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Banking regulation and Policy Department
Bangladesh Bank
Head Office
Dhaka

BRPD Circular Letter No- 05

Date: July 20, 2009
Shraban 05, 1416

Chief Executives
All Scheduled Banks in Bangladesh

Dear Sir,

Identifying Risk Factors Relating to Islamic Mode of Investment under Risk Based Capital Adequacy for Banks

Please refer to our BRPD circular no. 09 dated: 31/12/2008.

01. A separate Chapter (chapter-10) captioned 'Risk Factors Relating to Islamic Mode of Investment' including instructions for identifying risks relating to investments made by Islami Shariah based banking in Bangladesh is attached herewith.

02. As per the instructions, banks will require to identify risks relating to investments made under Islami Shariah based banking. All scheduled banks are therefore requested to submit the statements on RBCA in this line from the June, 2009 quarter to the Department of Offsite Supervision.

Sincerely yours,

(Abu Hena Mohd. Razee Hassan)
General Manager
Phone: 7117825

Encl: **CD-ROM**

10. Risk Factors Relating to Islamic Mode of Investment

Introduction

All Islamic banks and Islamic branches of conventional banking are required to measure and apply capital charges against credit, market and operational risk**.**

Features of Islamic Mode of Investment

Islamic modes of investments are asset-based. Gross return of these investments is the spread between the cost of the asset to the bank and the amount that can be recovered from selling or leasing it. Some investments can be categorized as equity participation and based on profit and loss sharing. Quards are beneficence financing based on service charge only.

Bai-Murabaha : The seller informs the buyer of his cost of acquiring a specified product; then the profit margin (or mark up) is negotiated between the buyer and the seller. The total cost is usually paid in installments.

Bai-Salam: Purchase with deferred delivery. The buyer pays the seller the full negotiated price of a product that the seller promises to deliver at a future date. This mode only applies products whose quality and quantity can be fully specified at the time the contact is made. Usually, it applies to agricultural or manufactured product.

Bai-Istisna: The Istisna'a sale is a contract in which the price is paid in advance at the time of the contract and the objects of sale is manufactured and delivered later. The majority of the jurists consider Istisna'a as one of the division of 'Salam Sale'.

Bai Muajjal: Deferred payment sales. The seller can sell a product on the basis of a deferred payment in installments or in a lump sum payment. The price of the product

is agreed upon between the buyers and the seller at the same time of the sale and cannot include any charge for deferring payments.

Ijārah: Leasing or lease purchase: A party leases a particular product for a specific sum and a specific period of time. In the case of a lease purchase, cash payment includes a portion that goes towards the final purchase and transfer of ownership of the product.

Higher Purchase under Sirkatul Melk : In this mode of investment Bank and borrower on the basis of contract purchase transport, machine & plant, building, apartment etc. Borrower uses it on the basis of rent and repays part of principal amount of bank. Thus borrower becomes owner of the property. In this process borrower deposit his equity to bank. Borrower pay the agreed rent and after full repayment bank handover the title to the borrower.

Quards al-Hasana: Beneficence loans. These are zero return loans that the Islamic principles exhort Muslims to make 'to those who need them'. Banks are allowed to charge the borrowers a service charge to cover the administrative expenses of handling the loan, provided that the charge is not related to the amount or maturity of the loan.

Jo'alah: Service charge. A party under take to pay another party a specified amount of money as a fee for rendering a specified service in accordance to the terms of the contract stipulated between the two parties. This mode usually applies to transactions such as consultations, and professional services, fund placements, and trust services.

Mushārakah: Equity participation contract. The bank is not the sole provider of funds to finance a project. Two or more partners contribute to the joint capital of an investment. Profit and losses are shared strictly in relation to the respective capital contributions. The kind of contract is usually employed to finance long-term projects.

Mudārabah : Trustee finance contract. Under this kind of contract, the bank provides the entire capital needed for financing a project, while the entrepreneur offers his labor and expertise. The profit from the project is shared between the bank and entrepreneur at a certain fixed ratio. Financial losses are borne exclusively by the bank. The liability of the entrepreneur is limited only to his time and efforts. However if the negligence or mismanagement of the entrepreneur is proven he may be held responsible for financial losses. Mudarabah is usually employed in investment project with short gestation periods and in trade and commerce.

Islamic banks mobilize funds on a profit sharing and loss bearing i.e. on Mudarabah basis (PLS). On the liability side, the contract between the bank and the depositors is known as unrestricted Mudaraba because depositors agree that their funds be used by the bank, ay its discretion, to finance to finance an open ended list of profitable investments and expect to share with the bank the overall profits accruing to the bank business.

Certain risk are associated with such PLS accounts. These risks are referred to as fiduciary and displaced commercial risk.

Fiduciary Risk: The bank shall have in place appropriate mechanisms to safeguard the interests of all fund providers. Where Investment Account holder funds are commingled with the banks own funds, the bank shall ensure that the bases for asset, revenue, expense and profit allocations are established, applied and reported in a manner consistent with the bank's fiduciary responsibilities.

Rate of Return risk and Displaced Commercial Risk**:** Banks are exposed to rate of return risk in the context of their overall balance sheet exposures. An increase in benchmark rates may result in the investment Account holder having expectations of a higher rate of return. Rate of return risk differs from risk in that banks are concerned with the result of their investment activities at the end of the investment-holding period. Such results cannot be pre-determined exactly.

A consequence of rate of return risk may be displaced commercial risk. Banks may be under market pressure to pay a return that exceeds the rate that has been earned on

assets financed by the investment account holder when the return on assets is under-performing as compared with the competitors' rates. In such case, banks may decide to waive their rights to part or its entire Mudarib share of profits in order to satisfy and retain its fund providers and dissuade them from withdrawing their funds.

Calculating Risk Weighted Assets (RWA) for Credit Risk

Credit risk is defined as the potential that a bank's counterparty will fail to meet its obligations in accordance with agreed terms. Investment (Credit) risk exposures in Islamic financing arise in connection with accounts receivable in Murabaha Contracts, Counterparty risk in Salam Contracts, Account receivable and counter party risk in Istisna Contracts, and Lease payment receivables in Ijara Contracts, and Sukuk held to maturity (HTM) in the banking book. Bai-muazzal contract and Higher Purchase under Sirkatul Melk (HPSM) mode in connection with installment payment receivables under HPSM agreement/contract may be added for credit risk exposure in connection with account receivable. In these investments Credit risk will be measured according to the Standardized Approach of Basel II as discussed bellow except for certain exposures arising from investment by means of Musharaka or Mudaraba contracts in assets in the banking book.

The assignment of risk weight (RW) shall take into consideration the following components :

a) The credit risk rating of a debtor, counterparty, or the obligor, or a security, based on external credit assessment and their RW as stated in Table-2 .
b) The credit risk mitigation (CRM) as stated in chapter 5
c) Types of underlying assets that are sold and collateralized or leased by the Islamic banks
d) Amount of specific provisions made for the past-due portion of accounts receivable or leased payments receivables

The Islamic banks will nominate the external credit assessment institutions (ECAIs) recognized by BB.

Credit Risk Mitigation

The exposure in respect of a debtor, counterparty or other obligor can be further adjusted or reduced by taking into account the credit risk mitigation (CRM) techniques employed by the Islamic Bank while collateral received is eligible financial for mitigation on the basis of adopting haircut formula or a guarantee as described in paragraph 5 (5). The Islamic Bank may consider the resultant net exposure applying the haircut formula. The Standard Supervisory Haircuts weight to offset its credit exposure is stated in Table 6&7.

Off-balance Sheet Exposures

Off-balance-sheet items under the standardized approach will be converted into credit exposure equivalents through the use of credit conversion factors (CCF) as stated in Table 3, 4 & 5. The resulting credit equivalent amount will be multiplied by the risk-weight associated with that counterparty credit rating as described in Table 2. Other clarifications and definitions in this regard are described in the paragraph 5(4).

Some fixed Risk Weights based on Preference of Underlying Assets

The RW of a debtor, counterparty or other obligor shall be reduced and has been fixed by BB on the basis of preferential treatment for some underlying assets where counterparties could be categorized as Retail and Small, or assets could be defined as Residential real estate (RRE) or Commercial real estate (RRE) as clarified in the section 5. The RW will be assigned as stated in the table 2.

Past Due Receivables

In the event that accounts receivable become past due, the exposure shall be risk-weighted in accordance with the statement of table-2. The exposures should be risk weighted net of specific provisions.

Calculating Capital Charge for Market Risk

Market risk is defined as the risk of losses in on- and off-balance sheet positions arising from movements in market variables i.e. prices, foreign exchange rate etc. The risks in Islamic Bank that are subject to the market risk capital requirement are:

i) Trading positions in *Sukūk (securities)*;

ii) Investment in equity instrument in the trading book, and

iii) Foreign exchange related issues through out the banking and trading book including gold; and

iv) Commodities /inventory throughout the banking and trading book.

(If there is no commodity/inventory under the ownership of the Bank, Market Risk will not applicable against Commodity/ inventory sold to the Counterparty)

(i) Sukūk (securities) held for trading (HFT) and Equity Position Risk

The capital charge for securities in Banks' trading book comprises two charges that will be separately calculated for the following types of risk:

Specific Risk: The capital charge for specific risk is 10% on all equity positions and Sukūk (securities) to be calculated on a mark to market basis.

General Market Risk: The capital charge for general market risk is 10% on all equity positions and Sukūk (securities). The value of the instrument will be calculated on mark to market basis of ***Sukūk* Held for Trading.** In the case of equity investments made by means of a *Mushārakah* or a *Mudārabah* contract where the underlying assets are commodities, the market risk provisions for commodities will be applicable according to statement as described in section (iii) below.

ii) Measuring the Foreign Exchange Risk in a Portfolio

The Islamic Banks are allowed to calculate the risks inherent in mix of long and short foreign exchange positions including gold and silver in different foreign currencies through the banking and trading book. The capital charge is 10% on the overall net position as described and calculated in the section 6(III).

(iii) Commodities and Inventory Risk

The minimum capital requirements to cover the risks of holding or taking long positions in commodities, including precious metals but excluding gold and silver

(which falls under foreign exchange) as well as the inventory risk which results from holding assets with a view to re-selling or leasing them. A commodity is defined as a physical product, which is and can be traded on a secondary market, e.g. agricultural products, minerals (including oil) and precious metals. Inventory risk is defined as arising from holding items in inventory either for resale under a *Murābahah* contract, or with a view to leasing under an *Ijārah* contract. In the case of inventory risk the net position, long or shot, in each commodity requires a capital charge of 15% to cater for directional risk plus an additional capital charge of 3% of the gross positions, i.e. long plus short positions, to cater for basis risk. The capital charge of 15% applies to assets held by Islamic Banks in inventory with a view to resale or lease. For Istisnā work-in-process (WIP), WIP inventory belonging to the Islamic bank shall attract a capital charge of 8% (equivalent to a 100% RW). In the case of the balance of unbilled WIP inventory under Istisnā` without parallel Istisnā`, in addition to the RW for credit risk a capital charge of 1.6% is applied (equivalent to a 20% RW) to cater for market risk exposure. The funding of a commodities position that exposes the Islamic Banks to foreign exchange exposure is also subject to capital charge as measured under the foreign exchange risk.

Mode of Investment wise clarification for credit and Market risks:

The minimum capital adequacy requirements for both credit and market risks are set out for each of the following Sharī`ah compliant financing and investment instruments:

a) Murābahah and Murābahah for the Purchase Orderer;
b) Salam and Parallel Salam;
c) Istisnā and Parallel Istisnā;
d) Ijārah and Ijārah Muntahia Bittamleek;
e) Mushārakah and Diminishing Mushārakah; and
f) Mudārabah;

a) Murabaha and Murabaha for the purchase orderer (MPO):

1. Introduction

In Murābahah and MPO(Bai Murabaha), the capital adequacy requirement for credit risk refers to the risk of a counterparty not paying the purchase price of an asset to the Islamic bank/branch. In the case of market (price) risk, the capital adequacy requirement is with respect to assets in the Islamic bank's possession which are available for sale either on the basis of Murābahah or MPO (Bai Murabaha), or also on assets which are in possession due to cancellation of Purchase Proposal (PP) in non-binding and binding MPO (Bai Murabaha).

Murābahah and Non-binding MPO

In a *Murābahah* transaction, the Islamic bank sells an asset that is already available in its possession, whereas in a MPO transaction the Islamic bank acquires an asset in anticipation that the asset will be purchased by the orderer/customer. This price risk in *Murābahah* contracts ceases and is replaced by credit risk in respect of the amount receivable from the customer following delivery of the asset. Likewise, in a non-binding MPO transaction, the Islamic bank is exposed to credit risk on the amount receivable from the customer when the latter accepts delivery and assumes ownership of the asset.

Binding MPO

In a binding MPO (Bai Murabaha), the Islamic bank has no 'long' position in the asset that is the subject of the transaction, as there is a binding obligation on the customer to take delivery of the asset at a pre-determined price. The Islamic bank is exposed to counterparty risk in the event that the orderer in a binding MPO does not honour his/her obligations under the PP, resulting in the Islamic bank selling the asset to a third party at a selling price which may be lower than the cost to the Islamic bank. The risk of selling at a loss is mitigated by securing a Hamish Jiddiyyah (HJ) (a security deposit held as collateral) upon executing the PP with the customer, as commonly

practiced in the case of binding MPO. The Islamic bank would have recourse to the customer for any shortfall in the HJ to compensate for the loss.

2. RW for Credit Risk in the Murābahah contract:

Murābahah and Non-binding MPO

The credit exposure shall be measured based on accounts receivable in *Murābahah* (the term used herein includes MPO), which is recorded at their cash equivalent value i.e. amount due from the customers at the end of the financial period less any provision for classified assets. The accounts receivable (net of specific provisions) amount arising from the selling of a Murābahah asset shall be assigned a RW as stated in Table -2 based on the credit standing of the obligor (purchaser or guarantor) as rated by an ECAI that is approved by BB.

Binding MPO

In a binding MPO, an Islamic bank is exposed to default on the purchase orderer's obligation to purchase the commodity in its possession. In the event of the orderer defaulting on its PP, the Islamic bank will dispose of the asset to a third party. The Islamic bank will have recourse to any HJ paid by the orderer, and (a) may have a right to recoup from the orderer any loss on disposing of the asset, after taking account of the HJ, or (b) may have no such legal rights. In both cases, this risk is mitigated by the asset in possession as well as any HJ paid by the purchase orderer. In case (a), the Islamic bank has the right to recoup any loss (as indicated in the previous paragraph) from the orderer, that right constitutes a claim receivable which is exposed to credit risk, and the exposure shall be measured as the amount of the asset's total acquisition cost to the Islamic bank, less the market value of the asset as collateral subject to any haircut, and less the amount of any HJ. The applicable RW as stated in Table -2 shall be based on the standing of the obligor as rated by a recognized ECAI.

3. Capital Charge for the Market Risk in the Murābahah contract:

Murābahah and Non-binding MPO

In the case of an asset in possession in a *Murābahah* transaction and an asset acquired specifically for resale to a customer in a non-binding MPO transaction, the asset would be treated as inventory of the Islamic bank and using the simplified approach the capital charge for such a market risk exposure would be 15% of the amount of the position (carrying value). The 15% capital charge is also applicable to assets held by an Islamic bank in respect of incomplete non-binding MPO transactions at the end of a financial period. Assets in possession on a 'sale or return' basis (with such an option included in the contract) are treated as accounts receivable from the vendor and as such would be offset against the related accounts payable to the vendor. If these accounts payable have been settled, the assets shall attract a capital charge of 10% subject to (a) the availability of documentation evidencing such an arrangement with the vendor, and (b) the period for returning the assets to the vendor not having been exceeded.

Binding MPO

In a binding MPO the orderer has the obligation to purchase the asset at the agreed price, and the Islamic bank as the seller is only exposed to credit risk as above.

1) Foreign Exchange Risk

The funding of an asset purchase or the selling of an asset may well open an Islamic bank to foreign exchange exposures; therefore, the relevant positions should be included in the measures of foreign exchange risk described in the section 6(III)

b) Salam and Parallel Salam:

1. Introduction

A Salam contract refers to an agreement to purchase, at a predetermined price, a specified kind of commodity, which is to be delivered on a specified future date in a specified quantity and quality. The Islamic bank as the buyer makes full payment of the purchase price upon execution of a Salam contract.

In certain cases, an Islamic bank enters into a back-to-back contract, namely Parallel Salam, to sell a commodity with the same specification as the purchased commodity

under a Salam contract to a party other than the original seller. The Parallel Salam allows the Islamic bank to sell the commodity for future delivery at a predetermined price (thus hedging the price risk on the original Salam contract) and protects the Islamic bank from having to take delivery of the commodity and warehousing it.

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

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

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

2. RW for Credit Risk in the Salam contract:

The receivable amount generated from the purchase of a commodity based on a Salam contract shall be assigned a RW based on the credit standing of a seller/counterparty as rated by an recognized ECAI as stated in the table-2. The capital requirement is to be calculated on the receivable amount, net of specific provisions, of any amount that is past due by more than 90 days. The credit RW is to be applied from the date of the contract made between both parties until the maturity of the Salam contract, which is upon receipt of the purchased commodity. The credit exposure amount of a Salam contract is not to be offset against the exposure amount of a Parallel Salam contract, as an obligation under one contract does not discharge an obligation to perform under the other contract.

3. Capital Charge for the Market Risk in the Salam contract:

Against the price risk on the commodity exposure in Salam contract capital charge will be equal to 15% of the net position in each commodity, plus an additional charge equivalent to 3% of the gross positions, long plus short, to cover basis risk and forward gap risk. The 3% capital charge is also intended to cater for potential losses in Parallel Salam when the seller in the original Salam contract fails to deliver and the Islamic bank has to purchase an appropriate commodity in the spot market to honour its obligation. The long and short positions in a commodity, which are positions of Salam and Parallel Salam, may be offset for the purpose of calculating the net open positions provided that the positions are in the same group of commodities.* The funding of a commodity purchase or selling of a commodity may well leave an Islamic bank open to foreign exchange exposures, and in that case the relevant positions should be included in the measures of foreign exchange risk described in the section 6(III).

If the Islamic Banks purchase Goods/ Commodities from the seller and simultaneously sell the same to the ultimate buyer and if the Islamic Banks do not hold the goods/ Commodities at any stage, in that case, Market Risk will not be applicable*

c) Istisnā`and Parallel Istisnā:

1. Introduction

An Istisnā` contract refers to an agreement to buy from a customer a non-existent asset which is to be manufactured or built according to the ultimate buyer's specifications and is to be delivered on a specified future date at a predetermined price. The exposures under Istisnā` involve credit and market risks, as describe below. Credit exposures arise once the work is billed to the customer, while market (price) exposures arise on unbilled work-in-process (WIP). There is a capital requirement to cater for the credit (counterparty) risk of the Islamic bank not receiving the price of the asset from the customer or project sponsor either in pre-agreed stages of completion and/or upon full completion of the manufacturing or construction process. The capital adequacy requirement for the market risk an Islamic bank incurs from the date of manufacturing or construction. Which is applicable throughout the period of the contract on unbilled WIP inventory.

2. Credit Risk

The amount generated from buying of an asset based on an Istisna` contract shall be assigned a RW based on the credit standing of the customer as rated by an ECAI and as stated in Table 2.

(i) Exclusions: The capital requirement is to be calculated on the receivable amount, net of specific provisions, any amount that is secured by eligible collateral or any amount which is past due by more than 90 days.

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

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

3. Market Risk

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

(b) Istisna` without Parallel Istisna`: A capital charge of 1.6% is to be applied to the balance of unbilled WIP inventory to cater for market risk, in addition to the credit RW stated above.

This inventory is held subject to the binding order of the Istisna` buyer and is thus not subject to inventory price. However this inventory is exposed to the price risk.

(If the Islamic Banks sell commodity simultaneously to the ultimate buyer, no Market Risk will be applicable).

Foreign exchange risk: Any foreign exchange exposures arising from the purchasing of input materials, or from Parallel Istisna` contracts made, or the selling of a completed asset in foreign currency should be included in the measures of foreign exchange risk.

d) Ijārah and Ijārah Muntahia Bittamleek:

1. Introduction

Bank leases a particular product for specific sum for specific period of time. Under the Shariah, substantial risk and rewards of ownership of assets may not be transferred to lessees in Ijarah Muntahia Bittamleek/ Hire Purchase under Shirkatul Melk (HPSM) contracts. This should be carried on the balance sheet of the lessor and assigned a risk weighting as per credit standing of the counterparty. All liabilities and risks pertaining to the leased asset are to be borne by the Islamic bank including obligations to restore any impairment and damage to the leased asset arising from wear and tear and natural causes which are not due to the lessee's misconduct or negligence. Thus, in both Ijarah and IMB/HPSM, the risks and rewards remain with the lessor, except for the residual value risk at the term of an IMB/HPSM which is borne by the lessee, the risks and rewards remain with the lessor, except for the residual value risk at the term of an IMB which is borne by the lessee. The lessor is exposed to price risk on the asset while it is in the lessor's possession prior to the signature of the lease contract, except where the asset is acquired following a binding promise to lease. In an IMB contract, the lessor promises to transfer to the lessee its ownership in the leased asset to the lessee at the end of the contract as a gift or as a sale at a specified consideration, provided that (a)

the promise is separately expressed and independent of the underlying Ijarah; or (b) a gift **contract is** entered into conditional upon fulfillment of all the Ijarah obligations, and thereby ownership shall be automatically transferred thereupon.

2. Credit Risk

The applicable RW as stated in Table-2 shall be based on the standing of the obligor as rated by an ECAI that is approved by the BB. The lessor is exposed to credit risk in respect of the estimated value of the lease payments in respect of the remaining period of the Ijarah. This exposure is mitigated by the market value of the leased asset which may be repossessed. The net credit risk exposure shall be assigned a RW as stated in the Table-2 based on the credit standing of the lessee/counterparty as rated by an ECAI that is approved by BB.

IMB: The capital requirement for IMB is based on the following two components:

(a) the total estimated future Ijarah receivable amount over the duration of the lease contract. This exposure is mitigated by the market value of the leased asset which may be repossessed. The net credit risk exposure shall be assigned a RW as sted in the Table-2 based on the credit standing of the lessee/counterparty as rated by an ECAI that is approved by BB. and

(b) The price risk attached to the expected residual fair value of a leased asset. The estimated future Ijarah receivable amount shall be risk-weighted based on the credit standing of the lessee as rated by an ECAI after deduction of the value of the leased asset as collateral (subject to any haircut).

Exclusions: The capital requirement is to be calculated on the receivable amount, net of specific provisions, of any amount that is secured by eligible collateral or any amount which is past due by more than 90 days. The portions that are collateralized and past due are subject to the relevant RW.

3. Market Risk

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

bank and the capital charge applicable to such a market risk exposure would be 15% of the amount of the asset's market value.

e) Mushārakah and Diminishing Mushārakah;

1. Introduction

A *Musharakah* is an agreement between the Islamic bank and a customer to contribute capital in various proportions to an enterprise, whether existing or new, or to ownership of a real estate or moveable asset, either on a permanent basis, or on a diminishing basis where the customer progressively buys out the share of the Islamic bank ("Diminishing *Musharakah*"). Profits generated by that enterprise or real estate/asset are shared in accordance with the terms of *Musharakah* agreement whilst losses are shared in proportion to the respective contributor's share of capital. An Islamic bank may enter into a *Musharakah* contract with a customer as a means of providing a financing to the latter on a profit sharing and loss bearing basis. In this case, the *Musharakah* is normally of the diminishing type, in which the customer gradually purchases the Islamic bank's partnership share over the life of the contract. This type of financing is one of the *Shari`ah* compliant alternatives to avoid a conventional term loan repayable by installments, and as such it is exposed to credit risk in respect of the customer's purchase payments as well as to the risk attaching to the Islamic bank's share of the underlying assets.

Musharakah:

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

(a) Private commercial enterprise to undertake trading activities in foreign exchange,
Shares and/or Commodities: This type of *Musharakah* exposes the Islamic bank to the risk of underlying activities, namely foreign exchange, equities or commodities.

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

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

(i) Musharakah with Ijarah sub-contract: Ownership of such assets can produce rental income for the partnership, through leasing the assets to third parties by means of *Ijarah* contracts. In this case, the risk of the *Musharakah* investment is essentially that of the underlying *Ijarah* contracts, i.e. credit risk mitigated by the collateral represented by the leased assets. However, in some cases the lessee is not a third party but the Islamic bank's partner as customer. The existence of such an *Ijarah* sub-contract in addition to a *Musharakah* exposes the Islamic bank to credit risk in respect of the partner's obligation to service the lease rentals.

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

Diminishing Musharakah:

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

revenue generated from the assets of the *Musharakah*, such as *Ijarah* lease rentals in which the rental entitlements to the Islamic bank shall be adjusted periodically according to the IIFS's share of ownership in the asset. The Islamic bank's position in a Diminishing *Musharakah* thus entails two kinds of exposure. The amounts due from the partner to purchase the agreed shares of the asset on the agreed dates are subject to credit risk in respect of the partner's ability and willingness to pay, with the shares of the partner in the asset providing credit risk mitigation as collateral. The capital invested by the Islamic bank is also subject to the risk that the amounts recoverable from the partner may be less than the amount invested because the value of the Musharakah assets has decreased (capital impairment risk).

f) Mudārabah:

A *Muḍārabah* is an agreement between the Islamic bank and a customer whereby the Islamic bank would contribute capital to an enterprise or activity which is to be managed by the customer as the (labour provider or) *Muḍārib*. Profits generated by that enterprise or activity are shared in accordance with the terms of the *Muḍārabah* agreement whilst losses are to be borne solely by the Islamic bank unless the losses are due to the *Muḍārib*'s misconduct, negligence or breach of contracted terms. A *Muḍārabah* financing can be carried out on either:

(a) a restricted basis, where the capital provider allows the *Muḍārib* to make investments subject to specified investment criteria or certain restrictions such as types of instrument, sector or country exposures; or

(b) an unrestricted basis, where the capital provider allows the *Muḍārib* to invest funds freely based on the latter's skills and expertise.

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

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

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

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

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

This type of *Muḍārabah* exposes the Islamic bank to the risk of the underlying activities, namely foreign exchange, equity or commodities.

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

This type of *Muḍārabah* exposes the Islamic bank to risk as an equity holder, which is similar to the risk assumed by a partner in venture capital or a joint-venture, but not to market risk. As an equity investor, the Islamic bank serves as the first loss position and its rights and entitlements are subordinated to the claims secured and unsecured creditors.

(c) Muḍārabah investments in project finance

An Islamic bank advances funds to a customer who acts as *Muḍārib* in a construction contract for a third-party customer (ultimate customer). The ultimate customer will

make progress payments to the *Muḍārib* who in turn make payments to the Islamic bank. The essential role of the Islamic bank in this structure is to provide bridging finance to the *Muḍārib* pending its receipt of the progress payments. In this *Muḍārabah* structure:

(i) the Islamic bank has no direct or contractual relationship with the ultimate customer (but the Islamic bank may stipulate that payments by the ultimate customer to the *Muḍārib* be made to an account ("repayment account") with the Islamic bank which has been opened for the purpose of the *Muḍārabah* and from which the *Muḍārib* may not make withdrawals without the Islamic bank's permission); and

(ii) the Islamic bank as investor advances funds to the construction company as *Muḍārib* for the construction project and is entitled to a share of the profit of the project but must bear 100% of any loss.

The Islamic bank is exposed to the risk on the amounts paid to the *Muḍārib*, and as these amounts are made on a profit sharing and loss bearing basis they are treated under credit risk as "equity positions in the 'banking book'". In principle, the Islamic bank's credit exposure is to the *Muḍārib*, not to the ultimate customer; however, as described below, a structure may involve the "*Muḍārabah* repayment account" instead of making payments to the *Muḍārib,* which transfers much of the credit risk to the ultimate customer.

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

<u>Direct payment by ultimate customer into account opened with the Islamic bank and effectively pledged to the Islamic bank</u>

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

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

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

2. Equity Position Risk

The equity exposure can be measured based on the nature of the underlying investments as follows: (a) For investments held in the trading book, the exposure is equal to the fair value; or (b) For investments held to maturity, the exposure is equal to the historical cost less any provisions for impairment. The *Muḍārabah* exposures, net of specific provisions, shall be measured as follows:

The Capital Charge shall be based on the applicable underlying assets as set out in the market risk section No. 6.

The investment in foreign exchange and trading in gold/silver shall be measured according to the treatment of as set out in paragraphs 6(III), which requires 10%

capital charge on the greater of either net long or net short positions and 10% capital charge on the net position of gold/silver.

The Capital Charge of a *Muḍārabah* that invests in quoted shares shall be measured according to equity position risk approach where positions in assets tradable in markets will qualify for treatment as equity position risk in the trading book, which would incur a total capital charge of 20% as set out in paragraphs 6(II).

Calculating Capital Charge for Operational Risk

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

The proposed measurement of capital to cater for operational risk in Islamic Banks will be based on the Basic Indicator Approach as set out in the Basel II. Under the Basic Indicator Approach, a fixed percentage of 15% of annual average gross income, averaged over the previous three years. Figures for any year in which annual gross income is negative or zero, should be excluded from both the numerator and denominator when calculating the average [b]. The capital charge may be expressed as follows:

$$\mathbf{K = [(GI_1 + GI_2 + GI_3) \times \alpha]/n}$$

Where:-

K = the capital charge under the Basic Indicator Approach

GI = only positive annual gross income over the previous three years (i.e. negative or zero gross income if any shall be excluded)

α = 15%

n = number of the previous three years for which gross income is positive.

Gross income is defined as:

(a) Net income from financing activities which is gross of any provisions and operating expenses and of depreciation of Ijarah assets;

(b) Net income from investment activities; and

(c) Fee income (e.g. commission and agency fee)

Less:
Investment account holders' share of income i.e. Profit Paid on Mudaraba Deposits (PPD)

The gross income includes income attributable to restricted and unrestricted Profit Sharing Investment Accounts' funds, but excludes extraordinary or exceptional income. Net income from investment activities includes the Islamic Bank's share of profit from Mushārakah and Mudārabah financing activities.

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

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

(a) Murābahah and Ijārah contracts

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

(b) Salam and Istisnā` contracts

- A sale and purchase contract cannot be inter-dependent and inter-conditional on each other, such as Salam and Parallel Salam; Istisnā` and Parallel Istisnā`.

- It is not allowed to stipulate a penalty clause in respect of delay in delivery of a commodity that is purchased under Salam contract, however it is allowed under Istisnā` or Parallel Istisnā`.
- The subject-matter of an Istisnā` contract may not physically exist upon entering into the contract.

(c) Mushārakah and Mudārabah contracts

- The capital of the Islamic Banks is to be invested in Sharī`ah compliant investments or business activities.
- A partner in Mushārakah cannot guarantee the capital of another partner or a Mudārib guarantees the capital of the Mudārabah.
- The purchase price of other partner's share in a Mushārakah with a binding promise to purchase can only be set as per the market value or as per the agreement at the date of buying. It is not permissible, however, to stipulate that the share be acquired at its face value.

The extent of losses arising from non-compliance with Sharī`ah rules and principles cannot be ascertained owing to lack of data. Therefore, the Islamic Banks is not required to set aside any additional amount over and above the 15% of average annual gross income over the preceding three years for operational risk. A higher capital charge may be imposed by Bangladesh Bank to fit to cater for the Sharī`ah compliance risk of a particular Islamic Banks.