Title
Istisna`

Issuance Date
24-Jun-2014

Effective Date
The policy document will be effective upon issuance of the final document.

Applicability
DFIA
FSA
IFSA

Summary
This concept paper consists of two main components, Shariah and operational requirements in relation to the application of istisna` contract in Islamic financial transaction. First component specifies salient features and essential conditions of istisna` contract. Second component focuses on the establishment of robust policies and procedures governing istisna` contract and enhanced consumer and market conduct requirements to ensure fair conduct of istisna` transactions.

Bank Negara Malaysia (the Bank) invites written feedback and comments only on the operational requirements of istisna` contract under Part C. The Shariah requirements under Part B are included for reference purpose. To facilitate the Bank's assessment, please support each comment with a clear rationale, accompanying evidence or illustration and proposed alternative.

Additional instruction for Islamic financial institutions (IFI)
In addition to providing general feedback, IFI are required to respond to the specific questions set out throughout this CP.

Please respond to the Bank by 25 July 2014 addressed to:
Pengarah
Jabatan Perbankan Islam dan Takaful
Bank Negara Malaysia
Jalan Dato’ Onn
50480 Kuala Lumpur

Any queries may be directed to:
Azren Rizuani Aziz :azren@bnm.gov.my
Mohammad Hafiz Norazmar :mhn@bnm.gov.my
Nurlina Alias :nurlinaalias@bnm.gov.my

Issuing Department
Islamic Banking and Takaful
Istisna Concept Paper
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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) is developing a Shariah-based regulatory policy with the objective to provide a comprehensive guidance to the Islamic financial industry with respect to end-to-end compliance with Shariah. This Shariah-based regulatory policy consists 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 by the IFI. The operational requirements set out the expectations with respect to the oversight function, 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 istisna` contract. The Bank invites written feedback and comments only on the operational requirements of istisna` contract under Part C. The Shariah requirements in Part B serves as reference to facilitate IFI in providing feedback and comments on operational aspects of istisna` in line with the Shariah requirements. The feedback must be supported with clear rationale, accompanying evidence or illustration, as appropriate to facilitate effective review of the standard.

Additional instruction for IFI
In addition to providing general feedback, IFI are required to respond to the specific questions set out throughout this CP.

Please respond to the Bank by 25 July 2014 addressed to:

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Jabatan Perbankan Islam dan Takaful
Bank Negara Malaysia
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Any queries may be directed to:
Azren Rizuani Aziz : azren@bnm.gov.my

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PART A  OVERVIEW

1. Introduction

1.1 Compliance with the requirements of a specific Shariah contract is a prerequisite in ensuring the legitimacy of the financial transaction entered into between the Islamic financial institution (IFI) and its customers. Failure to meet the requirements may render such financial transaction invalid and this, may lead to adverse impact on the IFI’s safety and soundness. In this regard, the Bank embarks on the development of a Shariah contract-based regulatory policy to ensure end-to-end compliance with Shariah and therefore, enhance the integrity and sustainability of the IFI.

1.2 The Shariah contract-based regulatory policy consists of two components, namely Part B (Shariah requirements) and Part C (Operational requirements). The Shariah component provides clear stipulation of Shariah rulings with respect to the salient features and essential conditions of a specific Shariah contract, to facilitate sound understanding and cohesive application among the IFI. The operational component outlines regulatory expectations for good governance, robust documentations, effective risk management, fair and transparent market practices. These operational requirements aim to complement and support effective application of Shariah contract.

1.3 *Istisna* is a type of sale contract where a subject matter is transacted before it comes into existence. Hence, it is important that the selling price and the specification of the subject matter be determined and agreed by contracting parties upon entering into *istisna* contract.

1.4 In the context of Islamic financial transaction, an IFI may enter into *istisna* contract with a customer who requires an asset that needs to be constructed or manufactured based on a given specification. As a seller, the IFI undertake to construct or manufacture the asset and deliver the completed asset to the customer on the agreed delivery date. The customer (purchaser) may pay the selling price on deferred basis, either in lump sum or instalments basis.
1.5 Typically, the IFI is expected to enter into an arrangement with a competent and reputable contractor to undertake the construction or manufacturing work. Shariah emphasises that the obligation to deliver the completed \textit{istikna} asset must remain with the seller, regardless of whether the seller directly undertake the \textit{istikna} work or hiring another party to complete the work.

2. Policy objectives

2.1 This concept paper (CP) aims−

(a) to provide reference on the Shariah rulings relating to the application of \textit{istikna} contract;

(b) to specify key operational requirements governing the implementation of \textit{istikna} contract that are in line with Shariah; and

(c) to ensure sound financial and consumer protection are implemented throughout the life cycle of \textit{istikna} contract.

3. Scope of policy document

3.1 This policy document covers all products and services that are structured based on \textit{istikna} contract.

4. Applicability

4.1 This policy document is applicable to all Islamic financial institutions as defined in paragraph 7.2.

5. Legal provisions

5.1 The requirements in this policy document are:

(a) specified pursuant to sections 29 (1) and (2) of the Islamic Financial Services Act 2013 (IFSA); and

(b) issued pursuant to sections 41 and 129 (3) of the Development Financial Institutions Act 2002 (DFIA).

6. Effective date

6.1 The policy document comes into effect 1 January 2015.
Question 1.

a) Please provide your comment on the adequacy of the proposed effective period.

b) Highlight any significant operational consideration (with appropriate justification) that needs to be addressed to ensure effective implementation of the policy document.

7. Interpretation

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

7.2 For the purpose of this policy document-

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

“G” denotes guidance which 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” means-

(a) Islamic banks and takaful operators licensed under the IFSA;

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

(c) prescribed institutions under the DFIA approved under section 129(1) of the DFIA to carry on Islamic banking business or Islamic financial business.
7.3 Further interpretation and definition is given in Appendix 1.

8. Related legal and policy documents

8.1 This policy document must be read together with the legal and policy documents listed in Appendix 3.
PART B SHARIAH REQUIREMENTS AND OPTIONAL PRACTICES OF ISTISNA`

Definition and Nature of Istisna`

9. Definition

S 9.1 Istisna` refers to a contract to sell to a purchaser a non-existent asset that is to be constructed, built or manufactured according to the agreed specifications and delivered on a specified future date at a pre-determined price.

10. Nature

S 10.1 The istisna` contract shall be binding on the contracting parties upon entering into the contract provided that it fulfills all its essential elements that include specifications of the asset and determination of price, time of delivery and payment modes.

S 10.2 The specific inherent nature of the istisna` contract is the construction, building or manufacturing of an asset according to the agreed specifications and its delivery by the seller to the purchaser.

S 10.3 The asset constructed, built or manufactured in accordance to the agreed specifications and conditions shall be accepted by the purchaser, and the seller shall be entitled to the price of the istisna` asset.

Components of Istisna`

11. Contracting parties

S 11.1 The contracting parties in an istisna` contract are the seller (sani`) and the purchaser (mustasni`) (collectively referred to as contracting parties).

S 11.2 The contracting parties shall have the legal capacity\(^1\) to enter into the istisna` contract.

\(^1\) The legal capacity of a person, from Shariah perspective, is defined as the capacity to assume rights and responsibilities; and the capacity to give legal effect to his action. Among the important conditions are that the

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11.3 The contracting parties in an *istikna* contract may be a natural person or a legal person.

11.4 A party to an *istikna* contract may enter into the contract through an agent.

12. **Offer and Acceptance**

12.1 The *istikna* contract shall be entered into through an offer and acceptance between the contracting parties.

12.2 The offer and acceptance may be expressed by appropriate documentation or by any other methods which do not contravene Shariah principles including customary business practices ('urf tijari).

12.3 Any term or condition of the *istikna* contract that has been mutually agreed upon by the contracting parties and does not contravene the Shariah shall be binding on the contracting parties.

13. **Asset**

13.1 The *istikna* asset refers to the item to be constructed, built or manufactured by the seller on the instruction of/at the request of the purchaser according to agreed specifications.

13.2 The specifications of the *istikna* asset to be constructed, built or manufactured shall be agreed upon by the contracting parties (agreed specifications) at the time of entering into the *istikna* contract.

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person must possess sound mind and the capacity to distinguish between what is harmful or and what is beneficial to one’s interests. Legal capacity of a legal entity is defined as eligibility of an entity to acquire rights and assume responsibilities. In Malaysia, the legal capacity is governed under by the Contracts Act 1950 and the Age of Majority Act 1971.

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13.3 The *istisna* asset may represent a unique or homogeneous asset that can be constructed, built or manufactured such as a house, vehicle, garment, aircraft or furniture.

13.4 The *istisna* asset shall not be an existing or completed asset that has been specifically identified at the time of entering into the *istisna* contract.

13.5 At the time of entering into the *istisna* contract, the contracting parties may agree on a certain degree of variation or tolerance in terms of the expected level of accuracy in meeting the agreed specifications of the asset as long as it is in line with the acceptable market practice.

14. **Price and mode of payment**

14.1 The price of the *istisna* asset shall be determined and agreed upon by the contracting parties (agreed price) at the time of entering into the *istisna* contract.

14.2 The *istisna* asset may be priced/valued in the form of monetary, services or in-kind value or consideration.

14.3 The agreed price of the *istisna* asset may be paid at any time and in any form such as spot, progressive or deferred either by installments or bullet payments subject to the agreement of the contracting parties.

14.4 The agreed price of the *istisna* asset may be revised after entering into the *istisna* contract and before delivery of the *istisna* asset to the purchaser due to the following circumstances:

(a) A reduction in the cost of constructing, building or manufacturing of the *istisna* asset. In this case, the amount of *ibra* to the purchaser is given at the discretion of the seller;

(b) An increase in the cost of constructing, building or manufacturing of
the *istiknas* asset. In this case:

i. the purchaser may agree to revise the agreed price of the *istikna* asset to effect the transfer of the cost to the purchaser; or

ii. in the event that the purchaser does not agree to the revision of agreed price of the *istikna* asset, the seller shall bear the increased cost of constructing, building or manufacturing of the *istikna* asset.

(c) The purchaser requests for a change in the agreed specifications of the *istikna* asset by the purchaser. In this case, if the seller may agree to the purchaser’s request, the contracting parties may agree to revise the agreed price of the *istikna* asset accordingly.

G 14.5 Revision of the agreed price of the *istikna* asset after the delivery of the asset to the purchaser may arise due to the seller’s failure to comply with the agreed specifications. In this case, the revised price of the *istikna* asset is subjected to the agreement of the contracting parties.

S 14.6 Any additional costs or expenses incurred during the construction, building or manufacturing period, such as those arising from regulatory or legal requirements, shall be borne by the seller unless agreed otherwise by the purchaser.

S 14.7 Notwithstanding paragraph 14.6, it is allowed for the contracting parties to agree at the time of entering into the *istikna* contract to incorporate a clause that any additional costs or expenses arising from regulatory or legal requirements shall be borne by the purchaser.

S 14.8 After entering into the *istikna* contract, the extension of the payment period shall not lead to an increase in the price of the *istikna* asset.
15. **Istisna` work and delivery**

**G** 15.1 Work to build, construct, transform, convert or process the *istisna`* asset to be constructed, built or manufactured may be performed by the seller and/or by any party appointed by the seller.

**G** 15.2 The seller may fulfil his obligation to deliver the *istisna`* asset by sourcing from the market as long as it fulfils the agreed specifications.

**G** 15.3 The purchaser may stipulate a condition that the asset is to be constructed, built or manufactured by the seller himself.

**S** 15.4 The time of delivery of the *istisna`* asset shall be determined and agreed by the contracting parties at the time of entering into the *istisna`* contract.

**S** 15.5 The *istisna`* asset meeting the agreed specifications shall be delivered to the purchaser and the obligation of the seller is discharged upon acceptance of the delivery by the purchaser.

**S** 15.6 The ownership in the *istisna`* asset must be effectively transferred from the seller to the purchaser.

**S** 15.7 The transfer of ownership shall take effect by the purchaser taking possession of the *istisna`* asset.

**S** 15.8 The transfer of ownership is effected by the purchaser taking possession of the *istisna`* asset in a valid sale and purchase contract even though there is no legal registration of the ownership, provided that the sale and purchase is supported by evidence of transaction.

**S** 15.9 The possession of the *istisna`* asset is effected when the seller releases the asset (*takhliyah*) which results in the purchaser having access (*tamkin*) and assuming its risks through any mechanism permitted by the Shariah including the customary business practices (*`urf tijari*).

**S** 15.10 Possession of the asset shall be either in the form of physical possession (*qabd haqiqi*) or constructive possession (*qabd hukmi*).
S 15.11 The seller shall be held liable for any actual loss or damage incurred by the purchaser due to his failure to observe timely and effective delivery of the *istikna* asset.

G 15.12 The purchaser may accept the delivery of the *istikna* asset in accordance to the agreed specifications prior to the agreed delivery date.

G 15.13 In the event that the *istikna* asset is incomplete or not in accordance with the agreed specifications, the purchaser may exercise the following options:
(a) reject the delivery of the *istikna* asset thereby dissolving the contract;
(b) accept the delivery of the *istikna* asset at the agreed price; or
(c) accept the delivery of the *istikna* asset subject to new terms to be mutually agreed by the contracting parties such as a revision to the agreed price or extension of time to meet the agreed specifications of the asset.

G 15.14 In the event that the seller fails to complete and deliver the *istikna* asset, the purchaser may exercise the following options:
(a) purchase the *istikna* asset on an as-is basis; or
(b) dissolve (fasakh) the *istikna* contract.

S 15.15 Pursuant to paragraph 15.14 (a), the effect is that the purchaser shall pay the *istikna* selling price up to the stage of completion of the *istikna* asset and therefore the purchaser owns the asset. The seller shall compensate the purchaser for any loss incurred due to the seller’s failure to complete and deliver the asset.

S 15.16 Pursuant to paragraph 15.14 (b), the effect is that the seller shall return any amount paid to the purchaser and the ownership of the *istikna* asset remains with the seller. The seller shall compensate the purchaser for any loss incurred due to the seller’s failure to complete and deliver the asset.
15.17 The seller shall not stipulate in the *istisna* contract waiver of liability for failure to complete the construction of the *istisna* asset according with the agreed specifications and within the agreed time.

15.18 The contracting parties may stipulate certain warranties for the completed and delivered *istisna* asset in the *istisna* contract.

15.19 Any defect in the *istisna* asset which is discovered upon delivery of the asset but accepted by the purchaser shall disqualify the purchaser from exercising the defect option (*khiyar al-`ayb*).

15.20 Any defect in the *istisna* asset which occurred before the delivery of the asset but is discovered by the purchaser after the acceptance of the asset shall entitle the purchaser to exercise the defect option (*khiyar al-`ayb*).

15.21 A purchaser may terminate the *istisna* contract if there is any defect in the *istisna* asset. Alternatively, the purchaser may accept the defective *istisna* asset, with or without any variations to the terms of the *istisna* contract.

15.22 The seller shall not stipulate in the *istisna* contract waiver of liability for any material defect which affects the agreed specifications of the *istisna* asset after acceptance of the asset by the purchaser.

15.23 The contracting parties may include in an *istisna* contract terms of warranty and clauses requiring maintenance work to be carried out by the seller after the *istisna* asset is delivered to, and accepted by the purchaser safeguard the interest of the purchaser against defects.

15.24 In the event that the *istisna* asset is delivered according to the agreed specifications and time, the purchaser shall accept the delivery of the asset and pay the agreed price to the seller.
S 15.25 Pursuant to paragraph 15.24, in the event that the purchaser delays acceptance of the *istikana* asset, the seller will act as the custodian of the asset, and the seller shall not be held liable for the asset except in the event of misconduct (*ta’addi*) or negligence (*taqsir*). Any cost related to the safekeeping of the asset shall be borne by the purchaser.

S 15.26 In the event of delay in accepting the *istikana* asset by the purchaser, the contracting parties are allowed to mutually agree to any of the following:

(a) the seller agrees to safe keep the *istikana* asset for the purchaser in consideration of a certain fee to be paid by the purchaser. Due to the imposition of fee, the liability of safekeeping the asset remains with the seller in his capacity as the custodian of the asset; or

(b) the purchaser appoints the seller as an agent to act on behalf of the purchaser to engage the services of a third party to safekeep the *istikana* asset. In this case, the seller may charge the purchaser for this service. The liability of safekeeping the *istikana* asset remains with the purchaser except in the event of misconduct (*ta’addi*), negligence (*taqsir*) or breach of specified terms (*mukhala’fat al-shurut*) by the seller.

G 15.27 The *istikana* contract may incorporate a clause which provides that the seller shall act as an agent for the purchaser in disposing of the *istikana* asset at fair market value or at a mutually agreed price, in the event that the purchaser fails to accept the delivery of the asset within a reasonable time, or if the purchaser specifically directs the seller to do so.

G 15.28 The contracting parties may agree to utilize the proceeds from the sale specified in paragraph 15.27 to settle any outstanding amount on the agreed price of the *istikana* asset and to pay any actual costs and expenses incurred therefrom.
15.29 Where an *istikna* asset is disposed in accordance with paragraph 15.27, any surplus of the sale proceeds shall be refunded to the purchaser while any shortfall shall be reimbursed by the purchaser.

15.30 The purchaser shall not sell the *istikna* asset to another party prior to taking its actual or constructive possession.

15.31 The contracting parties may agree, upon entering into or during the contract, that the purchaser may purchase the *istikna* asset under construction on an as-is basis. Consequently, the purchaser owns the *istikna* asset and therefore may sell it to another party.

15.32 A purchaser in an *istikna* contract may enter into another *istikna* contract to sell to another party an asset having similar specifications to the asset in the previous *istikna* contract. This is a parallel *istikna* arrangement.

15.33 The contracting parties may engage the services of a third party to provide additional services such as advisory or consultancy services relating to the *istikna* contract or asset. The cost of the third party engagement may be borne by both or either one of the contracting parties subject to mutual agreement between them.

15.35 Any variation to the *istikna* contract due to force majeure may be agreed upon by the contracting parties.
ARRANGEMENT OF ISTISNA’ CONTRACT WITH OTHER CONTRACT OR CONCEPT

16. Arrangement of Istisna’ contract with assurances

G 16.1 For the purpose of assurances, the Istisna’ contract may be arranged with other Shariah-based contracts or concepts such as kafalah, takaful coverage, rahn, hamish jiddiyah (security deposit), or `urbun (earnest money).

a) Assurance of Istisna’ contract through kafalah

G 16.2 A third-party guarantee through kafalah may be arranged together with an Istisna’ contract to guarantee the followings:

(a) the payment of the agreed price of the Istisna’ asset within the agreed time;
(b) the delivery of the agreed Istisna’ asset by the seller which meets the agreed specifications and within the agreed time; and/or
(c) the acceptance of the agreed Istisna’ asset within the agreed time by the purchaser.

b) Assurance of Istisna’ contract through takaful coverage

G 16.3 Upon entering into an Istisna’ contract, the seller may require the purchaser to subscribe to a takaful coverage to guarantee the payment of the agreed price of the Istisna’ asset in the event of loss of legal capacity by the purchaser.

G 16.4 The purchaser may require the seller to subscribe to takaful coverage to guarantee delivery of the Istisna’ asset by the seller.

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c) Assurance of *istikna*` contract through rahn

S 16.5  Collateral (*marhun*) in an *istikna*` contract (if any) shall be a Shariah-compliant asset.

S 16.6  Notwithstanding paragraph 16.5, interest bearing debt based asset such as conventional fixed deposit certificate, may be used as collateral provided the collateral is valued up to the principal amount.

S 16.7  The collateral shall be utilised as follows:

(a) to recover payment of the outstanding debt amount from the purchaser; or

(b) to guarantee delivery of the *istikna*` asset by the seller.

G 16.8  Pursuant to paragraph 16.7 (a), the contracting parties may agree to include the claim on actual costs incurred for the recovery of the outstanding debt payment from the collateral.

S 16.9  The seller in the *istikna*` contract may pledge the *istikna*` asset to the purchaser or to any other third party provided that the asset is not yet delivered to and possessed by the purchaser.

S 16.10  The purchaser in the *istikna*` contract shall not pledge an *istikna*` asset prior to its delivery and acceptance by the purchaser.

G 16.11  The contracting parties may agree upon entering into the *istikna*` contract that the purchaser may purchase the *istikna*` asset on as is basis. Consequently, the purchaser owns the asset and therefore may pledge it.
d) Assurance of *istisna* contract through *hamish jiddiyah*

G 16.12 The seller may require the purchaser to place a security deposit (*hamish jiddiyah*) with the seller to secure the purchaser’s undertaking to enter into the *istisna* contract.

G 16.13 The security deposit may be utilized to compensate against actual loss incurred in the event that the purchaser fails to enter into the *istisna* contract.

S 16.14 Pursuant to paragraph 16.13, where a security deposit has been utilized to compensate against actual loss suffered by the seller any remaining balance of the security deposit after payment of compensation against actual loss has been made shall be reimbursed to the purchaser.

G 16.15 Upon entering into the *istisna* contract, the security deposit may be treated as part payment of the agreed price of the asset.

S 16.16 The security deposit shall be returned to the purchaser prior to or upon settlement of the agreed price if it is not treated as part payment of the agreed price of the *istisna* asset.

e) Assurance of *istisna* through *`urbun*

G 16.17 Upon entering into the *istisna* contract, the purchaser may place earnest money (*`urbun*) with the seller, and the purchaser is given a specified time period to continue with or terminate the contract.

S 16.18 The earnest money shall be treated as part payment of the agreed price of the *istisna* asset if the purchaser exercises the option to continue with the contract within the specified time.
16.19 The seller shall be entitled to the earnest money if the purchaser fails to exercise the option to proceed with the contract within the specified time or decides to terminate the \textit{istisna`} contract.

17. Incorporation of rebate \textit{(ibra')} in \textit{istisna`}

17.1 In the event of early settlement by the purchaser after completion and delivery of the \textit{istisna`} asset, the seller may waive part of the outstanding agreed price in the form of rebate \textit{(ibra')} to the purchaser.

17.2 In the event of early settlement by the purchaser prior to completion and delivery of the \textit{istisna`} asset, the \textit{ibra'} mechanism is not applicable.

17.3 Pursuant to paragraph 17.2, the early settlement by the purchaser may occur through the purchasing of the \textit{istisna`} asset on an as-is basis.

17.4 A rebate clause shall be incorporated in the \textit{istisna`} contract provided that it is a requirement imposed by the authority.

17.5 In the event that the \textit{istisna`} contract involves payment of the agreed price on a deferred or instalments basis, the seller may provide periodic \textit{ibra'} to the purchaser based on certain benchmarks or thresholds agreed by the contracting parties.

18. Arrangement of \textit{istisna`} with \textit{ijarah mawsufah fi al-zimmah}

18.1 The contracting parties may enter into a forward lease agreement \textit{(ijarah mawsufah fi al-zimmah)}, where the purchaser may lease the \textit{istisna`} asset under construction to the seller or to any other party.

18.2 The \textit{ijarah mawsufah fi al-zimmah} contract shall be entered into separately from the \textit{istisna`} contract.

18.3 Pursuant to paragraph 18.2, it is allowed for the \textit{ijarah mawsufah fi al-zimmah}
contract to be incorporated in other legal documents such as:

(a) a master agreement provided that it does not carry the effect of the 
ijarah mawsufah fi al-zimmah contract; or
(b) a stand-alone document.

**19. Arrangement of istisna’ with ta’widh, gharamah and/or syart jaza’i**

**G** 19.1 The contracting parties may agree to include a clause in the istisna` contract stipulating late payment charges as determined by the relevant authorities.

**S** 19.2 Pursuant to paragraph 19.1, the late payment charges shall consist of:

(a) ta’widh (compensation) for actual loss borne by the seller, which may be recognised as income to the seller; and/or
(b) gharamah (penalty), which shall not be recognised as income. Instead, it shall be channelled to charitable bodies.

**G** 19.3 The seller may claim for compensation of the actual cost incurred in the event that the purchaser decides not to proceed with the contract after he has undertaken to enter into it through binding wa`d.

**G** 19.4 The contracting parties may agree, upon entering into or during the contract, to include a clause to impose a late delivery charge (shart jaza’i) on the seller in the event of late delivery of the istisna` asset by the seller and the amount may be recognized as income to the purchaser.
ARRANGEMENT OF PARALLEL ISTISNA´

20. Parallel istisna´ contract

S 20.1 A parallel istisna´ shall consist of two separate and independent istisna´ contracts, with similar specifications to the istisna´ asset.

S 20.2 The seller in each istisna´ contract shall deliver the respective istisna´ assets to the purchaser and the purchaser in each istisna´ contract shall pay the respective agreed price of the istisna´ asset to the seller. The obligations under and performance of each istisna´ contract shall be independent of the other istisna´ contract.

S 20.3 In the event that the purchaser engages/appoints a third party to construct, build or manufacture the istisna´ asset (third party), the seller is obliged to abide by the requirement and shall not appoint any other party to construct, build or manufacture the istisna´ asset.

S 20.4 In the event that a purchaser has already agreed to purchase an istisna´ asset from the third party, the seller in the istisna´ contract shall establish his ownership of the asset by:

(a) the purchaser terminating the earlier purchase contract and the seller entering into a new istisna´ contract with the third party; or

(b) any other means of transfer or ownership which is in compliance with Shariah.

G 20.5 The seller may appoint the purchaser as an agent to supervise the construction, building or manufacturing of the istisna´ asset by the third party to ensure that the istisna´ asset meets the agreed specifications and is delivered within the agreed time.

G 20.6 In the event that the purchaser has engaged/appointed a third party, the seller may request that the purchaser guarantees the performance of the third
party.

S 20.7 Pursuant to paragraph 20.6, the arrangement of *wakalah* with *kafalah* shall observe the following conditions:

(a) the *wakalah* contract shall not stipulate as a condition that the *wakil* (purchaser) must guarantee the *muwakkil* (seller); and

(b) the *kafalah* contract entered into by the *wakil* as guarantor shall be independent from his role as *wakil* to the effect that validity of the *wakalah* is not made contingent to the *kafalah* contract or vice versa.
Dissolution (Fasakh) and Completion (Intiha) of Istisna

21. Dissolution of Istisna

S 21.1 An istisna` contract is dissolved under the following circumstances:

(a) the purchaser in an istisna` contract with earnest money (`urbun) exercises the option to terminate the istisna` contract within the specified time period;

(b) the purchaser exercises the option to terminate the istisna` contract prior to its acceptance because the istisna` asset does not meet the agreed specifications prior to its acceptance (khiyar fawat al-wasfi);

(c) the purchaser exercises the defect option (khiyar al-`ayb) to terminate the istisna` contract;

(d) any of the contracting parties exercises the mutually agreed options to terminate the istisna` contract within the agreed time period; or

(e) the purchaser exercises the option the terminate the contract due to the seller’s failure to deliver the istisna` asset.

G 21.2 In the event of demise or dissolution of the seller, the purchaser may exercise the following options:

(a) purchase the istisna` asset on an as-is basis; or

(b) dissolve the istisna` contract.

S 21.3 Pursuant to paragraph 21.2 (a), the effect is that the purchaser shall pay the istisna` selling price up to the stage of completion of the istisna` asset and the purchaser owns the asset.

S 21.4 Pursuant to paragraph 21.2 (b), the effect is that the purchaser is entitled to claim the istisna` selling price from the legal heir or estate of the seller.

S 21.5 In the event of demise or dissolution of the purchaser, the istisna` selling price shall be borne by the legal heir or estate of the seller.
21.6 Upon dissolution of the *istisna* contract:

(a) the ownership of the *istisna* asset remains with the seller;
(b) the purchaser's obligation to pay the agreed price of the *istisna* asset is waived; and
(c) with the exception of paragraph 21.1 (a), any amount paid shall be returned to the purchaser.

21.7 The dissolution of an *istisna* contract shall be effective provided that the *istisna* asset can be returned to the seller.

22. **Completion of *istisna***

22.1 An *istisna* contract ends under the following circumstances:

(a) the acceptance of the *istisna* asset by the purchaser, regardless whether it meets the agreed specifications; and
(b) the full settlement of the agreed price by the purchaser.

22.2 Upon completion of the *istisna* contract, the contracting parties shall be free from any contractual obligations in respect of the *istisna* contract.
PART C OPERATIONAL REQUIREMENTS

23. Background

23.1 The regulatory expectations set out in Part C highlight on the need to establish effective policies and procedures to facilitate governance and oversight, documentations, risk management, business and market conduct as well as financial disclosure for *istikna`* contract. The objectives of these operational requirements are to provide adequate safeguard to relevant stakeholders’ interest, promote orderly implementation of business and risk management strategies and drive the development of necessary systems, processes and control measures while preserving the Shariah requirements.

24. Governance and Oversight

**Principle 1: IFI shall establish comprehensive governance and oversight structure with clear responsibilities in ensuring effective application of *istikna`* contract.**

24.1 The Board of Directors (the Board) must ensure—

(a) comprehensive internal policies governing *istikna`* transaction are established, approved\(^2\) and adhered to at all times by IFI;

(b) application of *istikna`* contract is in line with the IFI’s business and risk management strategies;

(c) the internal policies are reviewed regularly in order to remain current, relevant and adequate to manage overall operational conduct and risk profile of *istikna`* transaction. Any material changes to the internal policies must be approved by the Board;

(d) all Shariah-related matters are endorsed by the Shariah Committee (SC); and

(e) independent reviews are conducted regularly to assess compliance to the standards issued by the Bank and internal policies established by IFI.

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\(^2\) For avoidance of doubt, the internal policies shall be approved by the Board (which in line with Corporate Governance)
24.2 The SC is required to—

(a) validate and endorse the terms and conditions provided in documentation including contracts, product manual, marketing advertisement, sales illustrations and brochures are in compliance with Shariah;

(b) endorse the application of Shariah in relevant internal policies and procedures governing the application of *istikna* contract; and

(c) perform oversight role on the conduct of *istikna* contract transaction through the Shariah review and Shariah audit functions to ensure due adherence of Shariah requirements.

24.3 The senior management\(^3\) shall:

(a) develop and implement internal policies and procedures governing *istikna* transaction. At minimum the internal policies must cover the following aspects:
   (i) internal eligibility criteria of *istikna* asset;
   (ii) project monitoring;
   (iii) delivery arrangement (including treatment for non-delivery events); and
   (iv) defects management.

(b) clearly communicate the approved internal policies to internal stakeholders to facilitate effective implementation; and

(c) undertake regular review and monitor compliance on the established policies and seek the Board’s approval on enhancement to the documents.

\(^3\) Means a person having authority and responsibility for planning, directing or controlling the activities of the IFI including the chief executive officer, the chief operating officer, members of decision-making committees and other person performing key function such as risk management, compliance, internal audit or other functions as specified by the Bank.
Principle 2: IFI shall establish comprehensive policies and procedures to ensure *istikna*’ transaction are conducted in compliance with Shariah and facilitate proper oversight arrangement.

**S 24.4** IFI must develop internal eligibility criteria of *istikna*’ asset. At minimum, the criteria must ensure the *istikna*’ asset-

(a) complies with Shariah requirements; and

(b) consistent with the IFI risk management capacities.

**S 24.5** IFI shall establish internal policy and procedure on project monitoring. At minimum, the internal policy and procedure shall include the following:-

(a) scope of monitoring including identification of areas to be monitored such as cash disbursement to contractor against progression of *istikna*’ project;

(b) method of monitoring such as periodical on-site inspection or submission of progress report by contractor;

(c) timeline or frequency of the project monitoring;

(d) identification of party involved in project monitoring and the accountabilities;

(e) identification of trigger events that require IFI’s intervention; and

(f) procedure to manage trigger events including risk mitigation strategies to be undertaken by the IFI.

**S 24.6** IFI is required to develop internal policy and procedure in the event when customer is unable to accept the delivery of *istikna*’ asset on the agreed delivery date. At minimum, the internal policy and procedure shall include the treatment in the events of-

(a) delivery rejection by customer; and

(b) delay in delivery acceptance by customer.

**S 24.7** IFI shall establish internal policy and procedure on defect management. At minimum, the policy and procedure shall include mechanism to manage customer’s rights due to defect.

**G 24.8** Pursuant to paragraph 24.7, the IFI may outsource the defect management to
other party.

24.9 Pursuant to paragraph 24.7, in the event IFI provides warranty on the *istisna*` asset, the relevant document at minimum shall include the following:

(a) terms and conditions; and

(b) length of warranty period.

Question 2.

a) Highlight areas of internal policy that your institution foresees operational challenges.

b) What are other important areas that must be included in the internal policy?

c) If your institution currently offer *istisna*` financing, highlight the gap of your internal policies against the minimum requirements and guidance specified in this CP.

25. Documentations

**Principle 3:** IFI must identify and establish legal documentation to ensure the transaction is valid and implemented in accordance with Shariah.

25.1 IFI must develop a complete set of legal documentation on *istisna*` transaction that is enforceable and complies with Shariah.

25.2 At minimum, IFI shall ensure the following transactions are documented in writing and executed by contracting parties:

(a) *istisna*` contract and financing arrangement;

(b) acceptance of *istisna*` asset delivery by customer;

(c) where applicable, appointment of agency; and

(d) where applicable, acceptance of guarantee.

25.3 IFI must clearly stipulate the rights, duties, liabilities and obligations of contracting parties in the respective documentations.
IFI shall ensure that the order or application by customer for the construction or manufacturing of asset is supported by a written document. At minimum, the document shall outline the following:

(a) quantity of the asset to be constructed or manufactured;
(b) features of the asset;
(c) purpose of the asset;
(d) delivery time; and
(e) where applicable, proposed contractor or manufacturer of the asset.

In the event customer has entered into legal relationship with a contractor or manufacturer to purchase *istikna* asset, IFI's ownership must be evidenced in enforceable document. The mechanism to transfer ownership from customer to IFI must be shariah-compliant.

The documentation on *istikna* contract transaction shall include the following:

(a) specification of the asset or subject matter of sale;
(b) total selling price;
(c) settlement terms of selling price;
(d) delivery time or period;
(e) where applicable, provision of rebate due to early settlement of selling price;
(f) events of default; and
(g) clause on compensation or treatment due to events of default.

For the purpose of monitoring, IFI may include the following terms and conditions in the relevant legal documentations-

(a) work schedule which includes proposed timeline for cash disbursement from IFI; and

(b) roles and responsibilities of the party who monitor the *istikna* project.

Pursuant to 25.2(b), IFI shall include the following in relevant documentation on confirmation of delivery acceptance-

(a) date of acceptance;
(b) person who accepts the asset; and
(c) confirmation that the asset fulfils the agreed specification.

S 25.9 The terms & conditions in all legal documentations shall not-
(a) result in seller’s liability arising from incomplete delivery or not meeting specification is being waived with the exception of ‘force majeure’ event; and
(b) have a clause that require customer to absorb any increase in the construction cost.

G 25.10 Pursuant to 25.9, the contracting parties may mutually agree to change the terms on any or both contracting parties’ contractual obligation.

S 25.11 IFI shall ensure istisna’ contract is executed independently and separately from other Shariah contracts such as agency (wakalah) or guarantee (kafalah).

Question 3.

a) Please comment on the adequacy of the requirements with regard to the documentation and suggest any areas to be enhanced.

b) What type of document your institution uses or foresees to use to reflect ownership prior to entering istisna’ agreement in particular when the customer has entered into legal relationship with a developer?

26. Risk Management

Principle 4: IFI must institute and implement sound risk management system to effectively manage risks associated with istisna` contract.

Risk identification

S 26.1 IFI must identify and assess risks inherent in istisna` transaction.

Specification of istisna` asset

S 26.2 IFI shall require purchaser to submit written document on specification of the istisna` asset.
S 26.3 From the customer’s (purchaser) specification, IFI shall:
   (a) assess the asset and its purpose are Shariah compliant; and
   (b) establish requirement parameters to ensure relevant resources are available to construct or manufacture the *isti**sna*` asset.

G 26.4 Pursuant to paragraph 26.3(b), the requirement parameters may include funding sources, expertise and availability of contractor.

*Appointment of contractor or manufacturer*

S 26.5 IFI shall undertake due diligence to assess contractor or manufacturer’s capacity to fulfil its contractual obligation to construct or manufacture the *isti**sna*` asset as per specification agreed between contracting parties.

G 26.6 Pursuant to 26.5, IFI may assess the contractor or manufacturer’s historical performance and financial position.

G 26.7 IFI may maintain a list of approved alternative contractor or manufacturer to facilitate the construction or manufacturing of asset in the event that the original contractor or manufacturer fails to complete the *isti**sna*` asset.

G 26.8 IFI may request a third party or customer to guarantee performance of contractor or manufacturer to deliver *isti**sna*` asset as per agreed specification and at agreed time or period.

*Monitoring of *isti**sna*` project*

S 26.9 IFI must monitor the *isti**sna*` project based on the scope and frequency specified in the internal policy.

S 26.10 IFI shall take necessary action in line with the internal policy upon occurrence of predetermined trigger events.

S 26.11 IFI shall assess and review the suitability and effectiveness of monitoring method for different asset/ project.

G 26.12 IFI may appoint another party as its agent to monitor *isti**sna*` project.
Delivery procedure

S 26.13 IFI shall ensure the istisna` asset meets the agreed specification prior to delivery to customer.

S 26.14 IFI shall ensure the asset is delivered as per agreed delivery time.

G 26.15 IFI may employ risk transfer mechanism such as takaful coverage to minimize the risk associated with the delivery of the istisna` asset. For instance, the takaful coverage may minimise potential losses arising from any damage to the istisna` asset during the delivery process to customer.

S 26.16 Pursuant to 26.15, the scope of takaful coverage shall be determined and agreed upfront by contracting parties.

Question 4.

a) What are the additional risk management expectation that requires further attention and deliberation in this CP?

b) If your institution currently offer istisna` financing, highlight the gap of your existing risk management against the minimum requirements specified in this CP.

Question 5.

a) Highlight areas of risk management that your institution foresees operational challenges?
27. Consumer and Market Conduct

**Principle 5:** IFI shall undertake *istisna* contract transaction in a fair and transparent manner in line with Shariah to protect stakeholder's interest

S 27.1 Prior to entering into *istisna* contract agreement, IFI shall disclose the following:

(a) customer’s rights & obligation as a contracting party;
   i) customer’s (purchaser) obligation to accept delivery of *istisna* asset that has been completed and met specification;
   ii) customer’s (purchaser) right to defect options; and
   iii) customer’s roles as IFI’s agent and/or guarantor (if applicable).

(b) explanation on the actions that can be construed to be an event of default and negligence;

(c) description of eligible asset to be financed under *istisna* contract;

G 27.2 During term of agreement, IFI may disclose statement on work-in-progress of the *istisna* asset.

*Late delivery charges*

S 27.3 IFI (seller) shall compensate customers in the event of late delivery.

S 27.4 IFI is required to incorporate a clause on late delivery charges (LDC) as well as the formula used to compute the LDC in the relevant documentations.

S 27.5 For the purpose of LDC computation, IFI must adopt a regulated LDC\(^4\) (if any).

S 27.6 For asset without a regulated LDC, the computation method must be mutually agreed by contracting parties.

\[^4\] Regulated LDC refers to the standardized rate or formula that is determined and governed by respective authoritative bodies. For instance, real estate property is governed by the Ministry of Urban Well Being, Housing and Local Government.

Issued on: 24 June 2014
Ibra’ (rebate)

S 27.7 IFI shall grant ibra’ to all customers who perform early settlement and must observe Guidelines on Ibra’ (Rebate) for Sale-Based Financing with the exception of the guidelines’ treatment on termination of financing arising from non-delivery or non-possession of the underlying asset\(^5\).

S 27.8 Pursuant to paragraph 27.7, early settlement of istisna` financing shall refer to full payment of outstanding selling price prior to maturity of contract after delivery of completed asset.

S 27.9 The IFI is required to incorporate a clause on ibra’ in relevant documentation.

Treatment for non-delivery of istisna` asset

S 27.10 The IFI (seller) is required to provide options to customer in the event of non-delivery. The options must be endorsed by SC.

S 27.11 The IFI shall incorporate the options available to customer in relevant legal documentation.

S 27.12 The IFI must ensure that the customer is aware of the options and implication of each option. Illustration on the customer’s possible options and implication is provided in Appendix 4.
28. Financial Disclosure

Principle 6: IFI shall provide adequate disclosure and transparency in conducting *istikha* contract transaction to facilitate stakeholder's understanding and awareness.

28.1 IFI shall observe the requirements stipulated in the *Guidelines on Financial Reporting for Islamic Banking Institutions, Guidelines on Financial Reporting for Development Financial Institutions, Capital Adequacy Framework for Islamic Banks – Disclosure Requirements (Pillar 3)* issued by the Bank and all applicable MFRS.
APPENDICES

Appendix 1: Legitimacy of Istisna`

1. The legitimacy of istisna` 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 verses of the Quran imply the general permissibility of sales contract including istisna` contract:

   i. وَأَحَلَّ اللّهُ الْبَيْعَ وَحَرَّمَ الرِّبَا …” whereas Allah SWT has permitted trading and forbidden usury…” (Surah al-Baqarah, verse 275).

   ii. يَا أَيُّهَا الَّذِينَ آمَنُواْ أَوْفُواْ بِالْعُقُودِ “O you who believe! fulfil (all) obligations…” (Surah al-Maidah, verse 1).

The Sunnah of Prophet Muhammad (peace be upon him)

3. The following hadiths imply the permissibility of istisna` contract:

   i. عن عبيد الله عن نافع عن ابن عمر، قال: إن رسول الله صلى الله عليه وسلم اصطعب خاتما من ذهب، فكان يجعل فصه في باطن كفه إذا لبسه، فصنع الناس، ثم إنه جلس على المنبر فنزعه، وقال: إن كنت ألبس هذا الخاتم وأجعل فصه من
Ibn Umar reported that the Prophet (peace be upon him) had a golden ring made for himself, and when he wore it he used to turn its stone toward the palm of his hand. So the people too had gold made for themselves. The Prophet (peace be upon him) then ascended the pulpit, removed the ring, and he said, "I had it made for me, but now I will never wear it again." He threw it away, and then the people threw away their rings too.” (Sahih Bukhari and Muslim)

Sahl reported that the Prophet (peace be upon him) sent for a woman from the emigrants who had a slave who was a carpenter. The Prophet (peace be upon him) told her, "Order your slave to prepare wood (pieces) for a pulpit." So she ordered her slave, who went and cut wood from a tamarisk tree and prepared a pulpit for the Prophet (peace be upon him). When he finished the pulpit, the woman informed the Prophet (peace be upon him) that it had been finished. The Prophet (peace be upon him) asked her to send that pulpit to him so they brought it. Sahl said, “The Prophet lifted it and placed it at the place in which you see it now.” (Sahih al-Bukhari)

The consensus of contemporary Muslim jurists (ijma')

Issued on: 24 June 2014
4. Contemporary Muslim jurists have reached *ijma* on the permissibility of *istisna*.
### Appendix 2: Glossary

<table>
<thead>
<tr>
<th>Terms</th>
<th>Explanation</th>
</tr>
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<tbody>
<tr>
<td>Gharamah</td>
<td>Penalty</td>
</tr>
<tr>
<td>Hamish jiddiyah</td>
<td>A security deposit placed to secure the undertaking to purchase an asset before entering into the sale and purchase agreement</td>
</tr>
<tr>
<td>Ijarah mawsufah fi al-zimmah</td>
<td>Forward lease agreement</td>
</tr>
<tr>
<td>Kafalah</td>
<td>Guarantee</td>
</tr>
<tr>
<td>Khiyar al-`ayb</td>
<td>Option arising from a defect; the option of dissolving the contract on discovery of a defect in the asset purchased.</td>
</tr>
<tr>
<td>Khiyar al-ru`yah</td>
<td>Option to cancel upon viewing the manufactured asset</td>
</tr>
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<td>Marhun</td>
<td>Collateral</td>
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<td>Mukhalafah al-shurut</td>
<td>Breach of specified terms</td>
</tr>
<tr>
<td>Mustasni’</td>
<td>Purchaser</td>
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<tr>
<td>Qabd haqiqi</td>
<td>Physical possession. It refers to a state where a person has actual possession and the rights to control an asset.</td>
</tr>
<tr>
<td>Qabd hukmi</td>
<td>Constructive possession. It refers to a state where a person does not have actual possession but has the legal rights to control an asset.</td>
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<tr>
<td>Rahn,</td>
<td>Pledge/ Charge</td>
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<tr>
<td>Sani’</td>
<td>Seller</td>
</tr>
<tr>
<td>Shart jaza’i</td>
<td>Late delivery charge</td>
</tr>
<tr>
<td>Ta`addi</td>
<td>Misconduct</td>
</tr>
<tr>
<td>Takhliyah</td>
<td>Relinquishing or abandoning the rights of ownership</td>
</tr>
<tr>
<td>Tamkin</td>
<td>Enabling the person who has the ownership of an asset transferred to him make full use and assume liability of the asset.</td>
</tr>
<tr>
<td>Taqsir</td>
<td>Negligence</td>
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<tr>
<td>`Urbun</td>
<td>Earnest money</td>
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<td>------------</td>
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<tr>
<td>`Urf tijari</td>
<td>Common business practice which is acceptable by the community and does not contradict the Shariah rulings</td>
</tr>
</tbody>
</table>
Appendix 3: Related Shariah Rulings 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\textsuperscript{6};
(b) Shariah Governance Framework for Islamic Financial institutions
   Guidelines on Corporate Governance for Islamic Bank;
(c) Guidelines on Corporate Governance for Development Financial
   Institutions;
(d) Capital Adequacy Framework for Islamic Banks (Risk-Weighted
   Assets);
(e) Capital Framework for Development Financial Institutions;
(f) Capital Adequacy Framework for Islamic Banks (Disclosure
   Requirements);
(g) Risk Governance;
(h) Guidelines on Product Transparency and Disclosure;
(i) Guidelines on Financial Reporting for Development Financial
   Institutions;
(j) Guidelines on Property Development and Property Investment
   Activities by Islamic Banks;
(k) Guidelines on Financial Reporting for Islamic Banking Instituions;
(l) Guidelines on the imposition of Fees and Charges on Financial
   Products and Services;
(m) Guidelines on Rebate (ibra’) for Sale-Based Financing;
(n) Guidelines on Late Payment Charges for Islamic Financial
   Institutions; and
(o) Guidelines on Responsible Financing.

\textsuperscript{6} Including Shariah resolutions in Islamic Finance, standards, circulars or any directive pertaining to
Shariah matters issued by the Bank.
Appendix 4: Illustration of Customer’s Possible Options and Implication Arising From Non-delivery of *Istisna* Asset

<table>
<thead>
<tr>
<th>No.</th>
<th>Options</th>
<th>Implications</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Reject delivery</td>
<td>• Ownership of <em>istisna</em> asset remains with seller.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Customer (purchaser)’s obligation to pay <em>istisna</em> selling price is waived.</td>
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<tr>
<td></td>
<td></td>
<td>• Any amount paid to IFI (principal &amp; accrued profit) should be returned to customer</td>
</tr>
<tr>
<td>2.</td>
<td>Accept delivery &amp; pay original price</td>
<td>• Customer is required to pay pre-agreed selling price of <em>istisna</em> asset.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• IFI shall deliver the <em>istisna</em> asset to customer as-is basis.</td>
</tr>
<tr>
<td>3.</td>
<td>Accept delivery at new terms agreed by</td>
<td>• Customer is required to pay revised selling price of <em>istisna</em> asset.</td>
</tr>
<tr>
<td></td>
<td>contracting parties</td>
<td>• IFI shall deliver the completed <em>istisna</em> asset to customer on revised deadline.</td>
</tr>
</tbody>
</table>