose any material information, for example trade secrets, of the *mudarabah* venture to any third party without authorisation from the *mudarib*.

⁵⁷ Illustration of the disclosure requirements is given in Appendix 12.

⁵⁸ Exposure value as per MFRS.

⁵⁹ Refers to line-by-line consolidation.

APPENDICES

Appendix 1 Legitimacy of *mudarabah*

1. The legitimacy of the *mudarabah* contract is derived from the *Quran*, and founded on the *Sunnah* of the Prophet Muhammad (peace be upon him), and the consensus of Muslim jurists (*Ijma*).

The *Quran*

2. The following verse of the *Quran* implies the general permissibility of commercial venture including *mudarabah*.

(i) وَأَخْوَانٌ يَـضُرُّونَ فِي الْأَرْضِ يَبْتَغُونَ مِنْ فَضْلِ اللَّهِ

“...and others travelling in the earth in quest of Allah’s bounty...”⁶⁰

The word (يَضُرُّونَ) in the verse implies permissibility to travel in managing wealth to seek the bounty of Allah SWT which may take the form of *mudarabah*.

The *Sunnah* of The Prophet Muhammad (peace be upon him)

3. عن ابن عباس قال: كان العباس بن عبد المطلب إذا دفع مالا مضاربة اشترط على صاحبه أن لا يسلك به بحرا، ولا ينزل به واديا، ولا يشتري به ذات كبد رطبة، فإن فعل فهو ضامن، فرفع شرطه إلى رسول الله صلى الله عليه وسلم فأجازته.

“Ibnu Abbas (may Allah be pleased with him) reported that: “When Abbas Ibn Abd al-Muttalib gave his property to someone for *mudarabah*, he stipulated conditions for his partner not to bring the capital onto the sea; and not to bring with him the capital crossing a valley; and not to buy

⁶⁰ Surah al-Muzzammil, verse 20.

livestock with the capital; and if his partner violates the conditions, he should guarantee the loss occurred. These conditions have been brought to the attention of Prophet Muhammad (peace be upon him) and he approved them.”⁶¹

4. عن صالح بن صهيب عن أبيه قال: قال رسول الله صلى الله عليه وسلم: (ثلاث

فيهن البركة: البيع إلى أجل والمقارضة وأخلاط البر بالشعير للبيت لا للبيع)

“Suhayb (may Allah be pleased with him) reported that the Prophet Muhammad (peace be upon him) said: Three matters that have the blessing (of Allah): A deferred sale, *muqaradah* (*mudarabah*), mixing wheat with barley for domestic use and not for sale.”⁶²

Consensus of The Muslim Jurists (*Ijma'*)

5. The Muslim jurists have reached *Ijma'* among them on the permissibility of the *mudarabah* contract.

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⁶¹ Al-Bayhaqi, *Al-Sunan al-Kubra*, v. 6, p. 111.

⁶² Ibn Majah, *Sunan Ibn Majah*, hadith no. 2289.

Appendix 2 Glossary

Terms	Definition
<i>Hibah</i>	A transfer of ownership of an asset from a donor to a donee without any consideration.
<i>Mudarabah</i> asset	Asset created under a <i>mudarabah</i> venture.
<i>Mudarabah</i> venture	Business or profit generating activities undertaken by <i>mudarib</i> in managing capital provided by the <i>rabbul mal</i> .
<i>Mudarib</i>	Entrepreneur of a <i>mudarabah</i> venture.
<i>Mudarib yudarib</i>	<i>Mudarabah</i> contract where the <i>rabbul mal</i> invests his capital with a <i>mudarib</i> who subsequently invests the fund with another <i>mudarib</i> .
<i>Musyarakah</i>	A partnership between two or more parties, whereby all parties will share the profit and bear the loss from the partnership.
Profit sharing ratio	The ratio in which the profits are shared between the <i>rabbul mal</i> and <i>mudarib</i> .
<i>Rabbul mal</i>	Capital provider.
<i>Wa`d</i>	A promise or undertaking which refers to an expression of commitment given by one party to another to perform certain action(s) in the future.
<i>Wadi`ah</i>	A contract by which an asset is placed with another party for safekeeping.
<i>Wakalah</i>	A contract in which a party as principal authorizes another party as his agent to perform a particular task in matters that may be delegated, with or without imposition of a fee.

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Appendix 3 Related Shariah rulings and policy documents

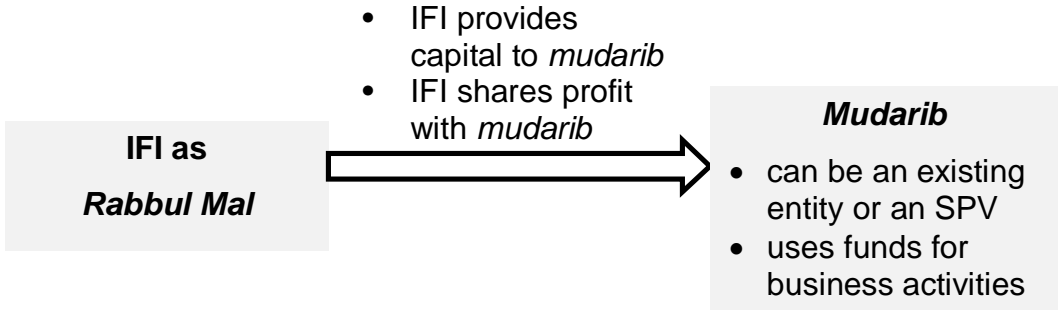
1. Investment Account
2. Shariah Advisory Council (SAC) rulings published by the Bank⁶³;
3. Guidelines on Corporate Governance for Licensed Islamic Bank;
4. Guidelines on Corporate Governance for Development Financial Institutions;
5. Shariah Governance Framework for Islamic Financial Institutions;
6. Rate of Return;
7. Musyarakah;
8. Guidelines on Financial Reporting for Islamic Banking Institutions;
9. Guidelines on Financial Reporting for Development Financial Institutions;
10. Capital Adequacy Framework for Islamic Banks – Disclosure Requirements (Pillar 3);
11. Guidelines on Product Transparency and Disclosure;
12. Capital Adequacy Framework for Islamic Banks (Capital Components);
13. Guidelines on Property Development and Property Investment Activities by Islamic Banks;
14. Guidelines on Investment in Shares and Interest-in-Shares and Collective Investment Schemes for Islamic Banks;
15. Single Counterparty Exposure Limit; and
16. Applicable Malaysian Financial Reporting Standards (MFRS).

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⁶³ Including Shariah resolutions in Islamic Finance, standards, circulars or any directive pertaining to Shariah matters issued by the Bank.

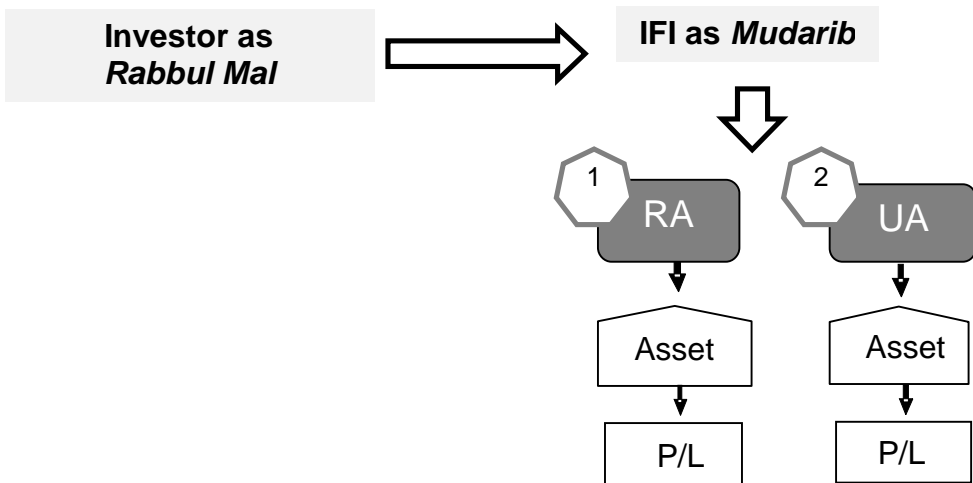
Appendix 4 Differences in the role of IFI in *mudarabah*

1. IFI's role as a *rabbul mal*



2. IFI's role as a *mudarib*

- Investor places fund to IFI
- Investor shares profit with IFI



- 1 Restricted Investment Account (RA) – capital provided by investor is invested into specific assets as determined by investor.
- 2 Unrestricted Investment Account (UA) – capital provided is invested into assets determined by the IFI.

Appendix 5 *Mudarabah* venture (providing capital via cash)

Diagram 1: Provide funding for a specific purpose in a company

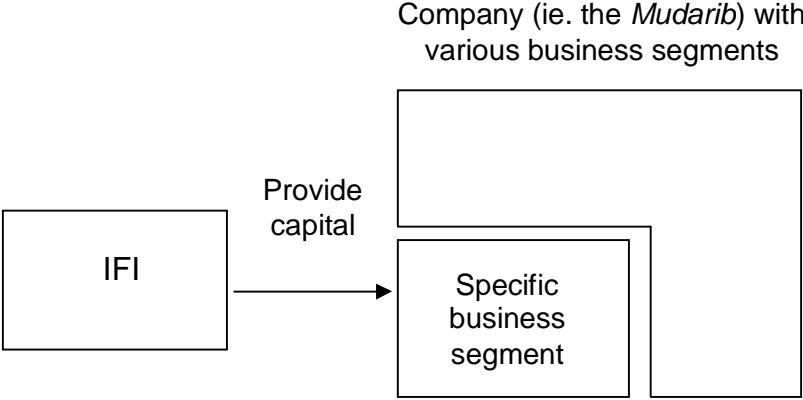
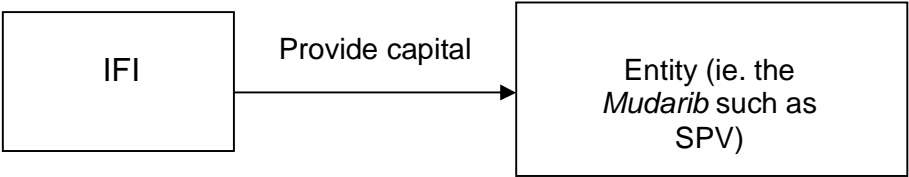


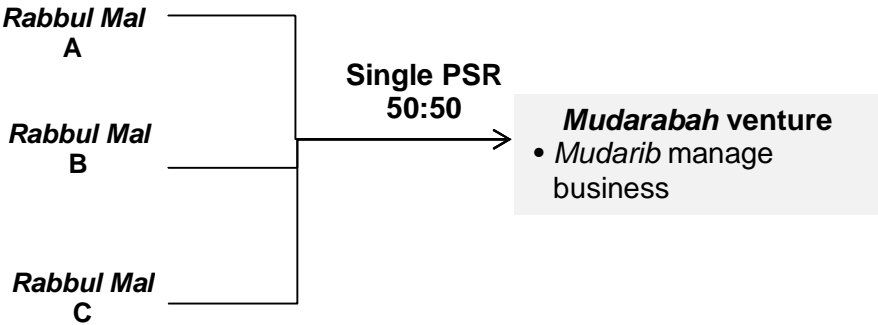
Diagram 2: Provide funding for a special purpose vehicle (SPV)



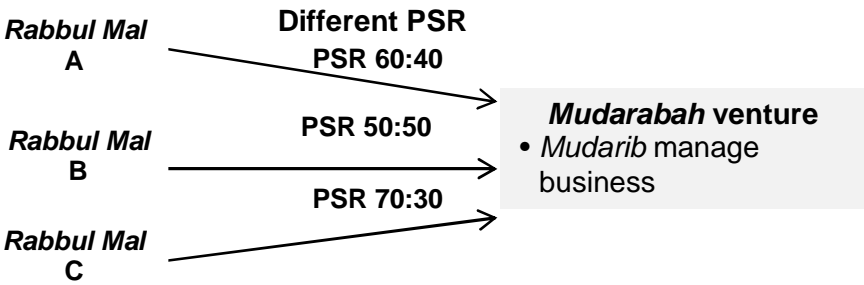
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Appendix 6 *Mudarabah* involving multiple *rabbul-mal*

Single PSR structure



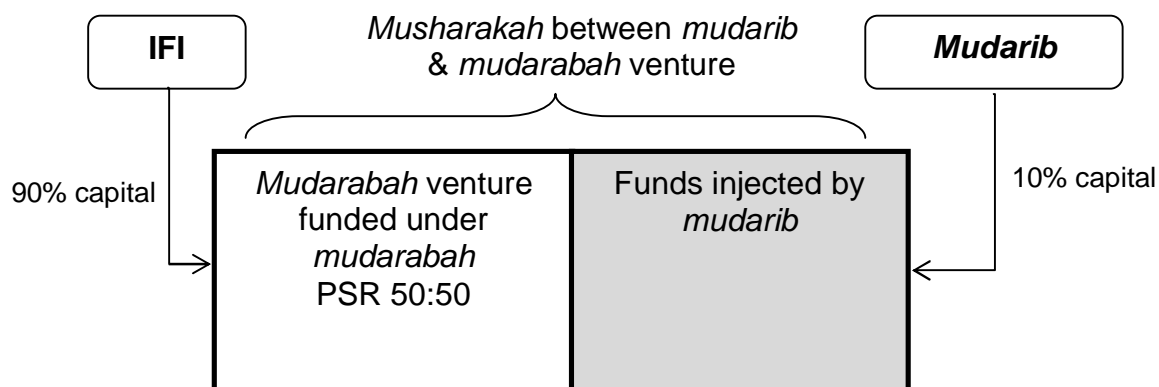
Multiple PSR structure



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Appendix 7 Proper distribution of profit and loss when *mudarib* injects capital

Example:

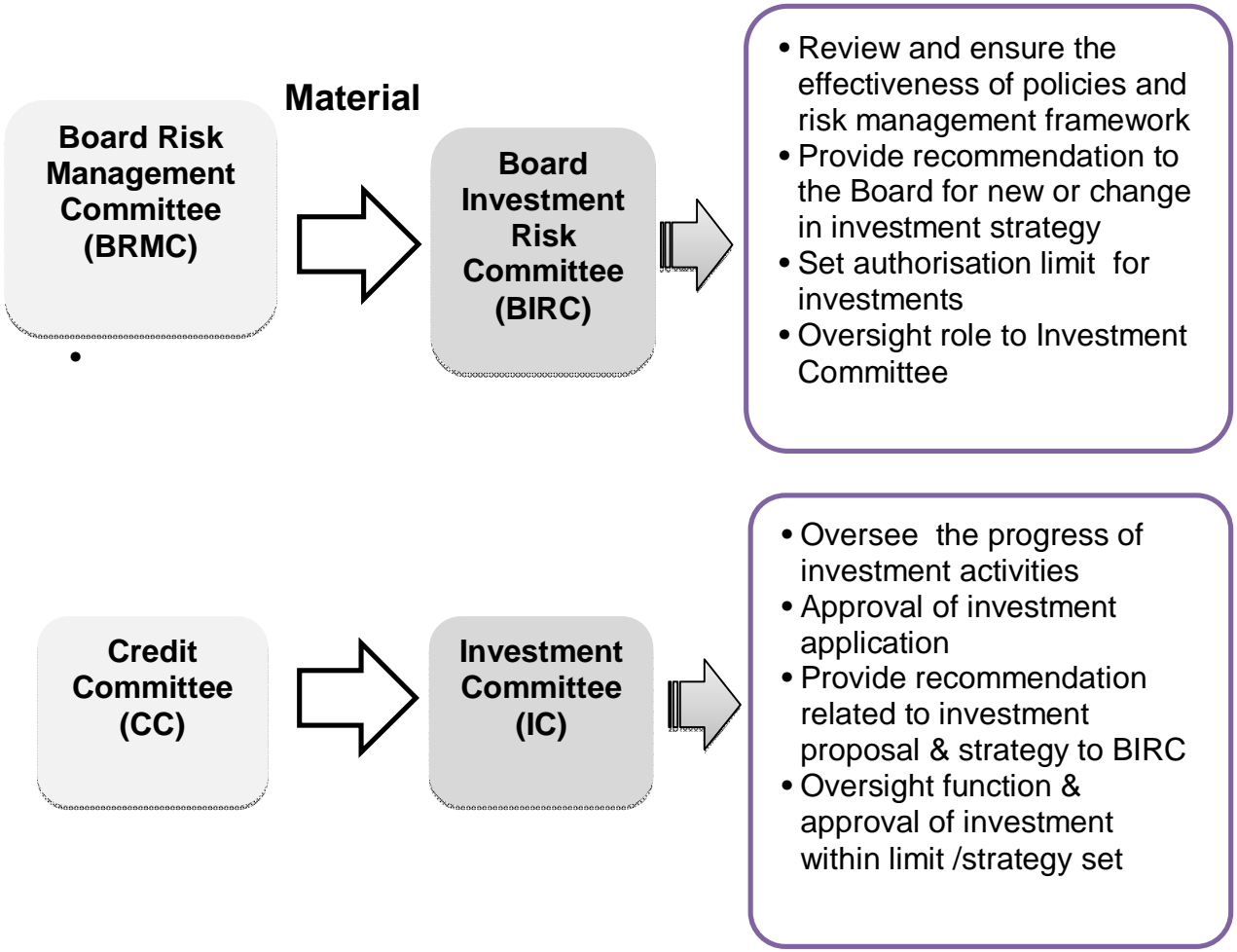


Upon the *mudarib* injecting his own funds/capital into the business:

1. *Musharakah* is formed between the *mudarib* and the *mudarabah* venture
2. Profit /Loss:
 - i) For the *musharakah*, loss shall be distributed according to the amount of capital contribution i.e. ratio of 90:10 and profit shall be distributed according to agreed terms and conditions;
 - ii) Subsequently, for the *mudarabah* venture, loss shall be absorbed by the *rabbul-mal* and profit is to be calculated as per PSR i.e. ratio of 50:50.

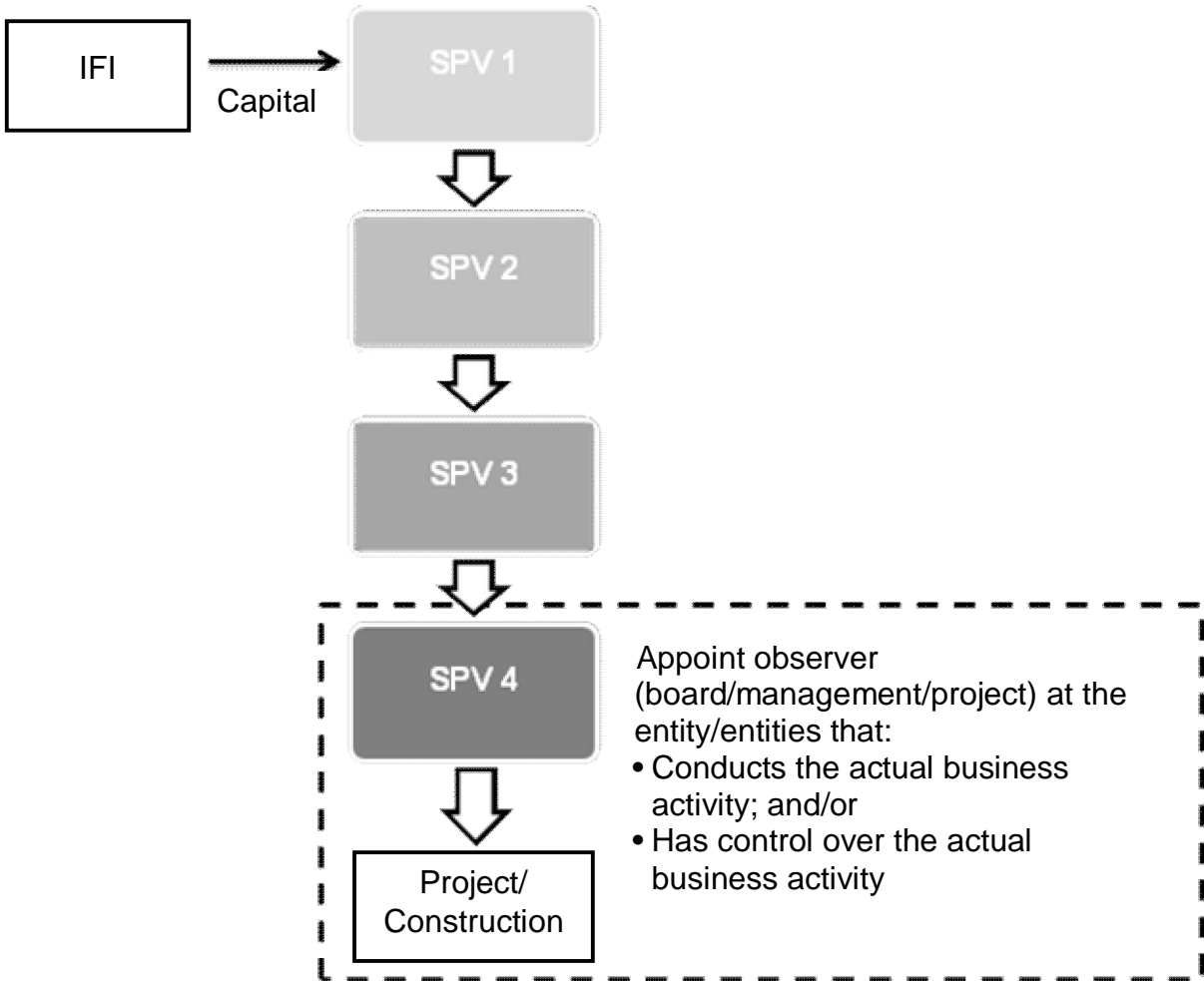
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Appendix 8 Dedicated structure



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Appendix 9 An example of complex structure in *mudarabah*



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Appendix 10 Prudential limits and requirements⁶⁴ based on sources of funds

Sources of funds	Policy Document	Guidelines on Property Development and Property Investment Activities by Islamic Banks		Guidelines on Investment in Shares and Interest-in-Shares and Collective Investment Schemes for Islamic Banks	Single Counterparty Exposure Limit (SCEL) for Islamic Banking Institutions
	Use of General Investment Account (GIA) is limited up to 15% of total GIA fund of IFI for funding real estate business	Permissible structure to participate in property development activities <ul style="list-style-type: none"> Must be through joint-venture or equity participation with reputable property development companies that are not subsidiaries of the IFI 	Investment in each real estate business shall not exceed 25% of IFI's total capital ⁶⁵	<ul style="list-style-type: none"> Aggregate book value of investment in shares, interest-in-shares, CIS and immovable properties shall not exceed 50% of IFI's total capital⁶⁵ Aggregate book value of investment in shares & interest-in-shares shall not exceed 25% of IFI's total capital⁶⁵ 	Treatment of exposures funded by RA and UA as per para 8.5 and 8.6 of the policy document
RA	Not applicable	Exempted ⁶⁶	Exempted	Exempted	Excluded ⁶⁷ for IFI as <i>mudharib</i>
UA	Applicable	Applicable	Applicable	Exempted	Excluded ⁶⁷ for IFI as <i>mudharib</i>

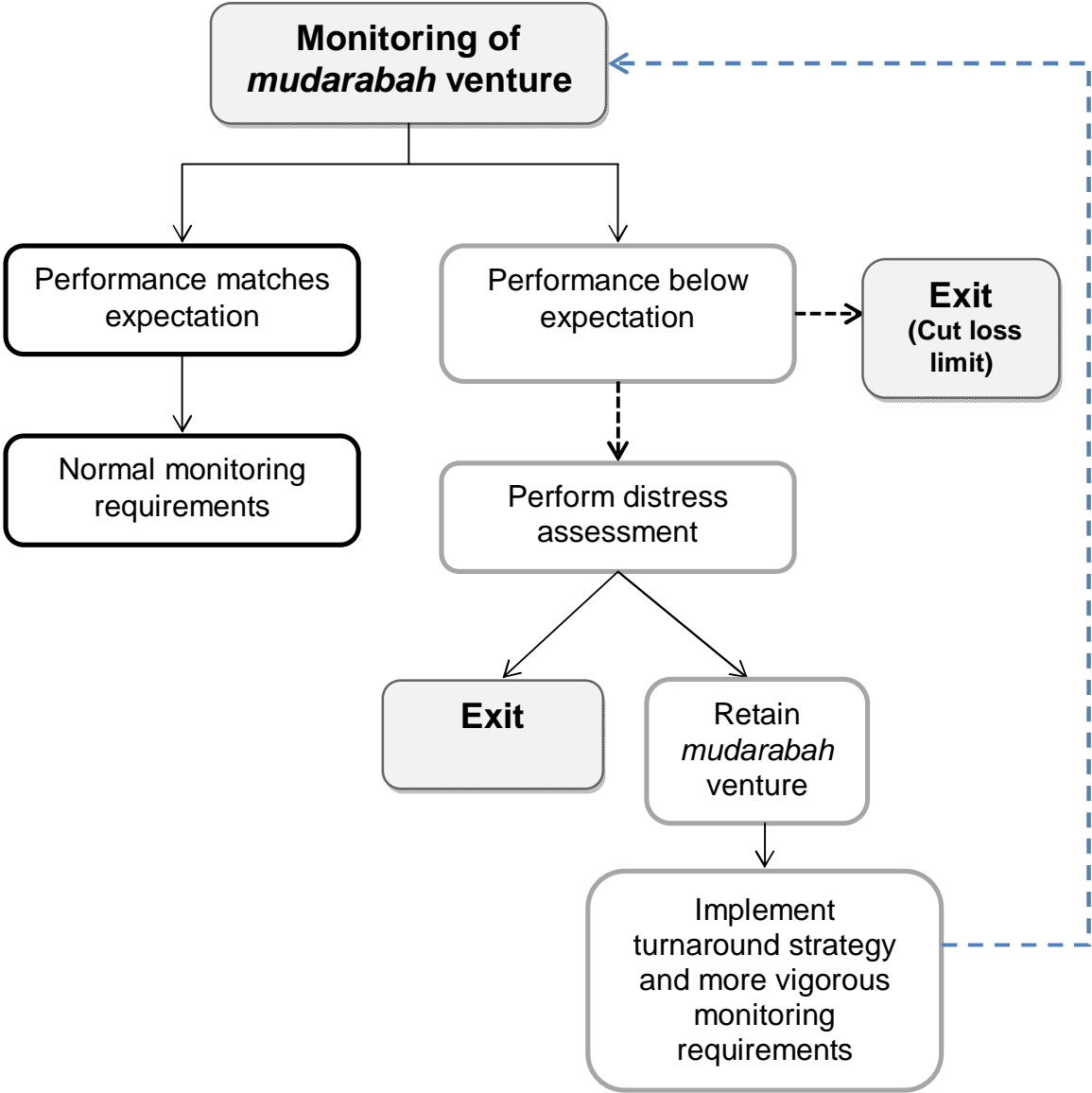
⁶⁴ Subject to changes in respective policy documents.

⁶⁵ Total capital as per defined in the Capital Adequacy Framework for Islamic Banks (Capital Components)

⁶⁶ RA funds which are off-balance sheet.

⁶⁷ For IFI which places RA/UA to another IFI, look-through approach shall apply.

Appendix 11 Distress assessment process flow



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Appendix 12 Illustration of additional financial disclosure for *mudarabah* venture

Notes to Account

Amount funded by:

Unrestricted Investment Accounts (UA)	x
Restricted Investment Accounts (RA)	x
Shareholders' fund	x
	xxx

Mudarabah

Sector	Initial capital (RM'000)	Losses/Impairment Provisions (RM'000)	Amount as at 31 Dec 20XX (RM'000)
Property	xxx	xxx	xxx
Manufacturing	xxx	xxx	xxx
Total	xxx	xxx	xxx

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