BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

Concept Paper

Shariah Requirements, Optional Practices and Operational Requirements of *Mudarabah*

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As part of the objectives to strengthen the Shariah-compliance practices among Islamic financial institutions (IFI), Bank Negara Malaysia (the Bank) embarks on the initiative to develop a Shariah-based regulatory standard. The Bank is issuing a series of Standards on Shariah contracts to enhance end-to-end compliance with Shariah. These Standards consist of two components, Shariah and Operational requirements. The Shariah requirements highlight the salient features and essential conditions of specific Shariah contracts to facilitate sound understanding of a particular contract. The Operational requirements set out the expectations with respect to the oversight function, product structuring, risk management, reporting and disclosure as well as consumer and market conduct. This Concept Paper (CP) provides both the Shariah and Operational requirements for *mudarabah* contract. However, this CP is seeking feedback only on the operational requirements of *mudarabah* contract under **Part C and D**, as the Shariah requirements in Part B have already been finalised. The Bank invites IFI to provide written feedback on specific questions set out in this CP as well as any general comments. In addition, IFI may seek clarification on specific issues/areas and highlight alternative proposals for the Bank to consider. The feedback must be supported with clear rationale, accompanying evidence or illustration, as appropriate to facilitate effective review of the standard.

Responses shall be submitted to the Bank by 20 January 2014 to:

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PART A OVERVIEW

1. Introduction

1.1 Compliance with all validity conditions specified by Shariah is prerequisite of a legitimate Islamic finance products and services. It is essential for Islamic financial institutions (the IFI) to establish comprehensive operational framework that is consistent with Shariah to govern the conduct of Islamic finance transactions. In this regard, IFI must ensure that its entire financial activities are implemented with good governance, prudent and transparent manner. This will ensure the integrity of Islamic finance transactions and financial stability of IFI continues to be preserved and sustained respectively.

1.2 In Islamic finance, IFI employs several Shariah contracts in carrying out its financial activities. One of the Shariah contracts is *mudarabah,* which is a contract based on 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.*

Objectives

1.3 This policy document outlines the Shariah requirements and optional practices of *mudarabah* as well as key operational requirements governing the implementation of *mudarabah* that are in line with Shariah, to ensure sound financial practices throughout the life cycle of *mudarabah*.

Scope of Policy Document

1.4 This policy document covers all products and services structured using the *mudarabah* contract[1] other than capital market instruments[2].

[1] Both IFI as *rabbul mal* and/or *mudarib.*

[2] Under the purview of Securities Commission.

1.5 Part B provides the Shariah requirements that must be adhered to in ensuring the validity of *mudarabah* and its optional practices.

1.6 Part C and D complement the Shariah requirements under Part B and the relevant existing regulatory framework on governance and oversight, structuring, risk management, disclosure as well as consumer and market conduct issued by the Bank. It describes five key principles for sound management and operationalisation of *mudarabah* as follows:

a) **Principle 1**: IFI must establish comprehensive policies and procedures to facilitate proper oversight arrangement and ensure *mudarabah* are conducted with sound practices and in compliance with Shariah;

b) **Principle 2**: IFI must ensure the implementation of *mudarabah* is supported with comprehensive processes and procedures, adequate systems and robust documentations;

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

d) **Principle 4**: IFI must institute and implement sound and integrated risk management system to effectively manage risks throughout the life cycle of *mudarabah*; and

e) **Principle 5**: IFI must undertake *mudarabah* in a fair and transparent manner to protect stakeholder's interest.

1.7 Part D provides more specific operational requirements for *mudarabah* venture, which consists of products or services structured using *mudarabah* contract when IFI is the *rabbul mal*[3].

[3] Recorded as assets in the books of the IFI.

2. Applicability

2.1 This policy document is applicable to all Islamic financial institutions as defined in paragraph 5.2.

These institutions are referred to in this policy document as "Islamic financial institutions (IFI)".

2.2 Part B of this policy document shall also apply to a licensed takaful operator under the IFSA.

3. Legal Provisions

3.1 The requirements in this policy document are:

a) specified pursuant to section 29(1) and (2) of IFSA; and

b) directions issued pursuant to section 129(3) of DFIA.

4. Effective date

4.1 This policy document comes into effect on 20 December 2013.

5. Interpretation

5.1 The terms and expressions used in this policy document shall have the same meanings assigned to them in the FSA, IFSA and DFIA unless otherwise defined in this policy document.

5.2 For the purposes 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 may consist of such information, advice or recommendation intended to promote common understanding and sound industry practices which are encouraged to be adopted.

"Islamic financial institutions" or "IFIs" means:

(a) licensed Islamic banks under the IFSA;

(b) licensed banks and licensed investment banks under the FSA approved under section 15(1)(a) FSA to carry on Islamic banking business; and

(c) prescribed institutions under the DFIA approved under section 129(3) DFIA to carry on Islamic banking business or Islamic financial business; and

for the purposes of Part B only, shall include licensed takaful operators under the IFSA.

5.3 Further interpretation and definition is given in **Appendix 1**.

6. Related legal and policy documents

6.1 This policy document must be read together with the legal and policy documents listed in **Appendix 2**.

7. Policies Superseded

7.1 This policy document supersedes the requirements for *mudarabah* in the *Guidelines on Musharakah and Mudarabah Contracts for Islamic Banking Institutions* and *Shariah Standard on Mudarabah*.

PART B SHARIAH REQUIREMENTS AND OPTIONAL PRACTICES OF *MUDARABAH*

8. Definition and Nature of *Mudarabah*

S 8.1 *Mudarabah*[4] is a contract between a *rabbul mal* and a *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 *mudarib* according to 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*).

S 8.2 *Mudarabah* is a contract based on fiduciary relationship (*aqd al-amanah*). Under this principle, *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 8.3 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) Contracting parties have agreed to enter into a *mudarabah* for a specified time or have agreed not to terminate the contract within a specified time.

[4] The terms *muqaradah* and *qirad* are synonymous to *mudarabah*.

8.4 *Mudarabah* is categorized into two types:

S

a) Unrestricted *Mudarabah* (*Mudarabah Mutlaqah*) is a contract in which the *rabbul mal* permits the *mudarib* to manage the *mudarabah* capital without any specific restriction.

S

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

i) A restricted *mudarabah* is a contract in which the *rabbul mal* imposes specific restriction on the *mudarabah* terms.

G

ii) 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 8.5 The contracting parties may mutually agree to change the type of *mudarabah* they have entered into to another type of *mudarabah* at any point of time.

COMPONENTS OF *MUDARABAH*

9. Contracting Parties

S 9.1 The contracting parties in *mudarabah* consist of *rabbul mal* and *mudarib*.

S 9.2 *Rabbul mal* and *mudarib* shall have legal capacity[5] to execute contract, including the capacity to perform agency (*wakalah*) contract either as a principal or as an agent.

G 9.3 The contracting parties in *mudarabah* may be a natural person or a legal person.

[5] The legal capacity of a person is defined as capacity to have rights and responsibilities; and capacity to have 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.

G 9.4 The contracting parties in a *mudarabah* contract may involve more than one *mudarib* or *rabbul mal*.

G 9.5 In the case of *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 certain portion of 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.

10. Management of *Mudarabah*

S 10.1 *Mudarib* shall have the right to manage *mudarabah* venture.

S 10.2 *Mudarib* is responsible to ensure proper management of the *mudarabah* venture and acts in the interest of the *rabbul mal*.

S 10.3 Mandate of the *mudarib* shall be provided under the terms and conditions of the contract.

G 10.4 *Mudarib* may assign *mudarabah* capital under his management to another *mudarib* in another *mudarabah* (*mudarib yudarib*) or to another manager (*wakil*) subject to the condition that the consent of *rabbul mal* is obtained.

S 10.5 *Rabbul mal* shall not involve in managing *mudarabah* venture but shall have a right of access to reasonable information regarding the *mudarabah* venture.

11. Capital

S 11.1 Capital is an asset provided by *rabbul mal* to the *mudarib* for the purpose of *mudarabah*.

S 11.2 *Mudarabah* capital shall be provided by *rabbul mal* and managed by the *mudarib*.

S 11.3 *Mudarabah* capital shall be identifiable, readily available and accessible for *mudarib* to commence business activities.

G 11.4 *Mudarabah* capital may be in the form of cash or in-kind which may include intangible assets.

S 11.5 Capital in-kind shall be valued based on the valuation determined by a third party which may include experts, valuers or as agreed upon by the contracting parties at the inception of the contract.

S 11.6 *Mudarabah* capital denominated in different currencies shall be valued based on a specific currency agreed by the contracting parties at the inception of the contract.

S 11.7 *Mudarabah* capital shall not be in the form of a debt due to *rabbul mal* either from *mudarib* or a third party.

S 11.8 All remaining capital shall be returned to the *rabbul mal*, if any, upon dissolution or termination of the *mudarabah* contract.

S 11.9 Any amount of capital due to *rabbul mal* under paragraph 11.8 and profit, if any, shall be deemed as liability due to the *rabbul mal*.

S 11.10 The *mudarib* shall not guarantee the *mudarabah* capital except in the case of his misconduct (*ta`addi*), negligence (*taqsir*) or breach of specified terms (*mukhalafah al-shurut*).

G 11.11 *Rabbul mal* and *mudarib* may agree for a gradual withdrawal of *mudarabah* capital by the *rabbul mal*.

G 11.12 *Mudarib* may with the consent of *rabbul mal* commingle the *mudarabah* capital with other investment fund.

S 11.13 Pursuant to paragraph 12.12, *mudarib* shall observe the agreed terms and conditions of the respective contract.

G 11.14 *Mudarib* may inject his own fund into the *mudarabah* capital subject to the consent of *rabbul mal* and hence a *musharakah* contract is formed between the *mudarib* (as partner under *musharakah*) and the *mudarabah* venture.

G 11.15 *Mudarabah* expenditure may be charged to *mudarabah* capital.

S 11.16 The *mudarabah* expenditure shall be direct expenses that are identifiable and measurable with regard to a specific investment activity[6].

G 11.17 The capital may be fully or partially disbursed as per the terms of the contract.

G 11.18 The effect of a failure of *rabbul mal* to provide capital under a *mudarabah* contract (defaulting *rabbul mal*) in the following situations shall be as follows:

a) **No capital has been paid.**

In this situation, 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.

G b) ***Mudarabah* contract involving one *mudarib* and one *rabbul mal* with staggered capital payment.**

In this situation the contracting parties may, subject to the terms and conditions of the contract:

i) revise the *mudarabah* contract based on the actual capital provided;

[6]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.

or

ii) terminate the contract and consequently:

a. *Mudarib* shall return the capital contributed to the *rabbul mal,* if any, and share the profits with the *rabbul mal*, if any; and

b. *Rabbul mal* shall bear the *mudarabah* expenditure incurred by *mudarib*. If the justified *mudarabah* expenditure[7] incurred exceeds the actual capital contribution, such liability shall be borne by the *rabbul mal* up to the limit of the total capital amount committed under the contract.

G c) ***Mudarabah* contract involving one *mudarib* and multiple *rabbul mal* with single capital payment by each *rabbul mal* where one or more *rabbul mal* failed to pay.**

In this situation, the *mudarib* may agree to terminate the *mudarabah* contract with *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.

G d) ***Mudarabah* contract involving one *mudarib* and multiple *rabbul mal* with staggered capital payment by each or some of the *rabbul mal* where one or more *rabbul mal* failed to pay the subsequent capital.**

In this situation, the non-defaulting contracting parties shall have the following remedies including:

i) requiring the defaulting *rabbul mal* to sell his interest to the other *rabbul mal* or a third party;

ii) the non-defaulting contracting parties may agree to revise the *mudarabah* contract based on actual capital paid; or

[7] Explanation on *mudarabah* expenditure is provided under paragraph 11.16

iii) the non-defaulting contracting parties may agree to 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.

12. Profit

S 12.1 Profit sharing is the primary motive of the *mudarabah* contract and therefore it is a fundamental component of the contract.

S 12.2 Profit is the value created over and above the *mudarabah* capital which is determined based on profit determination method acceptable by market standard or practices.

S 12.3 The *mudarib* shall not guarantee any profit.

S 12.4 *Rabbul mal* and *mudarib* shall share profit based on a ratio mutually agreed between them.

S 12.5 PSR shall be determined at the inception of the contract. Nonetheless, PSR may be revised during the tenure of the *mudarabah* subject to mutual agreement.

S 12.6 *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 12.7 The profit in the form of certain percentage shall not be linked to the *mudarabah* capital amount.

G 12.8 Notwithstanding paragraph 12.7, 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 *mudarabah* capital amount.

G 12.9 In a multi-tiered *mudarabah*, two or more profit sharing arrangements may be agreed upon. In the first tier, *rabbul mal* and *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 for 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 12.10 In the case where *mudarib* commingled or injected his own fund to the *mudarabah*, 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*.

G 12.11 *Rabbul mal* and *mudarib* may agree on a PSR for a certain threshold of profit. If the actual profit exceeds the threshold, the excess amount may be distributed based on a different PSR agreed by the parties or be paid to any of the contracting parties as per agreement.

G 12.12 *Rabbul mal* and *mudarib* may agree on a threshold of profit whereby in the case of profit generated exceeds the threshold, an amount of profit equivalent to threshold is paid to one of the contracting parties and the remaining is shared according to PSR. In the case of profit generated is below the threshold, the profit is shared based on PSR.

G 12.13 The agreed PSR may vary to correspond with different periods of investment, different amount of capital or due to pre-mature withdrawal of capital provided that such conditions are agreed upon at the inception of the *mudarabah* contract.

S 12.14 In a single *mudarabah* contract involving more than one *mudarib*, a common profit sharing ratio is agreed between *rabbul mal* and all the *mudarib*. All *mudarib* shall share the *mudarib*'s profit portion as per agreed terms.

S 12.15 Profit shall be recognized based on the following methodology:

a) Realized basis by actual liquidation of assets of *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*).

12.16 In the case of profit recognised based on constructive basis:

G a) a profit reserve may be created; and

S b) a final consolidation and adjustment shall be undertaken at the end of a certain period or at the times of actual realization of profit to arrive at the actual amount of profit.

S 12.17 Profit shall be distributed upon the maturity of the *mudarabah* or at an agreed period.

S 12.18 Unrealized gains recognized during the *mudarabah* tenure shall be recognized as profit and be included in the profit and loss calculation for the *mudarabah*.

S 12.19 A *mudarib* is only entitled to profit for works which are integral to the *mudarabah* venture and shall not earn any additional fee for such works.

G 12.20 *Rabbul mal* may commission *mudarib* for a fee to perform works apart from the works integral to *mudarabah* venture.

G 12.21 A party may waive his right to the profits, if any, to the other contracting party on the basis of waiver (*tanazul*) on the date of distribution of the profit.

G 12.22 The parties to the contract may agree to set aside the profit as a reserve (e.g. profit equalization reserve) or for any other purpose.

S 12.23 In relation to paragraph 12.22, the reserve shall only be created from the profit of the *mudarabah*.

S 12.24 In case where profit reserved is utilised to cover depletion of *mudarabah* capital, only the profit portion of the *rabbul mal* in the reserve shall be utilised[8].

G 12.25 Contracting parties may agree to a condition whereby *rabbul mal* may be subject to lower or no profit payment if capital is withdrawn before the maturity of the investment period.

13. Loss

S 13.1 A loss is depletion from the value of capital.

S 13.2 Loss shall be borne by the *rabbul mal* up to the capital value.

S 13.3 The *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 13.4 Notwithstanding paragraph 13.3, in the case of loss the *mudarib* shall furnish the reason for the occurrence of loss.

S 13.5 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 13.6 In the case where *mudarib* commingled or injected his own fund to the *mudarabah*, the loss shall be borne based on the proportion of the *mudarib*'s capital contribution in the commingled fund.

G 13.7 The *mudarib* may voluntarily absorb the loss upon the maturity or dissolution of *mudarabah*.

[8] This requirement is specified to prevent implication of capital guarantee by *mudarib*.

ARRANGEMENT OF *MUDARABAH* WITH OTHER CONTRACTS

14. Arrangement for guarantee

S 14.1 *Mudarib* shall not guarantee the capital and/or profit.

G 14.2 Notwithstanding paragraph 14.1, the following measures may be exercised:

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

G b) The *rabbul mal* may require the *mudarib* to arrange for an independent third party guarantee by observing the following requirements:

S i) The guarantee shall be executed as a separate contract and be utilised to cover for any loss or depletion of capital.

S ii) The third party guarantor shall be independent from the *mudarib* such that it shall not be a related party where the *mudarib* has majority ownership and/or having control in the entity nor shall it be an entity that owns or having controls over the *mudarib*.

G iii) The third party guarantee may be in the form of performance guarantee of the *mudarabah* transactions or guarantee on *mudarabah* capital.

15. Arrangement of *Mudarabah* with *Wadiah*, *Wakalah* or *Musharakah*

G 15.1 Contracting parties may agree to an arrangement whereby a certain amount of fund is assigned as *mudarabah* capital and another portion of the fund is assigned under *wadiah, wakalah* or *musharakah* contracts.

S 15.2 Pursuant to paragraph 15.1, the contracting parties shall observe requirement of *mudarabah* on the part of fund assigned under *mudarabah* and shall observe requirement of *wadiah*, *wakalah* or *musharakah* on the part of fund assigned under the respective contract.

16. Arrangement of *Mudarabah* with *Hibah* or *Hadiyyah*

G 16.1 *Mudarib* may provide *hibah* or *hadiyyah* to *rabbul mal* subject to the following conditions:

S a) *Hibah* or *hadiyyah* shall not be sourced from *mudarabah* capital or *rabbul mal*'s portion of profit.

S b) Provision of *hibah* or *hadiyyah* shall not amount to a guarantee of capital and/or profit by *mudarib*.

17. Dissolution of *Mudarabah*

S 17.1 The *mudarabah* contract may be dissolved under the following circumstances:

a) Unilateral termination by any of the parties in the absence of any prohibitive circumstances as per paragraph 8.2;

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 between the parties;

d) Contract expires upon the maturity date agreed by the parties;

e) Demise or dissolution of either *mudarib* or *rabbul mal* or loss of legal capacity;

f) Invalidity of *mudarabah.*

PART C OPERATIONAL REQUIREMENTS

18. Background

18.1 The regulatory expectations set out in Part C emphasize on instituting effective policies and procedures to facilitate governance and oversight function, structuring, risk management, information disclosure as well as consumer and market conduct for *mudarabah*[9]. The policy intent of these operational requirements is to provide adequate safeguard to stakeholders' interest, promote cohesive implementation of business and risk management strategies and drive the development of necessary systems, processes and control measures while preserving the Shariah requirements.

19. Governance and Oversight

Principle 1: IFI must establish comprehensive internal policies and procedures to ensure *mudarabah* are conducted using sound practices, comply with Shariah and have proper oversight arrangement.

S 19.1 All aspects of IFI operations should adhere to and be reinforced by credible corporate governance practices. In this regard, policy document complement the existing broad principles and requirements on corporate governance stipulated in *Guidelines on Corporate Governance for Licensed Islamic Banks (Revised BNM/GP1-i)* and *Guidelines on Corporate Governance for Development Financial Institutions.*

S 19.2 IFI is expected to have in place additional requirements on governance and oversight function due to the distinct nature of *mudarabah* venture. IFI is required to provide focus, strong understanding of the risk profile as well as ensure availability of resources with the appropriate knowledge and skill set.

[9] When IFI is both the *rabbul mal* and/or the *mudarib*. Illustration on the differences in the role of IFI is given in the **Appendix 4.**

S 19.3 While the broad governance and oversight principles can be applied to *mudarabah*, greater emphasis needs to be applied due to the complexity and the distinct risks in *mudarabah*. The emphasis includes additional role of Board, Board committee, Shariah committee and senior in managing *mudarabah*.

Board of Directors

S 19.4 The Board of Directors (the Board) is responsible to establish sound governance structure to facilitate effective oversight function on the management and implementation of transactions under *mudarabah*. The adequacy of governance shall commensurate with the nature, complexity and risk profile associated with *mudarabah*.

S 19.5 The roles and responsibilities of the Board with respect to *mudarabah* shall include the following:

a) set and oversee the business strategy and risk appetite with regard to the *mudarabah*;

b) approve and oversee policies and procedures for effective risk management and compliance with regulations on *mudarabah*;

c) ensure that a comprehensive and effective Shariah governance framework is in place; and

d) ensure that there are adequate and qualified personnel with sufficient knowledge and competency on the concept, application and risks associated with *mudarabah*. The Board shall also ensure that the necessary expertise is suitable to the type of business or product where the IFI will be financially involved.

S Board Committee

19.6 Board committee has the responsibility to ensure *mudarabah* is effectively managed in accordance with the agreed terms and conditions. Key responsibilities of the board committee include assisting the Board in performing the oversight function and provide recommendations in respect of the management, operations and performance of *mudarabah.*

S 19.7 Board committee shall consist of members with sufficient knowledge, competency and understanding of the application and risks associated with *mudarabah,* especially with regard to the type of business or product where the IFI is or will be financially involved.

Shariah Committee

S 19.8 The IFI is responsible to ensure that the overall operations of *mudarabah* are compliant with Shariah.

S 19.9 Shariah committee shall perform the following roles and responsibilities to ensure activities associated with *mudarabah* are conducted in line with Shariah requirements. The Shariah committee is responsible to:

a) endorse that the Shariah requirements are appropriately applied in the relevant policies and procedures governing *mudarabah*;

b) validate and endorse that the terms and conditions stipulated in legal documentation and other documents[10] are in compliance with Shariah;

c) advise or provide clarification to the Board pertaining to issues on Shariah matters;

d) conduct review on *mudarabah* periodically and advise the IFI on relevant Shariah rulings, decision or guidelines on Shariah matters issued by the Bank and, if relevant, any other authorities; and

e) provide Shariah compliance report with regard to the compliance of the *mudarab*ah with Shariah. The statement of Shariah compliance shall be prepared in accordance with the requirements stipulated in the

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

Shariah Governance Framework for Islamic Financial Institutions, Financial Reporting for Islamic Banking Institutions and *Guidelines on Financial Reporting for Development Financial Institutions*.

Senior Management

S 19.10 Senior management of IFI is responsible in developing and implementing policies and procedures that govern *mudarabah*.

S 19.11 The roles and responsibilities of the senior management shall include the following:

a) formulate and implement business strategies, internal control and risk management requirements in line with IFI business objectives;

b) establish policies, processes and procedures with regard to proper management of *mudarabah* and ensure they are properly delegated to the relevant functions and communicated within the IFI ;

c) establish risk management policies and maintain adequate mechanism that are able to identify, measure and mitigate risk inherent in *mudarabah*;

d) undertake regular review and monitor compliance on the approved policies;

e) identify, assign and train personnel with the appropriate skill set to manage, monitor and review the performance of *mudarabah*; and

f) ensure timely disclosure of relevant information to the Board.

20. Structuring

Principle 2: IFI must ensure the implementation of *mudarabah* is supported by holistic processes and procedures, adequate systems and robust documentations.

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

Shariah Compliance

S 20.1 The IFI is responsible to ensure that the overall operations of *mudarabah* are in compliance with Shariah requirements. The product structure, strategies, terms of agreement, asset portfolio[11] and type of business involved[12] must be endorsed by the Shariah committee. The opinion of the Shariah Advisory Council (SAC) of the Bank shall be sought to resolve issues pertaining to Shariah matters as outlined in the *Shariah Governance Framework for Islamic Financial Institutions.*

S 20.2 The IFI must establish a holistic and effective management system that is supported by adequate policies and procedures and competent personnel to ensure that *mudarabah* continues to adhere with Shariah requirements.

Contracting Parties

S 20.3 Legal capacity of contracting parties shall be consistent with Contracts Act 1950. However, IFIs shall undertake suitability assessment to ensure suitability of contracting parties in entering into *mudarabah*.

[11] Such as the underlying asset portfolio for *Mudarabah* Investment Account

[12] Such as the business or services conducted by the *mudarib* in a *mudarabah* venture

S 20.4 The contracting parties' roles and responsibilities shall be stipulated clearly in the legal documentations.

G 20.5 The contracting parties in a *mudarabah* may involve more than one *rabbul mal* which could exist under the following structures:

a) A “single” PSR structure which creates *mudarabah* between the group of *rabbul mal* with the *mudarib*.

b) A “multiple” PSR structure which creates *mudarabah* between each *rabbul mal* with the *mudarib*.

Illustration of these structures is given in **Appendix 5.**

Management of *Mudarabah*

S 20.6 As per in paragraph 10.5, the *mudarabah* shall only be managed by the *mudarib* while the *rabbul mal* would has access to information. In this regard, the *rabbul mal* shall not be:

a) involved in the decision making in respect of the *mudarabah;*

b) influencing decision making in core business areas of the *Mudarabah* (eg. *rabbul mal* providing advisory services directly contributing to major decision making for the *mudarabah*); and

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

Question 1: Do you agree with the scope of prohibition of *rabbul mal*’s involvement above especially when IFI is the *rabbul mal*? If not, please provide suggestions on areas of exceptions, while ensuring compliance with Shariah requirements, supported with justifications.

Capital

S 20.7 IFI shall determine the value of capital[13] for the *mudarabah* at the time of contract.

S 20.8 Notwithstanding the type of capital allowed under paragraph 11.4, capital shall only be in the form of cash and is identifiable, readily available as well as accessible at the date of commencement of the *mudarabah*. In this regard, capital contributed by the *rabbul mal* shall not be in the following form:

a) debt or receivables owing to the *rabbul mal*;

b) encumbered assets (e.g. assets pledged as collateral); and

S 20.9 Upon disbursement of capital, the *rabbul mal* shall assume its rights and liabilities of the *mudarabah* up to the amount of capital disbursed or contributed.

G 20.10 Subject to consent from *rabbul mal*, the *mudarib* may commingle the *mudarabah* capital with other funds. In the event where there is commingling of funds, the IFI shall ensure:

S a) identification of funding purpose and assets in the terms and conditions;

S b) proper tagging of assets (either actual or proportionate) at all times using appropriate mechanism by the *mudarib* such as separate record keeping;

S c) proper valuation of underlying assets under the *mudarabah* are done periodically; an*d*

[13] To be received by the IFI as an entrepreneur or to be contributed by the IFI as a *rabbul mal*.

S d) rabbul mal's rights on underlying assets funded by rabbul-mal at all times, including upon exit and mudarib's winding-up.

S 20.11 Any commingling of funds arising from the injection of *mudarib's* own funds into the *mudarabah* will:

a) not nullify *mudarabah* contract between *rabbul mal* and *mudarib;*

b) continue to cause application of this policy document for *mudarabah* contract;

c) cause requirements of *Musharakah* to apply for the *musharakah*[14] between *mudarib* and the *mudarabah* venture; and

d) require proper distribution of profit and loss. Illustration is given in **Appendix 6**.

Profit

S 20.12 PSR shall be mutually agreed between *rabbul mal* and *mudarib* and be stipulated clearly in the agreement at the time of contract.

G 20.13 PSR may be revised during the tenure of contract, provided that the revised PSR is mutually agreed between contracting parties.

G 20.14 In determining the appropriate PSR, the IFI may consider the following factors:

a) estimated return on *mudarabah*;

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*.

[14] Shariah Requirements, Optional Practices and Operational Requirements of *Musharakah*.

S 20.15 Notwithstanding the requirements in paragraph 12.15, profit shall be recognized and measured based on the applicable Malaysian Financial Reporting Standards (MFRS).

S 20.16 As required under paragraph 12.16 (b), the contracting parties shall conduct an assessment at the end of certain period or upon actual realization 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*.

S 20.17 Methodology used for determining profit distribution must be objective, transparent and acceptable by all contracting parties. Only direct expenses can be deducted in calculating profit, also defined[15] as expenses which are:

a) Identifiable and measurable; and

b) Compulsory and must be incurred in order to complete specific activities in the *mudarabah*.

S 20.18 The contracting parties shall determine the time period or date for profit distribution of the *mudarabah*.

Loss

S 20.19 Notwithstanding the requirements in paragraph 13.1, loss shall be recognized and measured based on the applicable MFRS.

S 20.20 IFI shall ensure expectations and requirements on managing partner is sufficiently provided in the terms and conditions. This is to ensure proper conduct of managing partner as well as to protect the interest of the IFI in event of loss.

[15] As per definition under the Rate of Return Framework.

S 20.21 *Mudarib* shall be liable to the full sum of loss if it is caused by the *mudarib's* misconduct, breach of specified terms or negligence. Otherwise, the loss shall be borne by the *rabbul mal* up to the amount of capital disbursed or contributed in the *mudarabah*.

S 20.22 *Mudarib* shall provide justification and report on any occurrence of loss in a timely manner to the *rabbul mal*.

G 20.23 *Mudarib* shall not apply any mechanism which will effectively cause the *mudarib* to guarantee principal amount up-front such as upfront waiver on loss absorption or *wa'd* at price equivalent to capital provided.

Guarantee and Collateral

S 20.24 Any collateral taken from the *mudarib* shall only be liquidated in the event of misconduct or negligence or breach of specified terms of contract by the *mudarib*.

G 20.25 To cover for any other losses, an independent third party guarantee may be arranged. This guarantee will need to be executed in a separate contract.

S 20.26 For purposes of paragraph 20.25, the independent third party guarantee must not be provided by the following parties:

a) For corporate guarantors:

(i) entities with control on the *mudarib* or controlled by the *mudarib* as defined by MFRS 127 Separate Financial Statements e.g. parent, subsidiary

b) For individual guarantors:

(i) employee of *mudarib* or close relatives; or

(ii) controlling shareholders of *mudarib* or their close relatives.

Dissolution/ Termination/ Redemption (Exit)

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20.27 IFI, either as *mudarib* or *rabbul mal*, shall clearly stipulate the terms and conditions of exit, which include:

a) tenure of investment or venture;

b) time or intervals allowed for redemption;

c) qualifying criteria for exit before maturity;

d) methodology for valuation of underlying asset and calculation of profit and loss upon exit;

e) potential amount payable or to be received, including compensation or damages incurred; and

f) operational procedures for exit including submission of relevant documents, notice period, number of days taken to process the transaction and settlement period.

S 20.28 As part of the measures to mitigate risks, IFI shall have in place exit strategies, which may include ability to immediately cut loss. In addition, IFI shall take into consideration the overall impact to IFI which may include potential compensation or damages payable to partners.

Legal documentation

S 20.29 IFI must develop comprehensive and legally enforceable documentations for *mudarabah* transaction which are in compliance with Shariah and regulatory requirements.

S 20.30 At minimum, the legal documentations must clearly stipulate the following:

(a) purpose of *mudarabah*;

(b) contractual relationship between parties;

(c) rights, roles and responsibilities of parties to the *mudarabah;*

(d) capital contributed by *rabbul mal*;

(e) profit sharing ratio;

(f) loss that shall be borne by the relevant contracting parties;

(g) calculation methodologies and timing for profit distribution;

(h) tenure of *mudarabah*;

(i) pricing or valuation method of underlying asset;

(j) reporting obligation of the *mudarabah* performance which include the timing and the information to be reported*;*

(k) collateral and guarantees including rights over assets, if any,

(l) terms on dissolution, termination, redemption or withdrawal of *mudarabah*; and

(m) where applicable, fees and charges to be borne by the relevant contracting parties.

S 20.31 The use of Arabic terminology in the documents must be sufficiently clarified or translated to facilitate understanding of the contracting parties.

S 20.32 In the event of *mudarabah* arrangement with other Shariah contracts, IFI shall ensure that documentations involved are separated and executed in proper sequence as per Shariah requirements.

21. Risk management

Principle 4: IFI must institute and implement sound and integrated risk management system to effectively manage risks throughout the life cycle of *mudaraba*

21.1 The distinct risk profile of *mudarabah* may expose r*abbul mal* to various types of risks, such as equity risk, market risk, liquidity risk, credit risk and operational risk. These risks, which intermingle and change from one kind to another at different stages of the transaction, require a proper, comprehensive and sound risk management infrastructure, risk reporting and risk control framework.

S 21.2 IFI shall establish comprehensive risk management policies and procedures, systems and internal control which can address risks in line with IFI's risk appetite throughout the life cycle of *mudarabah* and cover, at minimum, the following;

a) identification and monitoring of risks;

b) appropriate valuation and calculation methodology for underlying assets and distribution of profit;

c) risk exposure limits;

d) risk mitigation techniques; and

e) monitoring and reporting mechanism.

S 21.3 IFI shall clearly specify and communicate the policies and procedures to all relevant functions within the IFI.

S 21.4 IFI shall establish a systematic process to review and update the policies, procedures and internal limits which shall be in line with the risk appetite of the IFI and take into consideration any changes in the industry.

S 21.5 IFI shall have a process in place to collect and analyse relevant information, either from contracting parties or external sources[16], relating to or that may have an impact on the *mudarabah*.

S 21.6 IFIs need to ensure continuous monitoring on *mudarabah* at all times. Any anomalies must be reported and escalated swiftly to the management for further action.

S 21.7 IFIs shall also have in place rigorous stress testing framework that would enable periodical assessment of the *mudarabah* and its implication to the financial condition of the IFI.

S 21.8 IFI shall assess the appropriate structure of products or services to be used under the *mudarabah* contract:

a) appropriate[17] with the type of risk; and

b) able to mitigate risks[18].

22. Disclosure and Reporting Requirements

Principle 5: IFI must undertake *mudarabah* transaction in a fair and transparent manner in line with Shariah and protect stakeholder's interest.

S 22.1 IFI shall maintain accounting records and other records in a timely manner that will sufficiently enable the preparation and reporting of true and fair financial statements.

S 22.2 IFI shall observe the requirements stipulated in the *Guidelines on Financial Reporting for Islamic Banking Institutions, Guidelines on Financial Reporting*

[16] Such as market reports, expert surveys or any other sources of information.

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

[18] For example, IFI as *rabbul mal* shall consider, among others, whether the *Mudarabah* requires a Special Purpose Vehicle and collaterals.

for Development Financial Institutions, Capital Adequacy Framework for Islamic Banks – Disclosure Requirements (Pillar 3) issued by the Bank and all applicable MFRS.

S 22.3 IFI shall disclose the structure of governance and oversight function in place for *mudarabah*. At minimum, the disclosure shall include the role of the Board, board committee, Shariah committee and senior management for *mudarabah*.

23. Consumer and Market Conduct

Principle 5: IFI must undertake *mudarabah* in a fair and transparent manner in line with Shariah and protect stakeholder's interest

S 23.1 The IFI is required to establish policies and procedures on proper consumer and market conduct to ensure *mudarabah* is conducted in a fair, transparent and responsible manner, in line with *Shariah* requirements.

Fair dealings

S 23.2 The internal policies and procedures on consumer and market conduct for *mudarabah* should ensure fair dealing practices which include the following:

a) suitability and affordability assessment of contracting parties;

b) information to be disclosed are provided in a timely manner to contracting parties and shall be accurate, clear, not misleading;

c) charges payable by customers (if any); and

d) IFI must take reasonable care to ensure suitability of advice and recommendation to customers.

S 23.3 IFI shall not disclose any material information, for example trade secret, of the *mudarabah* to any third party without authorisation from the contracting parties.

S 23.4 IFI shall ensure all contracting parties including the IFI disclose and properly manage all conflict of interests including those that may potentially occur.

S 23.5 IFI must ensure fairness in the contract terms at all times including in any amendments to the terms during renegotiation or extension of tenure.

Information Disclosure

S 23.6 At the pre-contractual stage, IFI shall provide adequate and relevant information to customers including in the marketing or promotional materials such as product disclosure sheet or any other equivalent materials to potential contracting parties with regard to *mudarabah.* At minimum, information to be disclosed shall include:

a) Comprehensive description of the *mudarabah*, which includes;

(i) contractual relationship between contracting parties;

(ii) concept of profit sharing between contracting parties and loss bearing by *rabbul mal*;

b) overview of the transaction structure;

c) roles, responsibilities, rights and obligations of contracting parties;

d) key terms and conditions of the contract; and

e) requirements for security deposit, guarantee and/or collateral (includes the rights and obligation of contracting parties on the collateral pledged).

S 23.7 IFI shall ensure sufficient effort have been given in facilitating the contracting parties' understanding of the concept of *mudarabah* contract.

S 23.8 At the point of entering the contract, the IFI shall disclose salient features of the *mudarabah* in legal documentations to facilitate the contracting parties' in understanding the terms and conditions of the *mudarabah* contract.

S 23.9 The IFI shall also periodically disclose relevant information to the customers during the tenure of *mudarabah* e.g. changes in charges payable by customers (if applicable).

PART D SPECIFIC OPERATIONAL REQUIREMENTS FOR IFI AS CAPITAL PROVIDER

24. Background

S 24.1 In addition to the general operational requirements in Part C, the IFI is subject to the specific operational requirements under this Part D for *mudarabah* venture which consists of products or services structured using *mudarabah* contract when IFI is the *rabbul mal*[19] or capital provider. IFI shall refer to the Investment Account Framework for specific operational requirements for *mudarabah* contract where the IFI perform the role as *mudarib*.

25. Governance and Oversight

25.1 Sound governance and oversight function requirement for *mudarabah* venture consist of a two-pronged approach **at IFI's** and **venture's level**.

IFI's level[20]

Dedicated Structure

S 25.2 Once the mudarabah exposure21 reaches 15% of total capital22, the IFI is expected to establish a dedicated oversight committee at board and

[19] Recorded as assets in the books of the IFI.

[20] Also includes requirements on governance and oversight under Part C.

[21] Includes non-sale based contracts where IFIs may be exposed to capital loss e.g. *Musharakah.*

[22] As defined under the Capital Adequacy Framework for Islamic Banks (Capital Components) and the Capital Adequacy Framework (Capital Components).

management level as well as function/unit (dedicated structure) for mudarabah venture to enable greater focus and in-depth deliberation of the various factors affecting such exposures. Illustration of the dedicated structure is given in **Appendix 7.**

Question 2: Do you agree with the threshold set by the Bank for the setting up of the dedicated structure? If not, please provide your justification.

S 25.3 If a dedicated Board Committee is established e.g. Board Investment and Risk Committee (BIRC):

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a) the membership shall comprise of at least three individual members, of which at the minimum one third shall comprise of independent members or non-executive member to ensure adequate check and balance; and

b) the independent member of the Board Committee may consist of a senior management personnel not directly involved in the management and operations of the *mudarabah.*

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S 25.4 IFI shall ensure that at least one member in the dedicated board or management committee has expertise and experience[23] in the main business segments[24] that IFI is involved in.

[23] 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.

[24] 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.

25.5 Dedicated function/unit is a function/unit to specifically conduct *mudarabah* venture, in order to ensure better focus given its unique nature and risk profile which differs from other types of contract. The objective of the creation of the dedicated function/unit is not only to facilitate specialisation in terms of skills and expertise but to also allow better concentration on *mudarabah* venture which would often require active involvement of the IFI.

S 25.6 The dedicated function/unit shall consist of personnel with appropriate expertise, knowledge and competencies in *mudarabah*, especially in the type of business or product where the IFI is or will be financially involved.

G 25.7 IFI may source external parties to complement the operations of the dedicated function/unit[25] in areas or business activities which the IFI has lack of expertise.

S 25.8 In the event that the IFI appoints an external party as per paragraph 25.7, the following measures shall be undertaken to ensure:

a) the external party has credibility as well as considerable knowledge and expertise in the areas or business activities involved;

b) there is no conflict of interest between the external party with the parties involved in the *mudarabah*; and

c) robustness in legal documentation governing the transaction with the external party to ensure enforceability of provisions such as liabilities, roles and responsibilities as well as confidentiality.

S 25.9 The dedicated function or unit shall execute its roles and responsibilities effectively and efficiently, which includes:

a) conduct appraisal on proposal received from potential mudarib and recommend the project to the management if viable;

[25] Includes advisory, assessment, monitoring, review or any other processes necessary in managing the *Mudarabah* transactions.

d) monitor the progress of *mudarabah* venture, regular on-site visits, on-going collection of relevant information and conducting analysis on impact to the *mudarabah* venture;

e) ensure risk management policies and internal control to manage exposures are adhered to; and

f) promptly alert the management if abnormalities are detected and prepare progress report to the management on a periodical basis.

Venture's level

Observer

S 25.10 For an IFI as a *rabbul mal*, the fulfilment of *mudarib*'s fiduciary duties is an integral element to the success and sustainability of *mudarabah* venture. Therefore, it is important for IFI to ensure that effective mechanisms are in place to monitor and assess whether the *mudarib* is executing his/her duties effectively, diligently and in accordance with the stipulated terms and conditions of the *mudarabah* contract.

S 25.11 IFI shall establish parameters to identify appropriate safeguard measures to ensure effective governance and oversight at the venture level.

G 25.12 One of the main safeguard measures may include appointment of an observer at both the *mudarabah* venture's board and the management or project level. This is to ensure that the IFI has enhanced access to timely information, understanding of issues and close monitoring of mudarib's conduct in executing its fiduciary duties both at the highest as well as at the working level in the *mudarabah* venture.

G 25.13 For the avoidance of doubt, where the *mudarabah* structure is complex such as involving multi-tiered SPV or indirect exposures, IFI may appoint observer as per paragraph 25.12 at the entity that conducts the actual business activity

and/or the entity that is able to control the actual business activity. Illustration of complex structure is given in **Appendix 8**.

S 25.14 If an observer is appointed, the IFI shall establish policies and procedures on the observer function, which includes eligibility criteria, roles and responsibilities as well as review mechanism to ensure its effectiveness.

S 25.15 The observer shall satisfy the following criteria:

a) have skill and possess in-depth knowledge of the nature of business involved under the *mudarabah* venture;

b) possess necessary qualification, experience and qualities that enable them to perform their duties effectively;

c) for board observer, the personnel must possess the maturity to understand the deliberation at *mudarabah* venture board level;

d) the observer is limited to employees of the IFI and its sister companies; and

e) the personnel must be “fit and proper” to hold the post. Criteria for consideration includes:

(i) his/her probity, diligence, competence and soundness of judgement;

(ii) his/her 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/improper business practices or any practices which would discredit him/her.

Question 3: With reference to paragraph 25.15(d) should the observer be limited to only the personnel of the IFI and its sister companies? If not, what are the safety measures and conditions may be required to ensure effectiveness of the third party representative?

S 25.16 The roles and responsibilities of the observer includes:

a) duly report the progress and performance of the *mudarabah* venture to the IFI in a timely manner;

b) safeguard IFIs' interest by carrying out his/her duties in the best possible way;

c) obtain necessary information in order to validate any issues faced by *mudarib*; and

d) maintain high level of integrity and avoid any transactions with the *mudarib* or other related entities of the *mudarib* for personal benefits or gains.

S 25.17 The IFI must take into account the following to ensure effectiveness of the observer's function:

a) IFI shall ensure that the observer is able to focus on the venture as one of their core job functions;

b) IFIs are required to establish internal limit on the number of invested entities for each individual who is allowed to be an observer e.g. IFI may wish to ensure each observer is limited to only two ventures at all times;

c) if the appointed observer is an external party to the IFI, he/she must provide a written undertaking on the obligation to comply with the secrecy provision stipulated in Section 145 of IFSA or Section 133 of FSA and Section 119 of DFIA;

d) any assignment of alternate observer shall be limited to only one other specified[26] personnel, who shall also be subject to the terms and conditions of the appointment of an observer; and

e) fees or remuneration payable to the observer for conducting this function cannot be sourced from the *mudarib*.

S 25.18 IFI shall immediately relinquish the observer's function upon disposal of the IFI's interest in the *mudarabah* venture.

S 25.19 IFI shall ensure that independence of all functions at the IFI and venture level involved in the *mudarabah* venture are preserved at all times to enable adequate check and balance e.g. the board and project observer shall not be the same person, head of the dedicated unit/ function should not be the board observer.

26. Structuring

Sources of funds

S 26.1 IFI's capital contribution under *mudarabah* venture are subject to the following requirements based on sources of funding:

a) funding from Unrestricted Investment Account (URIA) and Restricted Investment Account (RIA)[27] are allowed subject to ensuring that matching principles are in place which includes conditions that

[26] Specified means an alternate representative who shall be made permanent throughout the assignment and not be replaced by any other person.

[27] As defined under the Investment Account Framework.

significantly mitigate[28] liquidity risks;

b) shareholder funds are allowed subject to:

(i) IFI maintaining adequate capital as required under the *Capital Adequacy Framework for Islamic Banks (Capital Components) and Capital Adequacy Framework (Capital Components)*; and

(ii) IFI clearly establish its risk appetite for *mudarabah* venture and establish an internal limit on the use of shareholders fund which commensurate with this risk appetite.

c) funds from deposits are not allowed.

S 26.2 For avoidance of doubt, pursuant to paragraph 26.1 (a), when the mechanism of matching tenure is used, any extension to the tenure of the *mudarabah* venture must also be supported by an extension of redemption period for the URIA and RIA funds.

Question 4:

i) Are you agreeable to the proposal on sources of funding? Please provide justification and detail out other appropriate alternatives (if any);

ii) What are the sources of funds allowed for *mudarabah* venture at your institution and what are the conditions or internal limits imposed, if any?

[28] 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.

Usage of funds

S 26.3 IFI shall provide capital only in cash to the *mudarib.* In addition, the capital provided shall not be via acquisition of shares[29] of the *mudarib* or the *mudarabah* venture.

Question 5:

i) Do you agree with the requirement of providing capital via cash only? If not, in what circumstances would contribution of capital-in-kind be necessary?

ii) Do you agree with the prohibition of providing capital via subscription of shares? If not, in what circumstances would contribution in such form be necessary?

S 26.4 In utilizing funds for purposes of *mudarabah* venture, IFI shall assess business venture viability in line with IFI's risk appetite and strategy as well as ensuring understanding of the business profile i.e. cash flow, risk and reward.

Question 6: Paragraph 20.17 only allows direct expenses to be shared and paragraph 12.15 requires proper calculation and distribution of profit. Please provide your comments, supported with justifications, on whether structuring a *mudarabah* funding for working capital purposes is feasible in view of the requirements in the above-mentioned paragraphs.

Contracting parties

S 26.5 In addition to the requirements in paragraph 26.13, the terms and conditions for the appointment of *mudarib*, shall include clarification on the liabilities to be held by the *mudarib*.

G 26.6 IFI may wish to place safety measures to ensure that any assignment of the *mudarabah* by the *mudarib* to another *mudarib* (ie. second *mudarib*) or any

[29] i.e. where IFI subscribes to the shares issued by the mudarib.

involvement of outsourced parties will not impose additional risk to the *mudarabah* venture. In this regard, the IFI shall:

S a) stipulate criteria or conditions to the *mudarib* in the agreement to ensure proper selection, effective management and proper conduct of the second *mudarib* or the outsourcing parties;

S b) ensure that the *mudarabah* contract with the IFI and the contract between the *mudarib* with the second *mudarib* or outsourced parties are effective separately and shall not negate individual responsibility under each contract; and

S c) ensure that the terms and conditions of appointment are in line with paragraph 26.13.

Capital

S 26.7 In addition to the requirements in paragraph 20.6, when there is commingling of the *mudarabah* capital with other funds, the IFI shall ensure rights on underlying assets funded by the *mudarabah* contract are properly ring-fenced at all times, including upon exit of IFI from the *mudarabah* venture and upon liquidation of the *mudarabah* venture or the *mudarib*. Possible measures used to ensure rights on the underlying assets funded under *mudarabah* must be legally enforceable and effective.

Question 7: What are your comments on the feasibility of the following methods to secure rights to the underlying assets funded by the IFI under *mudarabah* venture, if the assets are recorded in the books of the *mudarib* (ie. *mudarib* legally owning the underlying assets)?

(i) Legal documentations to directly specify IFI's rights on the underlying assets;

(ii) Creation of 'trust concept', whereby the assets are held on trust basis by the *mudarib* for the IFI; or

(iii) Create security on underlying asset.

What would be your choice of method between the ones suggested above? Do you have suggestion of any other feasible methods?

G 26.8 Mudarabah capital may be fully or partially disbursed as per terms of contract and additional capital injection is allowed within the tenure of the venture.

Profit

S 26.9 Methodology used for determining profit calculation and distribution must be objective, transparent and acceptable by all contracting parties.

G 26.10 With regard to the final adjustment to the profit or loss calculation of the *mudarabah* venture as mentioned in paragraph 20.16, the IFI may wish to identify measures to prevent complications of profit being over-distributed, before such adjustments are made, between contracting parties.

Loss

S 26.11 IFI shall ensure that *mudarib* provides justification and detailed report on any occurrence of loss, underperformance against projected returns or derailment from expected performance in a timely manner to the IFI.

S 26.12 In order to mitigate risk, IFI shall only provide restricted *mudarabah* funding to the *mudarib.* Under this arrangement, the IFI shall identify specific requirements such as details on business scope, specific assets involved, milestones and deliverables by the *mudarib.*

G 26.13 IFI may set expectations on misconduct and negligence in the *mudarabah* terms and conditions (e.g. maintain proper books and records, conditions on communication with external parties) to provide clarity, encourage proper conduct of *mudarib* as well as protect the interest of the *rabbul mal* in the event of loss.

S 26.14 IFI shall structure the *mudarabah* funding via a separate entity such as Special Purpose Vehicle (SPV) if:

a) *mudarib* has other high-risk business activities which may affect the *mudarabah* venture. Examples of venture that is considered high-risk are:

i. untested new exploration or development e.g. pharmaceutical;

ii. industry with high rate of obsolescence e.g. technology sector; or

b) better management of *mudarabah* venture is needed such as rights to appoint observer and use of dedicated operational accounts.

S 26.15 If *mudarabah* is structured in the form of a separate entity, it shall be:

a) a limited liability entity (Eg. Limited Liability Partnership Act or Company's Act); and

b) for single-purpose only.

Question 8: How should single purpose under paragraph 26.14(b) be defined?

G 26.16 IFI may wish to impose negative covenants to protect its interest such as imposing conditions for any disposal of underlying assets or any other transactions that may be detrimental to IFI's interest. However, in line with the requirements in paragraphs 10.5 and 20.6, IFIs shall ensure that conditions imposed do not tantamount to IFI managing or controlling the *mudarabah* venture.

Guarantee/ Collateral

S 26.17 For purposes of requirements under paragraph 20.25, the IFI shall conduct assessment on:

a) the need for collateral/guarantee and its intended purpose[30];

b) the value of assets acceptable as collateral;

c) ability and eligibility of collateral providers/guarantors, which includes:

(i) no legal impediments on collateral such as ensuring assets are unencumbered;

(ii) financial strength of guarantors; and

(iii) independence of parties to the *mudarib* eligible as guarantors as per paragraph 20.26.

S 26.18 IFI shall ensure legal enforceability of any collateral or guarantee documentations.

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

Tenure

S 26.19 IFI shall determine a fixed tenure for the *mudarabah,* which among others takes into consideration the appropriate tenure to maximise returns. Any decision to extend the tenure of the *mudarabah* shall be done only after conducting appropriate assessment and renegotiation. The reassessment shall be supported by justifiable reasons such as delay in construction or significant change in market conditions. Reassessment may include but not limited to cost benefit analysis.

Dissolution/Termination/ Redemption (Exit)

S 26.20 As part of the measures to mitigate risks, IFI shall identify options to facilitate exit in order to immediately cut loss, taking into consideration the overall impact to IFI which may include potential compensation or damages payable to *mudarib*.

27. Risk Management

27.1 There are three main stages of activities prevalent in a *mudarabah* venture consisting of pre-contractual, during and exit.

Pre-contractual stage

27.2 At the pre-contractual stage, the risk management objective is to enable optimal decision making on the *mudarabah* venture before venturing into the *mudarabah,* which is reliant on the robustness of the assessment process.

Feasibility assessment

27.3 The assessment process is the main, and in some cases, the only effective measure for the IFI to ensure success in a *musharakah* venture.

S 27.4 IFI shall ensure that the objectives and criteria of potential *mudarabah* venture are in line with IFI's investment strategy.

S 27.5 IFI must ensure that a holistic and robust feasibility as well as due-dilligence framework is in place to facilitate effective decision making in assessing the viability of the *mudarabah* venture. The IFI shall:

a) ensure that the assessment methodologies employed are suitable for the type of products, services and business segments under the *mudarabah* venture. For example, use of an assessment framework under a similar business segment for sale-based financing[31] may not be exactly suitable for a *mudarabah* venture due to differences in the nature of funding;

b) assessment shall be based on historical data and empirical evidence as far as possible. Given potential data limitations, IFI may identify other means to support the assessment such as using relevant data as proxies. If judgment is involved, the IFI shall have in place the policies and procedures for application of judgment in the assessment process;

c) ensure that salient risks and important features affecting the prospects of the *mudarabah* financing have been taken into consideration. Salient risks such as investment, market, operational which includes legal and Shariah non-compliance, liquidity, as well as credit risk shall be assessed appropriately. All relevant factors affecting these risks shall be identified and assessed, including:

(i) credibility, capability, track record[32] and experience of the *mudarib* including any other key parties involved in the *mudarabah* venture such as agents, contractors or suppliers;

(ii) transaction or venture characteristics such as marketability of products or services which among other are influenced by type and design of products/services, consumer demand, location, promotional strategies and competition;

[31] Such as Murabahah financing

[32] Such as performance and financial track record

(iii) expected selling price, costs involved, expected cash-flow and potential changes affecting them;

(iv) enforceability of legal requirements, Shariah-compliance of business activities as well as economic and regulatory changes;

d) have robust methodology to assess projection of returns, costs involved and cash-flow, taking into consideration stressed conditions such as potential changes in the costs of materials, delay in sales, increase in labour costs or delays in delivery. For this purpose, the IFI shall ensure sound assumptions based on objective evidence are used in arriving at the projections. In addition, IFIs should 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) ensure information used for assessment purposes are current, relevant and obtained from reliable sources; and

f) ensure the assessment process is conducted by parties with appropriate knowledge and expertise in the relevant business activity. These parties, which may be internal or external, shall have no conflict of interest with the potential *mudarib.* If external parties are involved, IFI shall also have in place the policies and procedures on the selection of suitable external parties.

Question 9: In relation to paragraph 27.4(d), please provide your comments on the following:

a) What is the current assessment framework or methodology used in your institution for *mudarabah*? How is this assessment conducted?

b) What is the current assessment framework or methodology used in your institution for specialised financing which uses sale-based contracts such as *murabahah* or *istisna'*? How is this assessment conducted?

c) What should be the main areas of differentiation made to the assessment framework or methodology for specialised financing using *mudarabah* in comparison to those using sale-based contracts?

G 27.6 In addition to the assessment usually applied for sale-based financing, IFI may wish to apply an appropriate 'courtship' arrangement with potential *mudarib* before embarking in a *mudarabah* venture. This will involve arrangement to more thoroughly know-your-*mudarib* for a certain duration of time involving close monitoring, information collection and familiarisation process before entering into the *mudarabah* venture.

S 27.7 IFI shall ensure rights to full access to the books and records of *mudarib* and any information relevant or affecting the *mudarabah* venture is clearly stipulated in the terms and conditions.

S 27.8 IFI shall establish Dedicated Operational Account(s) of the *mudarabah* venture where all financial transactions of the venture shall be exclusively maintained in the IFI which will enable IFI to closely monitor transactions made by the *mudarabah* venture.

S 27.9 Any credit facilities other than the capital under *mudarabah* venture extended by the IFI to the *mudarib* shall be made on arm's length basis. The terms and conditions for these facilities should not be more favourable than those granted to other obligors with similar backgrounds and creditworthiness.

S 27.10 IFIs must identify the exit strategies for the *mudarabah* venture. The strategies may include the available options of exiting to ensure that IFI obtain the most profitable value realization.

S 27.11 The mechanism on exit strategies must be specifically and appropriately documented in *mudarabah* contract to ensure smooth exit process without any legal impediments.

S 27.12 IFI shall have in place investment rating framework which includes specific rating definitions, processes and criteria for assigning exposures to *mudarabah* ventures to grades within a rating system:

a) there must be sufficient details and clarity in the grade descriptions and criteria. This is to ensure those responsible for assigning ratings to consistently assign the same grade to *mudarib* or facilities with similar risk;

b) the criteria must also be consistent with the IFI's internal financing standards and policies for handling troubled obligors and facilities; and

c) rating criteria and procedures must be periodically reviewed to ensure relevance and resulting ratings are reflective of the current portfolio and reflect external conditions.

S 27.13 IFI shall classify the *mudarabah* venture as Non-Performing Investment (NPI) when there is capital loss based on projected cash flow.

Question 10: Due to the inherent nature of *mudarabah* venture which does not have a contractual repayment schedule, classification as NPI based on repayment conduct as practiced for sale-based contracts under *Classification and Impairment Provisions for Loans/Financing (GP3)* may be difficult.

i) Please provide the methodology and trigger events for classification as NPI for *mudarabah* venture in your institution;

ii) The proposal in paragraph 27.13 requires classification as NPI based on projected cash flow which is done at least quarterly. Please provide your opinion on the proposed method for NPI classification.

G 27.14 IFI may wish to adopt more prudent methods of classifying *mudarabah* venture as NPI based on level of deterioration in projection of returns e.g. NPI classification upon a specified series of reduction or significant percentage of reduction in returns projection.

During/ On-going Stage

Active monitoring and continued assessment

27.15 The risk management objectives at this stage are to ensure continuous monitoring and enable IFI to guide management towards achieving long term strategy and value creation.

S 27.16 IFI shall ensure continuous monitoring on *mudarabah* venture at all times by having an adequate and robust risk reporting, risk monitoring and risk control framework to reduce the overall risk exposure and safeguard bank's portfolio. Any anomalies must be reported and escalated swiftly to the management for further action.

S 27.17 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*.

S 27.18 IFIs shall conduct the following with regard to *mudarib*'s performance reporting:

a) identify areas for monitoring and information required from *mudarib* or other parties;

b) ensure that *mudarib* provides information including periodical reports regarding the performance of the venture to the IFI in a timely manner;

c) regular on and off-site monitoring to assess performance; and

d) validation of the reports received from the *mudarib* 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 as well as valuation of underlying assets.

S 27.19 The periodical report expected from the *mudarib* shall include the following:

a) *mudarabah* venture's performance;

(i) periodical management and financial accounts of the venture;

(ii) key performance indicators;

b) risk management practices;

c) minutes of Board of Director's meeting;

d) significant activities or changes that have material effect on the performance of *mudarabah* venture which includes:

(i) change in management such as resignation or election of new board of directors;

(ii) change in key contractual parties such as change of agent, contractor, supplier or other outsourcing party; and

e) regulatory changes on business requirements (e.g. safety and health regulations, construction regulations).

S 27.20 IFI shall conduct periodic assessment on projected returns of the *mudarabah* venture at least quarterly or sooner upon the occurrence of material changes affecting the *mudarabah*. The periodic assessment shall be subject to stressed conditions and any assumptions made must be based on objective evidence.

S 27.21 IFIs must have in place a sound impairment provisioning methodology that is able to detect and provide best estimates of losses and determine prudent level of provisions for the exposures to *mudarabah* venture.

S 27.22 IFI may wish to place safeguard measures to ensure that any involvement of outsourced parties will not impose additional risk to the *mudarabah* venture. In this regard, the IFI shall:

a) stipulate criteria or conditions to the *mudarib* in the agreement to ensure proper selection, effective management and proper conduct of the outsourcing parties; and

b) ensure that *mudarib* disclosure information about the appointed party (e.g. performance history, financial strength and company reputation).

G 27.23 IFI may impose conditions in the legal documentation to take action on *mudarib*'s failure to prepare timely periodical report (e.g. withhold/ delaying cash disbursement) if clear justification is not given within a stipulated period.

S 27.24 IFI must monitor the flow of transactions conducted under the dedicated operational accounts at all times. Any anomalies must be reported to the senior management for further action.

S 27.25 IFIs shall ensure robust asset-liability management to mitigate risk in terms of mismatch in returns and cash flows between *mudarabah* vis-à-vis IFI's source of funding.

G 27.26 Subject to mutual consent, the contracting parties may appoint an independent party to carry out audit and valuations on *mudarabah* venture to ensure transparency and objectivity in the valuation and distribution of profits.

Under performing mudarabah venture

S 27.27 If a *mudarabah* venture is or expected to be under-performing, the IFI is required to conduct a detailed assessment on whether the *mudarabah* venture would continue to be viable.

S 27.28 The viability assessment must consist, at minimum, consideration of the following;

a) possibilities for improvement on issues and factors that lead to the underperformance;

b) feasibility of improvement plans proposed by *mudarib*, such as change in management, operational processes and period for turnaround;

c) appropriateness of the revised projection of returns and assumptions used to support such projection;

d) additional funding required; and

e) whether the *mudarabah* venture's level of risk and reward are still within IFI's risk appetite.

G 27.29 IFI may appoint third party expert to conduct assessment on feasibility of the venture.

S 27.30 After conducting the viability assessment and to avoid the ever-greening of *mudarabah* venture, any decision not to exit must be:

a) based on plausible grounds, such as to minimise losses or high-potential to recover profit 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 identification of clear strategies, measures and action plan by the IFI, which may include renegotiating on the terms of the *mudarabah* venture.

S 27.31 IFI shall strengthen its risk monitoring, assessment and control functions if the underperforming *mudarabah* venture is continued. An example of a turnaround process flow for a *mudarabah* venture is stipulated in **Appendix 9**.

Exit Stage

S 27.32 IFI shall have clear processes and procedures on exit mechanism which shall be clearly stipulated and communicated to the relevant functions in order to ensure effective and efficient execution of exit.

S 27.33 IFI must make an assessment on the impact of each exit options and determine best value realisation.

S 27.34 IFI shall obtain legal opinion that the exit mechanism can be executed without any legal impediments.

S 27.35 IFI must assess any potential damages payable to *mudarib* or any other parties involved in the event of IFI's exit from the venture.

S 27.36 In case of recoveries and/or losses due to misconduct, breach of terms or negligence by *mudarib,* IFI must identify measures for claims based on the risk mitigation method adopted.

28. Disclosure and Reporting Requirements

Governance disclosure

S 28.1 In addition to the requirements under paragraphs 22.1 to 22.3, IFI shall maintain and disclose the structure of governance and oversight function in place for *mudarabah* venture. At minimum, the disclosure shall include:

a) roles of Board for *mudarabah* venture;

b) BRMC or equivalent committee roles for *mudarabah* venture;

c) roles of the senior management or investment committee; and

d) oversight mechanism at investment level e.g. Board observer resides in respective *mudarabah* venture and their roles.

Financial disclosure

S 28.2 Disclosure for *mudarabah* venture shall include the following:

a) value of venture:

(i) initial capital contribution;
(ii) outstanding or recoverable value[33] by sector including any impairment provisions made during the period

b) composition of aggregate sources of funds

Illustration of the disclosure requirements is given in **Appendix 10.**

[33] Exposure value as per MFRS.

Question 11:

a) Recognition and measurement shall be in accordance with the applicable MFRS.

iii) What is the recognition and measurement methodology and the applicable MFRS for mudarabah venture at your institution currently?

iv) How would the potential treatment under the impending IFRS 9 impact the recognition and measurement for mudarabah venture at your institution?

b) Kindly provide us with the data as per template in **Appendix 11**.

APPENDICES

Appendix 1 Definition and Interpretation

For the purpose of this policy, the following definitions shall have the following meanings.

Terms	Definition
Mudarabah asset	Asset created under a *mudarabah* venture.
Mudarabah venture	Business or profit generating activities, which reflects the concept of profit sharing and loss bearing, undertaken by *Mudarib* in managing capital provided by rabbul mal.
Mudarib	Entrepreneur of a *mudarabah* venture.
Mudarib yudarib	*Mudarabah* contract where *rabbul mal* invests his capital with a *mudarib* who subsequently invests the fund with another *mudarib*.
Profit sharing ratio	The ratio in which the profits are shared between *rabbul mal* and *mudarib*.
Rabbul mal	Capital provider.
Tanazul	Waiving of the entitlement to claim.
Musharakah (also known as Musyarakah)	A partnership between two or more parties which may take effect through contractual relationship (`aqd) or by operation of Islamic law, whereby all contracting parties will share the profit and bear loss from the partnership.
The Bank	Bank Negara Malaysia, a body corporate which continues to exist under the Central Bank of Malaysia Act 2009.
Mudarabah Investment Account	An investment, as defined under the section 2 of the IFSA, which uses *mudarabah* contract.
Wadiah	Safe keeping contract in which a party entrusted his property to another party for safe keeping and to be returned upon request
Wakalah	Contract between a party (principal) who appoint another party (agent) to perform certain duty on behalf of the principal in representable or assignable matters according to Shariah perspective, either voluntarily or with imposition of fee.

Hibah/*Hadiyyah*	Transfer of ownership of an asset to a person without any consideration in return.
Wa'ad	A promise or undertaking, refers to an expression of commitment given by one party to another to perform certain action(s) in the future.

Appendix 2 Related legal and policy documents

This policy document must be read together with the following legal and policy documents:

(a) Shariah Advisory Council (SAC) rulings published by the Bank;

(b) Shariah Governance Framework for Islamic Financial Institutions;

(c) Guidelines on Corporate Governance for Licensed Islamic Bank;

(d) Guidelines on Corporate Governance for Development *Financ*ial Institutions

(e) Risk Governance;

(f) Guidelines on Property Development and Property Investment Activities by Islamic Banks.

(g) Concept Paper on Investment Account Framework

(h) Guidelines on Product Transparency and Disclosure;

(i) Guidelines on Imposition of Fees and Charges on Financial Products and Services;

(j) Concept paper on Fair Treatment of Financial Consumer;

(k) Guidelines on Financial Reporting for Islamic Banking Institutions;

(l) Guidelines on Financial Reporting for Development Financial Institutions;

(m) Guidelines on Investor Protection; and

(n) Guidelines on Responsible Financing.

Appendix 3 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 ventures including *mudarabah*.

(i) وَآخَرُونَ يَضْرِبُونَ فِي الأَرْضِ يَبْتَغُونَ مِنْ فَضْلِ اللَّهِ

"…and others travelling in the earth in quest of Allah's bounty..."[34]

The word (يَضْرِبُونَ) 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 فأجازه.

"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 livestock with the capital; and if his partner violates the conditions, he should guarantee the loss occurred. These

[34] Surah *al-Muzzammil*, verse 20.

conditions have been brought to the attention of Prophet Muhammad (peace be upon him) and he approved them."[35]

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."[36]

Consensus of The Muslim Jurists (*Ijma'*)

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

[35] Al-Bayhaqi, *Al-Sunan al-Kubra*, v. 6, p. 111.

[36] Ibn Majah, *Sunan Ibn Majah*, *hadith* no. 2289.

Appendix 4 Differences in the Role of IFI in *Mudarabah*

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

IFI as *Rabbul Mal*

- IFI provides capital to *mudarib*
- IFI shares profit with *mudarib*

Mudarib

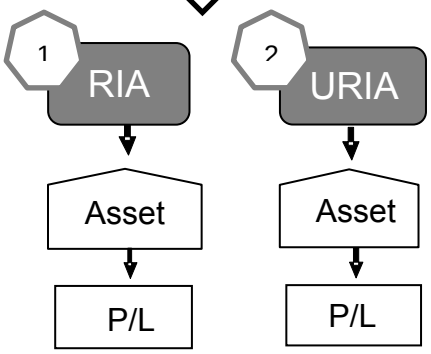
- can be an existing entity or an SPV
- used funds for business activities

2. Illustration of IFI's role as a *mudarib*

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

Investor as *Rabbul Mal*

IFI as *Mudarib*



1 Restricted Investment Account (RIA) – capital provided by investor is invested into specific assets as determined by investor.

2 Unrestricted Investment Account (URIA) – capital provided is invested into assets determined by IFI.

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

Diagram 1: Mudarabah venture – provided funding for a specific purpose

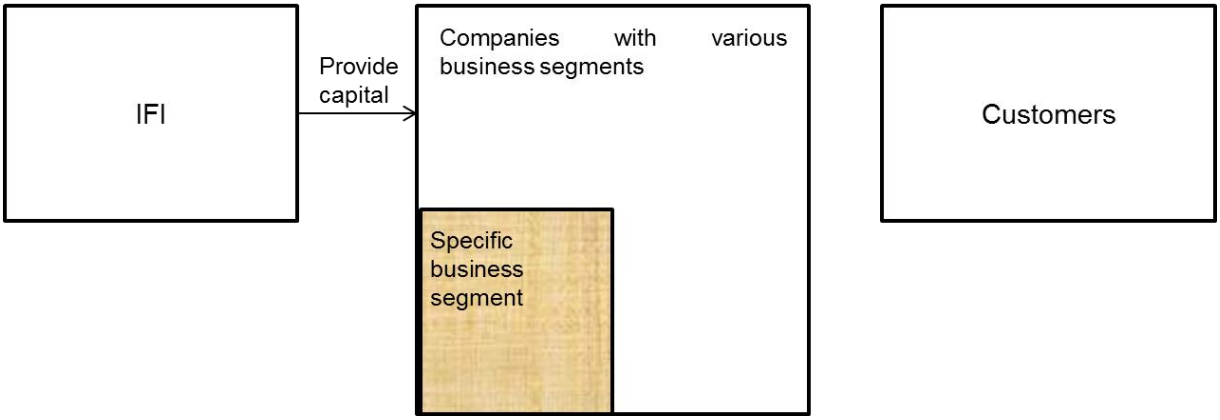
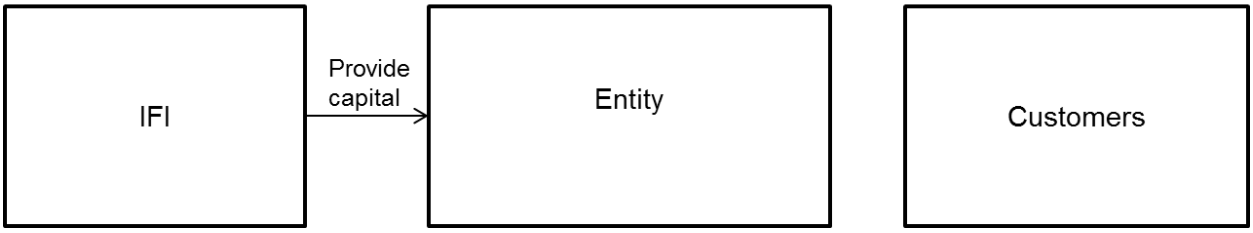
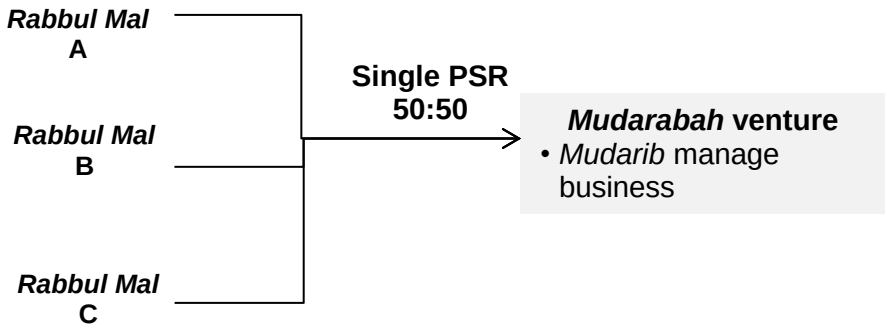


Diagram 2: Mudarabah venture – provided funding for a general purpose

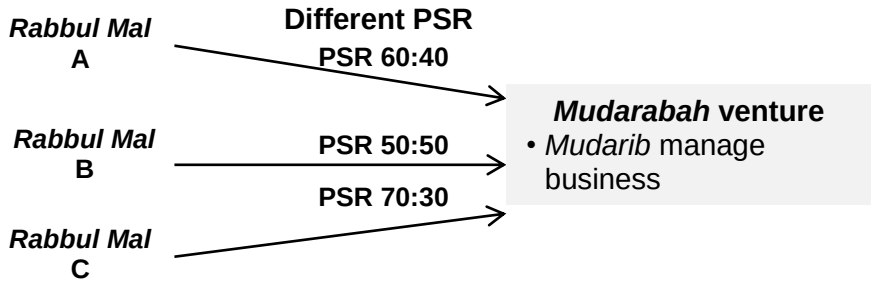


Appendix 6 Mudarabah Involving Multiple Rabbul Mal

Single PSR structure

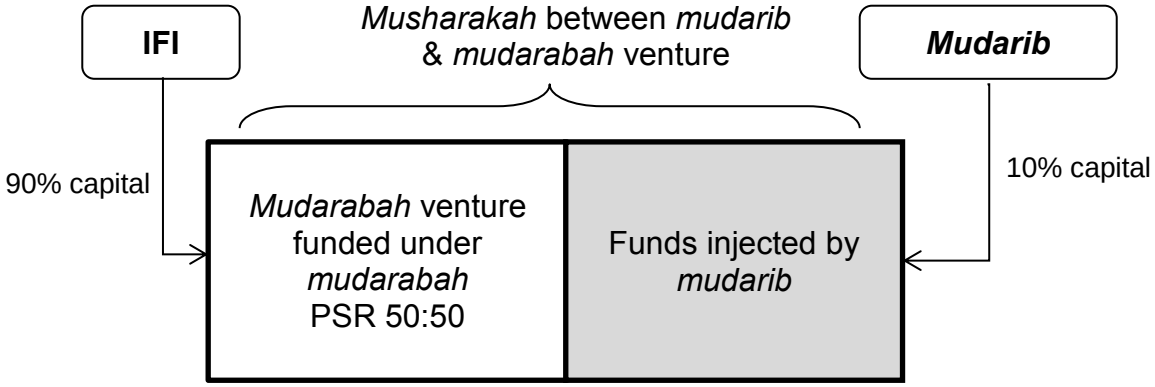


Multiple PSR structure



Appendix 7 Proper Distribution of Profit and Loss when *Mudarib* Injects Capital

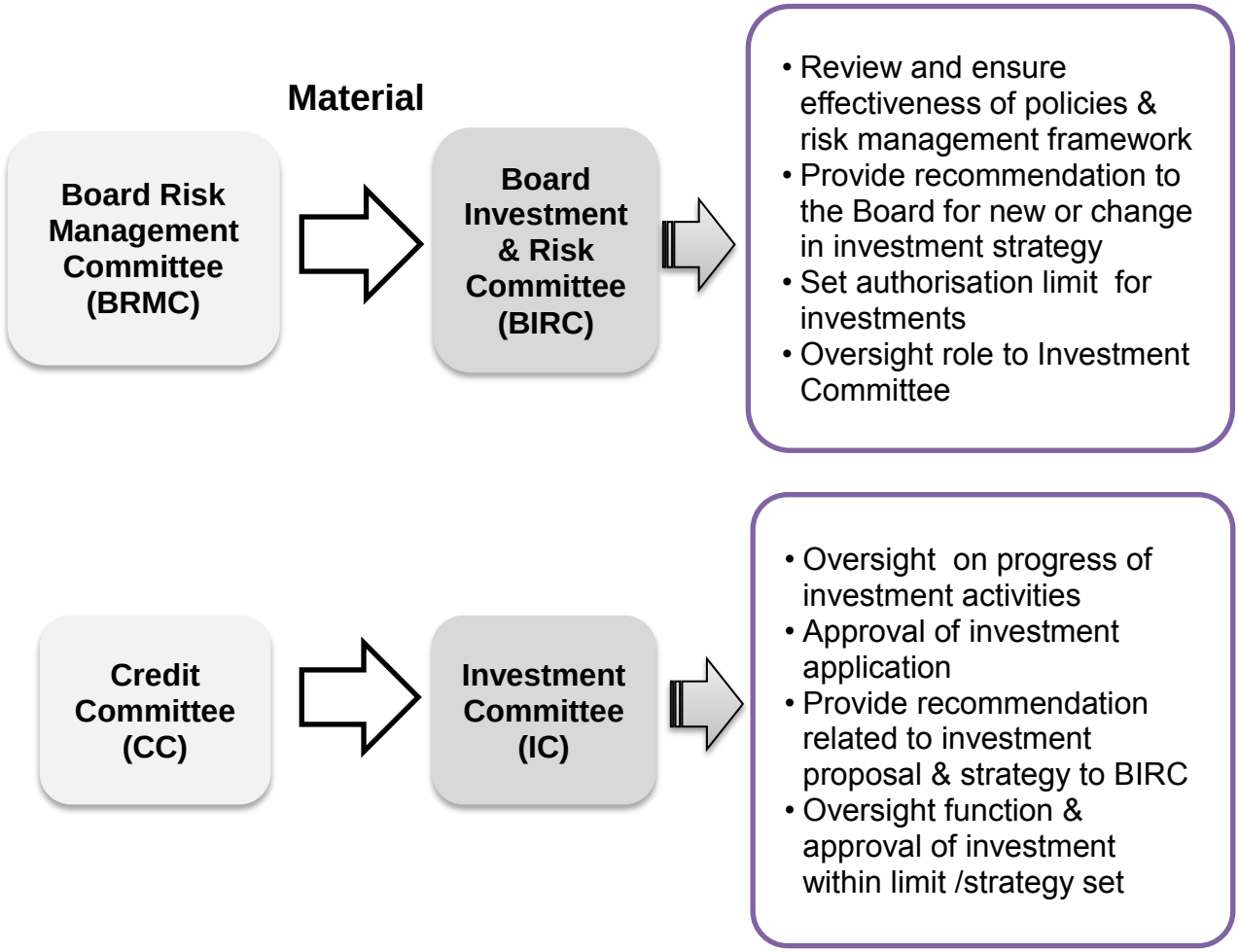
Example:



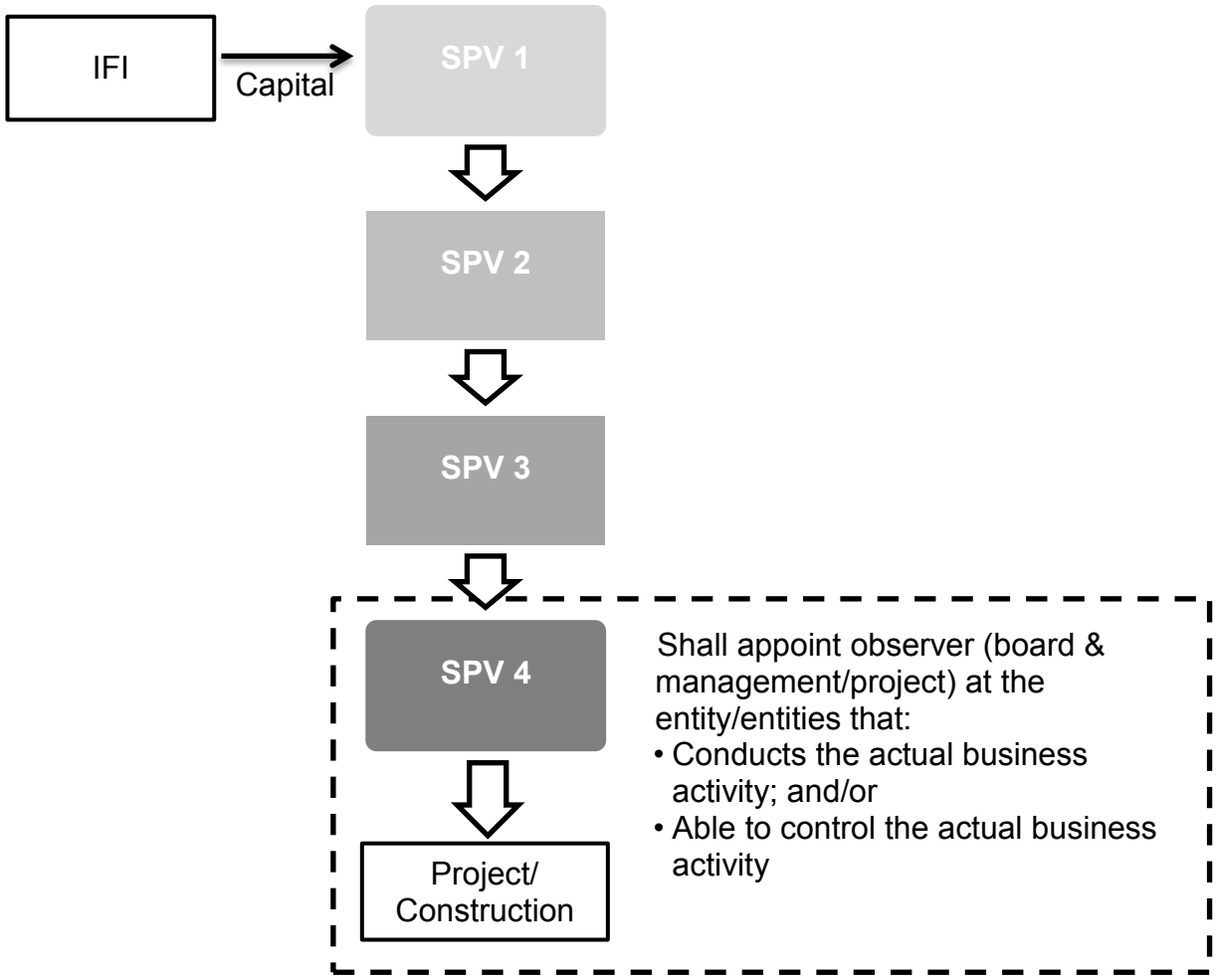
Upon *mudarib* injecting his own funds/capital into the business:

1. *Musharakah* is formed between the *mudarib* and the *mudarabah* venture
2. Profit /Loss:
    i) Shall first be distributed according to *musharakah*, depending on the amount of capital contribution ie. 90:10;
    ii) Subsequently, to be calculated as per *mudarabah* as agreed in the terms and conditions ie. 50:50.

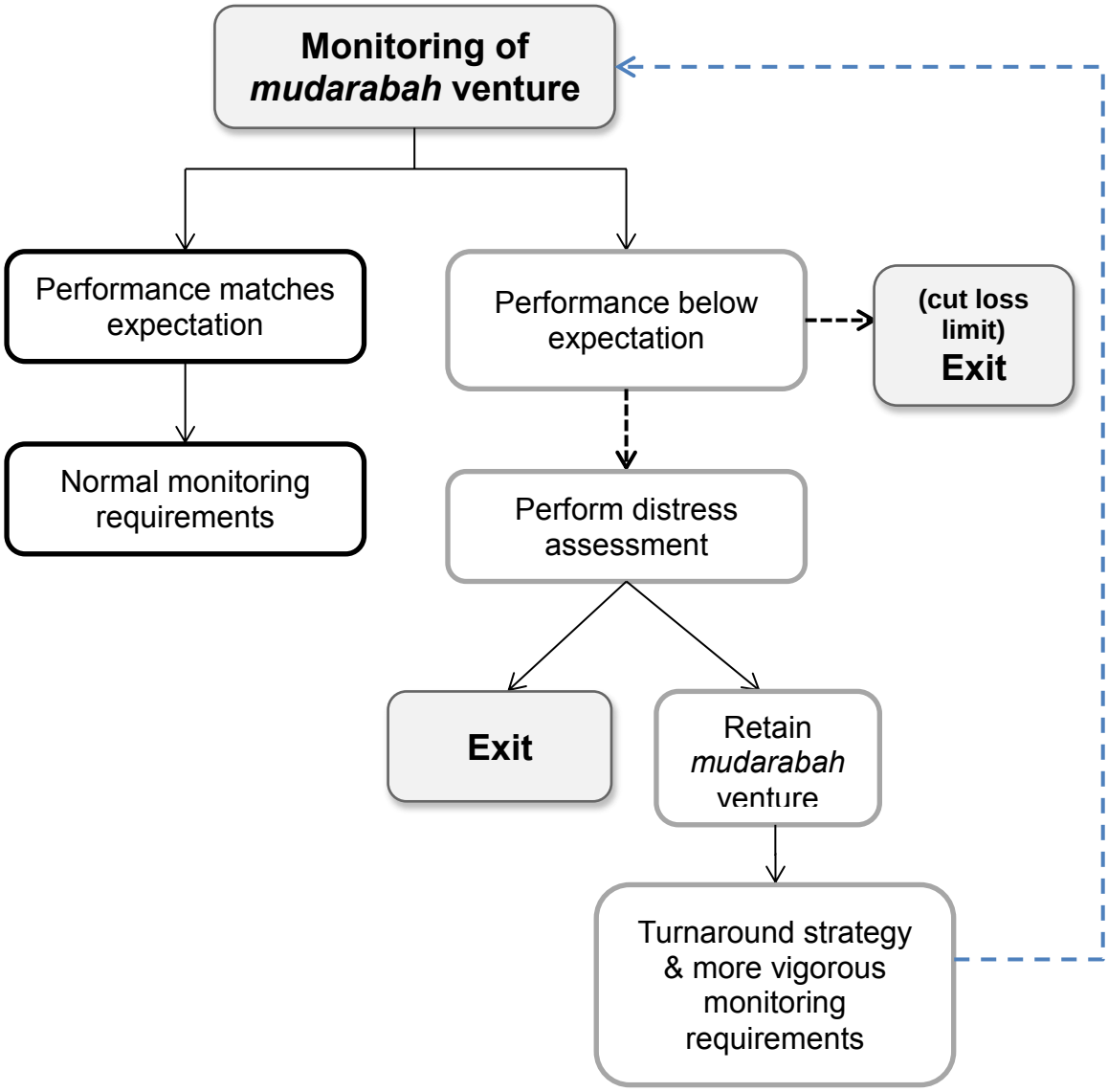
Appendix 8 Dedicated Structure



Appendix 9 An Example of Complex Structure in *Mudarabah*



Appendix 10 Distress Assessment Process Flow



Appendix 11 Illustration of Additional Financial Disclosure for *Mudarabah* Venture

Notes to Account

Amount funded by:	
Unrestricted Investment Accounts (URIA)	x
Restricted Investment Accounts (RIA)	x
Shareholders' fund	x
	xxx

Mudarabah

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

Appendix 12 Exposures on *Mudarabah* Venture

Question: Do you have any exposure? Yes (proceed to template below)/ No

Template:

Sector	**Initial capital**	**Impairment provisions**	**Amount as at 30 Nov 2013**	**Classification**[37] e.g. performing/ watchlist/ non-performing

[37] Should be based on IFI's internal definitions and classifications.