**SPEAKER PROFILE**

3. Led the Islamic Banking Personal Financial Services to build business in OCBC (2006-2007)
5. Now : Senior Vice President, Islamic Products for IBW UOB Bank (2016-Present), launched IBW business (July 2016)
6. Committee Member of AIBIM’s Qard WG, Investment Account WG, Tawarruq WG. IBFIM trainer (Deposits & Financing products).
7. Maintains a free-to-use website Islamic Bankers Resource Centre ([http://islamicbankers.me](http://islamicbankers.me))

**AMIR ALFATAKH**

UITM, HULL (UK), IIUM
THE SHIFT TO ISLAMIC STANDARDS

Policy Documents to align to international standards and practices
THE MALAYSIAN MASTERPLAN

From the establishment of the first Islamic Bank in 1983, Malaysia has long envisioned to establish itself as a significant global player in Islamic Banking & Finance.

This vision has been nurtured by BNM for many years which started with the Islamic Financial Masterplan in the early 2000's with the eventual vision of establishing Islamic Banking at 40% of all banking business by 2020.

Malaysia is now seen as one of the key Islamic Financial centres globally.
BIG CHANGES IN ISLAMIC BANKING

- Support from Government of Malaysia and the Market has been tremendous

- Malaysia aims to increase competitiveness within the region, ultimately grow internationally

- To support the national agenda, strong push for compliance to international standards including Basel requirements

- IFSA is intended to streamline the industry with BNM issuing specific standards as guidance
• For the past few years, BNM has re-looked at the Islamic Banking industry vs the development from the middle east

• Steps are being taken to rationalise existing local contracts to align with international standards

• IFSA 2013 combined and updated the individual Acts (IBA, Takaful Act) into one, and made Policy Documents and Guidelines into law
ISLAMIC FINANCIAL SERVICES ACT  
2013 (IFSA)  
Consolidation of all existing 
Islamic Banking and Takaful 
regulations into one
CHANGING THE LANDSCAPE

ISLAMIC FINANCIAL SERVICES ACT 2013 (IFSA 2013)

INTENDS TO RE-ALIGN ISLAMIC BANKING & FINANCE PRACTICES

&

OUTLINED THE IMPORTANCE OF SHARIAH COMPLIANCE (& ROLES OF SHARIAH COMMITTEE)

&

IMPACT OF NON-COMPLIANCE

&

PUT INTO FORCE REGULATIONS ISSUED BY BNM AS PART OF LAW
ISLAMIC FINANCIAL SERVICES ACT 2013

✓ Sec 6 IFSA: The principal regulatory objectives of the Act are to promote financial stability and compliance with Shariah

Sec 28 (1)
- IFI shall at all times ensure Shariah Compliance

Sec 28 (2)
- Shariah Compliance refer to compliance of the SAC

Sec 28 (3)
- Any incompliance activities needs to be notified to SC, the activities to be ceased, and the activities reported within 30 days

Sec 28 (4)
- Breach of Shariah Compliance may result in 8 years imprisonment, a fine of RM25 million or both
BANK NEGARA MALAYSIA AS THE DRIVER

ISLAMIC FINANCIAL SERVICES ACT 2013 (IFSA)

i. The Islamic Financial Services Act 2013 (IFSA) was introduced to re-align all the existing Acts governing Islamic Banking into a single Act.

ii. The scope of business has been re-defined to encompass all entities offering Islamic product and services

iii. Some contracts nature were also re-defined

iv. The responsibilities of all the stakeholders in an Islamic Banking business is emphasized, especially Shariah Committee

BNM POLICY DOCUMENTS & GUIDELINES

i. Since 2013 when IFSA was introduced, BNM had released multiple Guidelines and Concept Papers to be discussed with the industry players

ii. Comments and feedback on the intended guidelines were received from the various industry players

iii. Shariah Advisory Council (SAC) of BNM is also consulted before the paper is finalised.

iv. The final version: Policy Documents are introduced to Banks to comply
EVOLUTION OF ISLAMIC BANKING

Since the introduction of Islamic Banking Act in 1983, the industry has slowly evolved in terms of the following:

- Guiding principles of Islamic contracts by BNM
- Suitability of products towards customers needs
- Operational efficiency of Islamic products and services
- Shariah increased depth and quality of decision making
EVOlution of Financing Contracts

- Islamic Banking contracts had evolved over a period of time to cater for various customer needs.

- It started with a debt based structure but of late, has started to explore equity partnerships, profit and loss intermediation and risk sharing structures.
MORE THAN JUST “BANKING”

BNM promoted and encouraged IFI to explore the expansion of Islamic Banking contracts

Debt-based transactions → Equity-based and Equity Participation.

ISLAMIC CONTRACTS

- Debt Based
  - Murabahah
  - Tawarruq
  - AITAB
  - Musyarakah
  - Mudarabah
  - Istisna
  - Ijarah

- Equity Based

- Other
  - Qard
  - Wa’d
One of the main contention in Islamic Banking is the lack of development in “Equity-based” transactions.

Traditionally, IFI prefers Debt-based financing structures where risks are transferred to the customers at the soonest instance possible.

Equity financing means the fund provider takes the investment risks (risk-sharing).

The western countries have been successful in the “venture capitalist” model, where risks and rewards are shared.
RISK MATRIX FOR EQUITY STRUCTURES

There are various areas of concerns when an IFI considers Equity Financing as part of its portfolio.

Main issue is the risk on Capital, as IFI is not clearly set-up to undertakes such level of risks.

While many IFI may consider developing the Equity-based financing products, the Letter of Undertaking is used to guarantee that in the event the “risk-sharing” is realised, the customer will undertake to transfer the risks to the IFI. This effectively reverts the structure into a debt structure.

No clear guidelines provided by BNM for these structures before 2015.
EQUITY PARTICIPATION STRUCTURES - PD

- **Musharakah**
  - Issued April 2015
  - DEPOSIT (INVESTMENT ACCOUNT) & EQUITY FINANCING

- **Mudarabah**
  - Issued April 2015
  - DEPOSIT (INVESTMENT ACCOUNT) & EQUITY FINANCING

- **Istisna'**
  - Issued Dec 2015
  - EQUITY FINANCING

- **Ijarah**
  - Issued Aug 2016
  - EQUITY FINANCING
SHARIAH STANDARDS ON MUDARABAH

Shariah Requirements
Operational Requirements
Specific Requirements
1. Mudarabah has been one of the mainstay of Islamic Banking deposit products in the industry.

2. It is popular because it offered the “potential” of earning a deposit return based on actual performance.

3. However, as a financing contract, there is very little thought or development in this space.

4. The main challenge is the risk on capital for Mudarabah and the inability to impose any guarantee on the performance of the entrepreneur.

**THE MUDARABAH**

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

Entrepreneurial Arrangement
Sharing of Economic Profits

Capital Provider holds the risk of loss
Financing of General or Specific Project

MUDARABAH
PERMISSIBILITY OF MUDARABAH

Activities for the purpose of profit

The following verse of the Qur’an implies the general permissibility of commercial venture including mudarabah.

\[\text{وَفَاتَمَّتُ مَعَهُ وَمَعَ الَّذِي يَهُدُونَ مِنْ فَاحِشَةِ اللَّهِ} (1)\]

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

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

Preferred transactions

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

فيهن الورقة: البيع إلى أهل المفاوضة وأخلاء البر بالشعر للبيع لا للبيع)

"Suhayb (may Allah be pleased with him) reported that the Prophet Muhammad (peace be upon him) said: Three matters that have the blessing (of Allah): A deferred sale, muqaradah (mudarabah), mixing wheat with barley for domestic use and not for sale."⁶²
1. Unrestricted Mudarabah (Mudarabah Mutlaqah) – usually refers to a venture where the capital provider allows the entrepreneur to manage the venture as it sees fit, without restrictions.

2. Restricted Mudarabah (Mudarabah Muqayyadah) – usually refers to a venture where the capital provider provides specific mandate to be adhered to by the entrepreneur. The scope of the work and roles can be specified clearly at the start of the contract.

**Mudarabah Mutlaqah**

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

**Mudarabah Muqayyadah**

A restricted *mudarabah* is a contract in which the *rabbul mal* imposes specific restrictions on the *mudarabah* terms. The *rabbul mal* may specify conditions restricting the *mudarib* such as the determination of location, period for investment, type of project and commingling of funds.
In a Venture, the Bank enters into a more involved role as equity provider. A strong monitoring backbone maybe established for the Manager (Entrepreneur).

Roles & Responsibilities of Customer (as Entrepreneur) are clearly defined & agreed.
In a Financing, the Bank gets involved as a financier after assessing the Credit Risk. Many mitigating clauses are built and the Bank relies on these clauses in events the financing (and its returns) came into default.

Heavy reliance to the provisions in the legal documents
THE ESSENTIAL REQUIREMENTS

1. Nature of Contract
   - Fiduciary (trust) relationship between Manager (Mudarib) & Capital provider (Rab Ul Mal) either Restricted or Unrestricted Mudarabah

2. Contracting Parties
   - Mudarib (Manager) & Rabb Ul Mal (Capital Provider) + Agency role (if any)

3. Offer & Acceptance
   - Expressed verbally or in writing, as valid evidence

4. Management
   - Mudarib shall have right to manage venture without interference of Rabb Ul Mal (but have rights to reasonable information on the venture)

5. Capital
   - Capital is identifiable, available and accessible + cash or in-kind
   - No guarantee by Mudarib on Capital allowed

6. Profit
   - Primary motive is Profit Sharing but it cannot be guaranteed/fixed by Mudarib
   - The Profit Sharing Ratio (PSR) determined at the entering of contract
   - Borne by Rabb Ul Mal up to the Capital value
   - Mudarib is liable for loss if there’s Misconduct, Negligence, or Breach of Terms

7. Loss
   - Additional notes

Basic Requirements
## CAPITAL OF MUDARABAH

<table>
<thead>
<tr>
<th>Key Points</th>
</tr>
</thead>
<tbody>
<tr>
<td>Provided by Rabb Ul Mal</td>
</tr>
<tr>
<td>Identifiable, Available, Accessible</td>
</tr>
<tr>
<td>Cash, in-kind, intangibles. Debts do not qualify as Capital</td>
</tr>
<tr>
<td>Capital is a liability of the Mudarib and to be returned upon dissolution (remaining Capital)</td>
</tr>
<tr>
<td>Capital cannot be guaranteed, but can be repaid if there is misconduct, negligence, or breach in terms</td>
</tr>
<tr>
<td>Capital may be co-mingled with other funds with consent</td>
</tr>
<tr>
<td>Mudarib injecting own Capital changes the contract nature to Musyarakah</td>
</tr>
<tr>
<td>Identifiable direct expenses can be deducted from Capital</td>
</tr>
<tr>
<td>Failure to provide Capital when work has started qualifies for reimbursement, or revision or termination</td>
</tr>
</tbody>
</table>
# PROFIT OF MUDARABAH

## Key Points

<table>
<thead>
<tr>
<th>Point</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit Sharing = Primary Motive</td>
<td></td>
</tr>
<tr>
<td>Calculated based on acceptable market practice</td>
<td></td>
</tr>
<tr>
<td>Profit cannot be guaranteed by Mudarib</td>
<td></td>
</tr>
<tr>
<td>Profit Sharing Ratio (PSR) must be mutually agreed and determined at time of entering contract</td>
<td></td>
</tr>
<tr>
<td>PSR may be revised during the tenure but must be mutually agreed</td>
<td></td>
</tr>
<tr>
<td>No pre-determined fixed profit allowed which deprived the profit of other parties or from Capital</td>
<td></td>
</tr>
<tr>
<td>Multi tier Mudarabah and multi tier PSR is allowed, and based on certain threshold</td>
<td></td>
</tr>
<tr>
<td>Profit can be recognised based on actual liquidation or constructive profit recognition</td>
<td></td>
</tr>
<tr>
<td>Constructive Profit allows profit reserve created, with eventual adjustment to actual performance</td>
<td></td>
</tr>
<tr>
<td>Profit distribution at agreed period or on maturity</td>
<td></td>
</tr>
<tr>
<td>All parties can agree to set profit aside from reserve, not arising from Capital</td>
<td></td>
</tr>
</tbody>
</table>
ARRANGEMENTS WITH OTHER CONTRACTS

1. Kafalah
   - The Mudarib shall not guarantee the Capital, however may arrange for Collateral (disposable at termination of Mudarabah) or independent 3rd party guarantee (not related to Mudarib)

2. Wadiah, Wakalah, Musyarakah
   - Mudarabah funds can be partially split into other contracts such as Wadiah (safekeeping), Wakalah (Agency for Investment) and Musyarakah (partnership), observing the rules of each contract

3. Hibah
   - Hibah (gift) can be given by Mudarib to Rabb Ul Mal, but not from Capital or from Rabb Ul Mal’s share of profit, and not intended to guarantee Capital

4. Wa’d
   - A Wa’d (promise) can be arranged for the Mudarib/agent to purchase the Mudarabah asset upon occurrence of specific event, or period of time
THE OPERATIONAL REQUIREMENTS - MUDARABAH

1. Governance & Oversight
   - Board of Directors
   - Board Committee
   - Shariah Committee
   - Senior Management

2. Comprehensive Policies & Procedures
   - Shariah Compliance
   - Contracting Parties
   - Management of Mudarabah
   - Capital
   - Profit
   - Loss
   - Guarantee / Collateral
   - Exit from Venture
   - Documentation

3. Risks & Rewards
   - Shariah Compliance
   - Contracting Parties
   - Management of Mudarabah
   - Capital
   - Profit
   - Loss
   - Guarantee / Collateral
   - Exit from Venture
   - Documentation

4. Risk Management System
   - Policies and Procedures
   - Feasibility Assessment
   - Active monitoring & continued assessment
   - Underperforming ventures
   - Exit procedures

5. Transparency & Disclosures
   - Financial Reporting
   - Accounting Records
   - Disclosures

6. Fair Undertaking of Musyarakah
   - Fair dealings
   - Disclosure of Information
OPERATIONAL REQUIREMENTS: MUDARABAH VENTURE

Ideally, a Mudarabah should be managed as an entrepreneurial venture at the Bank’s level, with dedicated departments overseeing the operations of the venture. However, this organisation structure is not developed by any Banks at the moment.

The Bank as Capital Provider

- Dedicated function or unit at operational level: with relevant skills and expertise, conduct appraisals to recommend good ventures, regular monitoring and site visits, and proper risk management policies and internal controls
- Dedicated structure at Board and Senior Management Level: oversight committees with internal threshold (by BIC, IC) and investment limits

Mudarabah Venture

- Observer: mechanism to safeguard execution of Mudarib’s duties including appointment of observers (with relevant skills) with no conflict of interest, with reporting responsibilities
8. **Definition and Nature of Mudarabah**

8.1 *Mudarabah* is a contract between a *rabbul mai* and a *mudarib* under which the *rabbul mai* provides capital to be managed by the *mudarib* and any profit generated from the capital is shared between the *rabbul mai* and *mudarib* according to mutually agreed profit sharing ratio (PSR) whilst financial losses are borne by the *rabbul mai* provided that such losses are not due to the *mudarib’s* misconduct (*ta’addl*), negligence (*taqdis*) or breach of specified terms (*mukhalafah al-shuruf*).

8.2 *Mudarabah* is a contract based on fiduciary relationship (*aqd al-amanah*). Under this principle, *mudarib* manages the *mudarabah* asset in trust and is not liable for the impairment of the asset except for impairment which is a result of the *mudarib’s* misconduct (*ta’addl*), negligence (*taqdis*) or breach of specified terms (*mukhalafah al-shuruf*).

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

   a) The *mudarib* has commenced the work relating to the management of the capital of the *rabbul mai*, or

   b) Contracting parties have agreed to enter into a *mudarabah* for a specified time or have agreed not to terminate the contract within a specified time.

10. **Management of Mudarabah**

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

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

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

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

10.5 *Rabbul mai* shall not involve in managing *mudarabah* venture but shall have a right of access to reasonable information regarding the *mudarabah* venture.
PROFIT & LOSS - MUDARABAH

1. The Profit Sharing Ratio should be mutually agreed between contracting parties
2. PSR determined via estimated returns or benchmark against similar product with relevant costs
3. Realisation of profit agreed at certain intervals, but may adjust based on final realisation or dissolution of the venture
4. For losses, Bank may set criteria for negligence or misconduct for Mudarib to adhere to. Otherwise, Bank as Rabb Ul Mal will bear the losses
5. No guarantee of Capital is allowed
6. The venture should be separated from any other businesses.

PROFIT SHARING
Based on Agreed Ratio

LOSS BEARING
Borne by Capital Provider
EMPHASIS ON PROFIT AND LOSS TREATMENT

13. Loss

13.1 A loss is depletion from the value of capital.
13.2 Loss shall be borne by the rabbul mal up to the capital value.
13.3 The mudarib shall not be liable for any impairment of asset unless such loss is due to the mudarib’s misconduct (ta‘addh), negligence (taqṣir) or breach of specified terms (mukhtalafah al-shurut) of the contract.
13.4 Notwithstanding paragraph 13.3, in the case of loss the mudarib shall furnish the reason for the occurrence of loss.
13.5 In the case of multiple rabbul mal in a single mudarabah, the loss shall be borne by each rabbul mal proportionate to his capital contribution.
13.6 In the case where mudarib commingled or injected his own fund to the mudarabah, the loss shall be borne based on the proportion of the mudarib’s capital contribution in the commingled fund.
13.7 The mudarib may voluntarily absorb the loss upon the maturity or dissolution of mudarabah.

12. Profit

12.1 Profit sharing is the primary motive of the mudarabah contract and therefore it is a fundamental component of the contract.
12.2 Profit is the value created over and above the mudarabah capital which is determined based on profit determination method acceptable by market standard or practices.
12.3 The mudarib shall not guarantee any profit.
12.4 Rabbul mal and mudarib shall share profit based on a ratio mutually agreed between them.
12.5 PSR shall be determined at the inception of the contract. Nonetheless, PSR may be revised during the tenuro of the mudarabah subject to mutual agreement.
12.6 Mudarabah contract shall not stipulate a pre-determined fixed amount of profit to one contracting party which deprives the profit share of the other contracting party.
12.7 The profit in the form of certain percentage shall not be linked to the mudarabah capital amount.
12.8 Notwithstanding paragraph 12.7, the ex-post performance profit amount (based on the PSR which had been mutually agreed upon between the rabbul mal and the mudarib) may be translated into a fixed percentage yield of the mudarabah capital amount.
TYPES OF INVESTMENT ACCOUNTS

MUDARABAH (Profit Sharing)

WAKALAH FI ISTIHMAR (Agency for Investment)

MUSYARAKAH (Partnership)

UNRESTRICTED INVESTMENT ACCOUNT:
• General Investment
• Unmatched Balance
• Fixed/Unfixed Tenure
• Easy exit & Redemption
• Mixed Asset Portfolio

RESTRICTED INVESTMENT ACCOUNT:
• Specific Investment
• Matched Tenure & Balance
• Penalty on exit & Redemption
• Single Asset Utilisation
MUDARABAH INVESTMENT

In an Investment, the Bank becomes the Entrepreneur / Manager for the Customer’s funds, and invest into Shariah compliant business with intention to obtain returns to be distributed to the Customer (as Capital Provider).

Heavy reliance to the provisions in the legal documents
UNRESTRICTED INVESTMENT ACCOUNT

1. Customer has Cash to Invest based on risk profile. Customer given Product Disclosure Sheets and conducts Suitability Assessment
2. Investment into Portfolio is made. Tenure flexible
3. Investor free to redeem or further invest or re-invest into Portfolio
4. On specific valuation period, a blended return on Portfolio is realised. Losses, if any, is also determined
5. If any Profit, it is distributed based on Profit Sharing Ratio or Agreed Fees
6. Investment Asset can be divested or continued for another period
RESTRICTED INVESTMENT ACCOUNTS

1. Customer has Cash to Invest based on Specific risk profile. Customer assesses risk.
2. Investment into Asset is made. Tenure fixed
3. No redemption allowed during tenure. If redemption is made, penalty is imposed (unless replacement investor is found)
4. On maturity date, the final return on Asset is realised. Losses, if any, is also determined
5. The Specific Asset is divested / terminated
6. If any Profit, it is distributed based on Profit Sharing Ratio or Agreed Fees
VARIATIONS OF MUDARABAH

The Mudarabah PD also outlined some of the basic structures available where the issues are addressed in the PD. This covers both Bank’s role as a Rabb Ul Mal as well as Capital Provider in a venture.
OVERVIEW MUDARABAH PRODUCTS

Mudarabah financial products familiar in the “investment / deposit space” since its introduction in the mid 1990s. It was one of the most recognisable products in the market prior to the introduction of IFSA 2013.

Mudarabah as a depository product is also popular internationally.

However, for financing proposition, the solution remained elusive for Banks. The main reasons being:

1. Lack of Expertise to manage a venture & added responsibilities
2. High cost of Capital due to the risks (Up to 400% capital cover compared to a debt product of 50% - 100%)
3. Risk of Loss on Capital
4. Different risk profile and credit consideration
5. Entrepreneurial structure and features
MUDARABAH PRODUCTS

There are not may products available in the Islamic Financial market that are structured as pure Mudarabah.

Banks are not keen on providing financing structures where the capital is at risk. Mudarabah is traditionally used as a deposit structure.
3 PARTY MUDARABAH ARRANGEMENT
(RESTRICTED INVESTMENT ACCOUNT/PSIA)

1. Investors and Bank agrees on Mudarabah terms and conditions, and one party provide funds into Mudarabah Investment Fund. Investors & Bank signs Mudarabah Agreement as Fund Provider and Manager.

2. Bank, as manager in the agreement, enters into an Islamic financing / venture arrangement with the Entrepreneur, where the Entrepreneur agrees to share its profits with the Mudarabah Investment Fund.
### ISSUES WITH THE STRUCTURE

<table>
<thead>
<tr>
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<th>POSSIBLE SOLUTIONS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Requires the tenure to be fixed, usually middle to long term</td>
<td>The structure of Mudarabah is an entrepreneurial structure either as permanent investment (to recover capital = dissolution) or a fixed tenure venture (to recover capital = expiry). To recover capital earlier, a replacement investor needs to be found to take over the “share”.</td>
</tr>
<tr>
<td>Illiquid structure ie high cost of redemption</td>
<td>Redemption for Investment Account earlier than the stated tenure may result in higher cost to the investment. Often, additional borrowing is required for the redemption, where there are costs attached. Clear guidance on the process and costs needs to be informed upfront for early redemptions.</td>
</tr>
<tr>
<td>Long tenure returns pay-off</td>
<td>Usually structured over medium or long term, it is possible to structure the investment in shorter valuation periods to cater for profit recognition and pay-off. However it carries the risks of non re-investment if the returns on valuation are below expectations.</td>
</tr>
<tr>
<td>Capital is not guaranteed</td>
<td>The notion of investment carries the understanding that it is not capital protected. It is possible to look at “3rd party guarantees” on the Capital</td>
</tr>
</tbody>
</table>
2 PARTY MUDARABAH ARRANGEMENT
(INVESTMENT ACCOUNT PLATFORM - IAP)

1. Investors evaluates feasibility of projects as proposed by Bank (as Manager or Facilitator) and agrees on Mudarabah terms and conditions, and provide funds (Mudarabah Investment Fund).

2. Investors enters into a Mudarabah agreement directly with the Entrepreneur, where the Entrepreneur agrees to share its profits into the Mudarabah Investment Fund partners.
<table>
<thead>
<tr>
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<th>POSSIBLE SOLUTIONS</th>
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</thead>
<tbody>
<tr>
<td>Requires the tenure to be fixed, usually middle to long term</td>
<td>The structure of Mudarabah is an equity provider either as permanent investment (to recover capital = dissolution) or a fixed tenure venture (to recover capital = expiry).</td>
</tr>
<tr>
<td></td>
<td>To recover capital earlier, a replacement investor needs to be found to take over the “share”.</td>
</tr>
<tr>
<td>Illiquid structure ie high cost of redemption</td>
<td>Redemption for Investment into the platform earlier than the stated tenure may result in additional redemption cost. The entrepreneur may also not be able to raise the cash for redemption if it is in negative cash flow</td>
</tr>
<tr>
<td></td>
<td>Clear guidance on the process and costs needs to be informed upfront for early redemptions.</td>
</tr>
<tr>
<td>Valuation of the Investment</td>
<td>As the investor is directly invested (financing) into the entrepreneurs business, the valuation of the investment may be subjective and superficial.</td>
</tr>
<tr>
<td></td>
<td>Main consideration for a valuation of the investment may be through balance sheet and P&amp;L</td>
</tr>
</tbody>
</table>
INVESTMENT ACCOUNT PLATFORM (IAP)

Rethinking the way the Banks support customers who seeks “Investments” and companies that seek “funding”, riding on the expertise of Islamic Banks. Investors take on acceptable risks for rewards. This is a significant shift from the Basic Deposit way of raising funds.

Vision
To be the leading multibank platform for Shariah compliant capital mobilisation, supported by a conducive ecosystem.

Mission
To provide a tech-driven avenue of choice for fund raising and investment in support of real economic growth.

Objectives
To provide an enabling environment with different value propositions to accommodate the following stakeholders:

- **Sponsoring Bank**: Efficient capital management and sustainable source of fee-based income
- **Investor**: Wider range of shariah-compliant investment options in various types of economic activities
- **Venture**: Greater access to business financing

INVESTMENT ACCOUNT PLATFORM (IAP)
FEATURES OF IAP

i. Investment Accounts are being promoted by BNM to “match make” Banks and potentially good ventures via Investment Account Platform (IAP).

ii. The intention is to link between the retail / corporate “investors” directly with companies seeking funding for their businesses.

iii. This model is similar to crowd funding, but without the business having to surrender their equity to their “investors”
ONE OF THE INNOVATION OF ISLAMIC BANKING IS THE INTRODUCTION OF INVESTMENT ACCOUNT PLATFORM (AIP). THE IAP AIMS TO TAKE ADVANTAGE OF THE ISLAMIC PRINCIPLES OF RISKS AND PROFIT SHARING TO THE NEXT LEVEL

Benefits:

1. Encourages Profit Sharing, Risk Taking, and Strong Governance
2. Minimum Funding Size RM500,000 up to 5 years financing
3. Companies and SMEs with a 3-5 years financial track record
4. Rides on existing Bank credit infrastructures and assessment expertise
5. Pushes companies to become more transparent and competitive
1. Bank is no longer a Bank, but a equity funding facilitator. Bank will utilise its expertise to assess the viability of the investment

2. Direct funding from public investors to entrepreneurs or business partners. Funding not from Bank

3. Familiarise with structures similar to Venture Capitalist

4. Bank may provide Rating of the entrepreneurs and feasibility assessment to the Investors for a fee

5. Investors need to be more savvy to understand the behaviour of investment

6. The ownership of the Investment need to be clear ie it is taken by fund provider into their portfolio as direct investor

7. No capital charge or impairments to the Bank
REAL PERFORMANCE

Under the contract of Mudarabah

1. Principal is not protected

2. Profit is not guaranteed and is based on ACTUAL performance

WHAT DOES THIS MEAN?

It means Banks no longer can employ the following Displace Commercial Risk (DCR) techniques to boost returns on the profit:

• Gift (Hibah) from Shareholders Funds

• Waiver of Bank’s profit share / earned fee

• Restricted use of Profit Equalisation Reserves (PER)

---

1 Refers to the risk arising from the assets managed on behalf of the IAH which maybe borne by the IFI’s own capital, when the IFI foregoes part or all of its share of profits on the IAH funds, and/or make transfer to the IAH out of the shareholders’ fund as a result of commercial and/or supervisory concerns in order to increase the return to the IAH. The profit smoothing techniques are described in GN-3: Guidance Note on the Practice of Smoothing the Profits Payout to Investment Account Holders issued by the Islamic Financial Services Board on December 2010.
DISTRESSED MUDARABAH

As the structure is based on entrepreneurship arrangement, in the events of distress prior to default, the monitoring of the venture must already take place.

Considerations must include:

1. Current performance
2. Future expectations
3. Viability until end of tenure
4. Estimated losses
5. Turnaround strategy / exit strategy
**THE SAC RESOLUTIONS : GUARANTEEING CAPITAL**

Although in general, a Mudarabah arrangement should not guarantee capital, the SAC has issued a fatwa that it can be done provided it is provided by a third party that has no direct interest in the Mudarabah business.

This is a useful fatwa as it allows for the argument that the risks can be transferred to another party. However, operationalising it is a challenge as not many “guarantors” are able to distance themselves from having an interest with the Mudarabah business.
SUMMARY: MUDARABAH

1. Mudarabah is more familiar in the “deposit/investment” space as the risk of losing capital is on the customer as investors.

2. For financing structure, Mudarabah is deemed too risky as the Bank will become the “fund provider” and Bank hold the loss of capital risks.

3. With the Mudarabah standard, the recourse to losses remains almost non-existent except where customer can be proven negligent.

4. However, a potential solution to the development of a Mudarabah financing structure will be the exploration of “guarantee” of Mudarabah capital by a third party.
SHARIAH STANDARDS ON MUSLIMARAKAH

Shariah Requirements
Operational Requirements
Specific Requirements
The Musyarakah

Musyarakah is a partnership between two or more parties, whereby all contracting parties contribute capital to the musyarakah venture and share the profit and loss from the partnership.

1. One of the main perception towards Islamic Banking products that it should be operating based on profit sharing contracts

2. Musyarakah has a popular notion that is it the more “pristine” Shariah contract

3. It is fair to the customer and bank as equitable partners, sharing the good and bad times.

4. However, operationalising it has become a challenge for most banks, especially mitigating the risks tied to a Musyarakah.
OBJECTIVES OF THE CONTRACT

Joint Venture or Partnership Arrangement

Sharing of Economic Profits

Sharing of Economic Loss according to Equity contribution

Partnership into General or Specific Project

MUSYARAKAH
PERMISSIBILITY OF MUSYARAKAH

Rights from partnership arrangement

The following verses from the Qur’an generally indicate the validity of Musyarakah.

(a) قالن كأ كأ أكثر من تلك فهم شركاء في الثالث من بعده" وصيئ ببى أ وذين غير مصارٍ

“if there be more (brothers and sisters of the same mother), they shall (equally) share the third of the estate, after payment of any bequest that may have been bequeathed or debt (incurred); the bequests made should not harm (the rights of the heirs).”

The verse specifically underlines the rule of Islamic inheritance. However, in general context, Muslim jurists have regarded the text as containing general permissibility of any form of partnership.

Fairness in partnership arrangement

(b) وَإِنْ كَثِيرًا مِنْ العَدَدِ لَيْسَ غَيْبًا مِنْهُمْ عَلَى بَعْضَهُمْ إِلَّا الَّذِينَ آمَنُوا وَعَمُّوا الصَّالِحَاتَ وَقَلِيلٌ مَا هُمُ

“Truly many partners (in all walks of life) are unjust to one another: but not so those who believe and do good works, and they are few.”

The verse reminds the partners to bind themselves to ethical value dealing with each other. This indirectly indicates the acknowledgement of the Qur’an in partnership.
1. Partnership in Joint Ownership (Shirkah Al Milk) – usually refers to a financing arrangement (equity participation) entered as a joint venture.

2. Contractual Partnership (Shirkah Al Aqad) – usually entered into for the purpose of generating profit where one party acts as the agent for other partners. This includes:
   - i. Shirkah Al Amwal – investing sum of money for profit
   - ii. Shirkah Al A’maal – partnership agreeing to share profit based on their labour
   - iii. Shirkah Al Wujuh – partnership to purchase asset for the purpose of making a profit

Shirkah Al Milk

Refers to possession of an asset by two or more persons with or without prior arrangement to enter into a sharing in joint ownership. Under shirkah al-milk, each partner’s ownership is mutually exclusive. In this regard, one partner cannot deal with the other partner’s asset without the latter’s consent.

Shirkah Al Aqad

Refers to a contract executed between two or more partners to venture into business activities to generate profit. Under shirkah al-‘aqd, a partner is an agent for the other partners. In this regard, the conduct of one partner in the ordinary course of business represents the partnership.
In a Venture, the Bank enters into a more involved role as equity partner. A strong monitoring backbone must be established (including setting up an SPV) to control the partnership.

Roles & Responsibilities are clearly defined & agreed.
In a Financing, the Bank gets involved as a financier after assessing the Credit Risk. Many mitigating clauses are built and the Bank relies on these in events the financing (and its returns) came into default.

The returns of the financing may or may not be directly originating from the Financing itself, but also from other sources.

Heavy reliance to the provisions in the legal documents.
THE ESSENTIAL REQUIREMENTS

THE ESSENTIAL REQUIREMENTS

1. Nature of Contract
   - Partnership in joint venture (Al Milk) or Contractual Partnership (Al Aqad)

2. Components
   - Contracting parties (Partner & Entrepreneur) + Aqad

3. Management
   - Partners or third party appointed as Manager for the project (+remuneration)

4. Capital
   - Identifiable, readily available, accessible, made known to all partners (rights and liabilities). Conditions outlined for: redemption, withdrawal of principal paid

5. Profit
   - Profit Sharing Ratio to be agreed upfront based on PSR or other ratio
   - Recognised on divestment or other acceptable methodology

6. Loss
   - To be borne by equity providers based on capital contribution
# CAPITAL OF MUSYARAKAH

## Key Points

<table>
<thead>
<tr>
<th>Description</th>
<th>Details</th>
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</thead>
<tbody>
<tr>
<td>Identifiable, Available, Accessible and may be as Cash, in-kind, intangibles. Debts do not qualify as Capital</td>
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</tr>
<tr>
<td>Any Asset contributed as Capital, the risk associated to the Capital must be assumed by the Musyarakah</td>
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<tr>
<td>Capital Amount, with rights and responsibilities must be known at start of Musyarakah</td>
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<tr>
<td>Any additional Capital amount added may result in revision of the Profit Sharing Ratio</td>
<td></td>
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<tr>
<td>Failure to provide Capital at start of Musyarakah qualifies for reimbursement, or revision or termination</td>
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<tr>
<td>Capital cannot be guaranteed, but can be indemnified if there is misconduct, negligence, or breach in terms</td>
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<tr>
<td>Any gain/loss in Capital value from transfer of Share Capital shall be enjoyed/borne by the disposing party</td>
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<tr>
<td>Where withdrawal of Capital is allowed, the Loss Sharing Ratio will be adjusted accordingly</td>
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<tr>
<td>Identifiable direct expenses can be deducted from Capital</td>
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</table>
## Profit of Musyarakah

### Key Points

<table>
<thead>
<tr>
<th>Description</th>
<th>Details</th>
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<tbody>
<tr>
<td><strong>Profit Sharing = Primary Motive</strong></td>
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<tr>
<td>Calculated based on acceptable market practice</td>
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<tr>
<td><strong>Profit Sharing Ratio (PSR) must be proportionate of Capital contribution or mutually agreed at start of venture</strong></td>
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<tr>
<td>PSR may be revised during the tenure but must be mutually agreed by all partners</td>
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<tr>
<td>No pre-determined fixed profit allowed which deprived the profit of other partners</td>
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<tr>
<td>PSR may vary based on investment tenure, change or premature withdrawals of Capital, agreed mutually</td>
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<tr>
<td>Partners may agree on PSR based on certain profit threshold (actual performance)</td>
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<tr>
<td>Profit can be recognised based on actual liquidation or constructive profit recognition</td>
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<tr>
<td>Constructive Profit allows profit reserve created, and adjustment to actual performance</td>
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<tr>
<td>Distribution at agreed period or on maturity</td>
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<tr>
<td>All parties can agree to set profit aside from reserve, but not from Capital</td>
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</tbody>
</table>


ARRANGEMENTS WITH OTHER CONTRACTS

1. Kafalah
   - Partners may be required to provide collateral as last-resort security

2. Wa’d
   - A promise may be arranged that a partner undertakes to purchase or sell share from/to another partner in specified events, or via an Agent

3. Wakalah
   - Agency arrangement is allowed where the venture appoints one of the partners or a third party as the agent to act on behalf of the Musyarakah

4. Musyarakah Mutanaqisah
   - Venture into acquisition of asset to be governed under Shirkah Al Milk (partnership in joint ownership)
   - Venture into profit generating business as partners to be governed under Shirkah Al Aqd (contractual partnership)
# The Operational Requirements — Musyarakah Venture

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<tbody>
<tr>
<td><strong>IFI LEVEL</strong></td>
<td><strong>Shariah Compliance</strong></td>
<td><strong>Policies and Procedures</strong></td>
<td><strong>Financial Reporting</strong></td>
<td><strong>Fair dealings</strong></td>
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<td>Board of Directors</td>
<td>Sources of Funds</td>
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<td>Accounting Records</td>
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<td>Board Committee</td>
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<td>Active monitoring &amp; continued assessment</td>
<td>Disclosures</td>
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<tr>
<td>Shariah Committee</td>
<td>Contracting Parties</td>
<td>Underperforming ventures</td>
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<tr>
<td>Senior Management</td>
<td>Management of Musyarakah</td>
<td>Exit procedures</td>
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<tr>
<td>Dedicated Function / Unit</td>
<td>Capital</td>
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<tr>
<td>Investment Committees</td>
<td>Profit</td>
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<tr>
<td><strong>VENTURE LEVEL</strong></td>
<td>Loss</td>
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<tr>
<td>Musyarakah Representatives</td>
<td>Tenure</td>
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<td>Guarantee / Collateral</td>
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<td>Exit from Venture</td>
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<td>Documentation</td>
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</table>
**GUIDANCE ON MANAGING MUSHARAKAH**

10. **Management of Musharakh**

10.1 A Musharakh venture may be managed in the following manner:

(a) Management by all partners; or

(b) Management by certain partners or a single partner; or

(c) Management by a third party.

10.2 The appointment of a third party as the manager shall be executed in a separate contract.

10.3 The appointment of a manager may be executed based on wakalah (agency), ijara al-ashkhas (employment contract) or Musharakh.

10.4 A managing partner may be entitled to an agreed remuneration and/or any incentive as agreed by the partners for his services as manager in addition to his share in profit sharing as a partner.

10.5 A managing partner shall be liable for any loss caused by his misconduct (ta’addi), negligence (taqsir) or breach of specified terms (mukhalafah al-shurut).

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**8. Definition and Nature of Musharakh**

8.1 *Musharakh* refers to a partnership between two or more parties, which may take effect through contractual relationship (*`aqd*) or by operation of Islamic law, whereby all contracting parties will share the profit and bear loss from the partnership.

8.2 Generally, there are two types of Musharakh (shirkah), namely:

(a) *Shirkah al-Milk* (Partnership in joint ownership)

Partnership in joint ownership refers to possession of an asset by two or more persons with or without prior arrangement to enter into a sharing in joint ownership. Under *shirkah al-milk*, the partner's ownership are mutually exclusive. In this regard, one partner cannot deal with other partner's asset without his consent.

(b) *Shirkah al-`Aqd* (Contractual Partnership)

Contractual partnership refers to a contract executed between two or more partners to venture into business activities to generate profit. Under *shirkah al-`aqd*, the partner is an agent to the other partners. In this regard the conduct of one partner in the ordinary course of business represents the partnership.
Musyarakah requires significant monitoring as the Bank is invested as an equity partner in the venture. Any mismanagement of the venture results in direct loss to the Bank.
OPERATIONAL REQUIREMENTS : MUSYARAKAH MUTANQAISAH (FINANCING)

Purpose of Asset Acquisition
• May be arranged with other contracts such as Ijarah, Ijarah Mausufah fi Zimmah, Bai Musawamah and/or Istisna’
• The intention is to lease the usufruct to one of the partners and additional to sell equity from one partner to the other for eventual full ownership
• Partners may agree on specific method of price calculation, valuation on dissolution
• Breaches resulting in Musyarakah termination may result in sale of Asset to third party where the Asset is disposed and the proceeds are distributed, or the Asset is collateralised as security of deferred payment. Invocation of promise is allowed where the defaulting partner will undertake to purchase other partners shares

Purpose of Income Generating Ventures
• A promise (Wa’d) to purchase the shares gradually over a period of time at market value or fair price.
• Shall not guarantee capital
• In events where the share acquisition is accelerated, the price determination = market value or fair value or agree price by parties
• In breaches, the partners can invoke undertaking to compel the defaulting partner to purchase the shares of other partners or sell to third party
**SOURCES OF FUNDS**

In a Musharaka Financing arrangement, the funding of the Musharaka can originate from both Mudharaba Investment Account or Musharaka Investment Account.

1. **Mudharaba Investment Account**: Customer as Capital Provider and Bank as Fund Manager, where Profits from Musharaka Financing are shared and Losses are borne by Capital Provider.

2. **Musharakah Investment Account**: Customer and Bank are Capital Provider as Partners in the Musharaka Financing, where Profits are shared and Losses are borne by all Partners according to their Capital contributions.
PROFIT & LOSS - MUSYARAKAH

1. The Profit Sharing Ratio (PSR) should be proportionate to the capital contribution of each partner, unless mutually agreed between contracting parties
2. Partners may agree on PSR at a certain threshold, where all parties can agree
3. Realisation of profit agreed at certain intervals, but may adjust based on final realisation or dissolution of the venture
4. For losses, the partners will bear the losses according to Capital contribution, unless the criteria for negligence or misconduct of any partner was defined
5. No guarantee of Capital is allowed
6. The venture should be separated from any other businesses.
EMPHASIS ON PROFIT AND LOSS TREATMENT

13. Loss

13.1 Loss is depletion from the value of capital.

13.2 Loss shall be borne by the partners proportionate to the capital contribution and the loss is limited to the capital.

13.3 Upon realisation of loss, any partners may voluntarily absorb such loss.

13.4 Loss due to misconduct (la’add), negligence (taqsir) or breach of specified terms (mukhalat al-shurut) by a partner shall be borne by that partner.

12. Profit

12.1 Profit is the value created over and above the Musharakah capital which is determined based on a method acceptable by market standard or practices.

12.2 The partners in a Musharakah venture shall share profit based on a mutually agreed ratio among them.

12.3 Profit sharing ratio (PSR) shall be based on proportionate capital contribution by the partners unless mutually agreed otherwise at the inception of the contract.

12.4 The PSR may be revised during the tenure of the Musharakah subject to mutual agreement between the partners. The PSR may be revised either based on the mutual agreement of the partners or based on a certain benchmark agreed upon by the partners as the case may be.

12.5 The partners may agree on a PSR for a certain threshold of profit. In the event that the actual profit exceeds the threshold, the excess amount may be distributed based on a different PSR agreed by the partners or be paid to any of the partners as per agreement. In the case of profit generated is below the threshold, the profit is shared based on the PSR.

12.6 Musharakah contract shall not stipulate a pre-determined fixed amount of profit to any partners which may deprive the profit share of the other partners.

12.7 The expected return in the form of percentage which is attributed to the Musharakah capital amount is only permissible in the form of indicative profit rate.
VARIATIONS OF MUSYARAKAH

The Musyarakah PD also outlined some of the basic structures available where the issues are addressed in the PD.

It is not limited to only these structures.
In the strictest sense, Musyarakah financial products remains limited as the Banks are not set up for excessive levels of risks that is related to the structure of Musyarakah.

At a banking level, Musyarakah structure is offered on a very selective basis, and the main reasons are as follows:

1. Lack of Expertise to manage a venture & added responsibilities
2. High cost of Capital due to the risks (Up to 400% capital cover compared to a debt product of 50% - 100%)
3. Risk of Loss on Capital
4. Different risk profile and credit consideration
5. Entrepreneurial structure and features
MUSYARAKAH PRODUCTS

There are not many products available in the Islamic Financial market that can be structured with pure Musyarakah.

Banks are not keen on providing financing on structures where the capital is at risk.
3 PARTY MUSYARAKAH ARRANGEMENT
(RESTRICTED INVESTMENT ACCOUNT/ PSIA)

1. Investors and Bank agrees on Musyarakah terms and conditions, and both parties pools funds to create Musyarakah Investment Fund. Investors & Bank signs Musyarakah Agreement as partners.

2. Bank, as partner in the agreement, enters into an Islamic financing / venture arrangement with the Entrepreneur, where the Entrepreneur agrees to share its profits with the Musyarakah Investment Fund partners.
**ISSUES : RESTRICTED INVESTMENT ACCOUNT**

<table>
<thead>
<tr>
<th>ISSUES WITH THE STRUCTURE</th>
<th>POSSIBLE SOLUTIONS</th>
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<tbody>
<tr>
<td>Requires the tenure to be fixed, usually middle to long term</td>
<td>The structure of Musyarakah is an equity participation structure either as permanent investment (to recover capital = dissolution) or a fixed tenure venture (to recover capital = expiry). To recover capital earlier, a replacement investor needs to be found to take over the ”share”.</td>
</tr>
<tr>
<td>Illiquid structure ie high cost of redemption</td>
<td>Redemption for Investment Account earlier than the stated tenure may result in higher cost to the investment. Often, additional borrowing is required for the redemption, where there are costs attached. Clear guidance on the process and costs needs to be informed upfront for early redemptions.</td>
</tr>
<tr>
<td>Long tenure returns pay-off</td>
<td>Usually structured over medium or long term, it is possible to structure the investment in shorter valuation periods to cater for profit recognition and pay-off. However it carries the risks of non re-investment if the returns on valuation are below expectations.</td>
</tr>
<tr>
<td>Capital is not guaranteed</td>
<td>The notion of investment carries the understanding that it is not capital protected. It is possible to look at “3rd party guarantees” but discussions on-going.</td>
</tr>
</tbody>
</table>
2 PARTY MUSYARAKAH ARRANGEMENT
(INVESTMENT ACCOUNT PLATFORM - IAP)

1. Investors evaluates feasibility of projects as proposed by Bank (as Manager or Facilitator) and agrees on Musyarakah terms and conditions, and provide pool funds (Musyarakah Investment Fund).

2. Investors enters into a Musyarakah agreement directly with the Entrepreneur, where the Entrepreneur agrees to share its profits with the Musyarakah Investment Fund partners.
## ISSUES: INVESTMENT ACCOUNT PLATFORM

<table>
<thead>
<tr>
<th>ISSUES WITH THE STRUCTURE</th>
<th>POSSIBLE SOLUTIONS</th>
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</thead>
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| Requires the tenure to be fixed, usually middle to long term | The structure of Musyarakah is an equity participation structure either as permanent investment (to recover capital = dissolution) or a fixed tenure venture (to recover capital = expiry).  
To recover capital earlier, a replacement investor needs to be found to take over the "share". |
| Illiquid structure ie high cost of redemption     | Redemption for Investment into the platform earlier than the stated tenure may result in additional redemption cost. The entrepreneur may also not be able to raise the cash for redemption if it is in negative cash flow  
Clear guidance on the process and costs needs to be informed upfront for early redemptions. |
| Valuation of the Investment                      | As the investor is directly invested (financing) into the entrepreneurs business, the valuation of the investment may be subjective and superficial.  
Main consideration for a valuation of the investment may be through balance sheet and P&L |
1. Investors and Bank agree on Musyarakah terms and conditions, and both parties pool funds to create Musyarakah Investment Fund. Investors & Bank sign Musyarakah Agreement as partners.

2. Bank, as partner in the agreement, enters into an Ijarah arrangement with the Lessee (Customer), where the Customer agrees to pay Rental into the Musyarakah Investment Fund.
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<th>ISSUES WITH THE STRUCTURE</th>
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<tbody>
<tr>
<td>Transfer of Ownership</td>
<td>As MM deals mostly in property, the ownership of the property (as the underlying asset for Aqad) must be perfectly registered in each parties name. This may not be possible in certain jurisdiction due to limitations on ownerships. There are many other issues including usage and types of properties. Shariah consideration can be sought with aqad relying on other documentary evidence.</td>
</tr>
<tr>
<td>Behaviour of a Conventional product</td>
<td>While MM remains a favourite amongst scholars due to the “equity” perception, the structure actually mirrors closely a conventional banking product. While some Banks puts in a “ceiling rate” to provide certainty, but the rate is not a mandatory requirement. Diligent observance on certain Conventional banking practice is required to avoid Shariah non-compliance</td>
</tr>
<tr>
<td>Valuation of the Investment</td>
<td>Ideally, as a property has a valuation in the market that moves with demand and supply, there are many other factors that ultimately decide the value, such as access roads, locality, neighbourhood, amenities and commercial and leisure infrastructure. The valuation of the investment will rely on Amortised Costs as it may be quite similar to a debt financing. The valuation will be based on the outstanding market value of the property.</td>
</tr>
</tbody>
</table>
DISTRESSED MUSYARAKAH

As the structure is based on partnership arrangement, in the events of distress prior to default, the monitoring of the venture must already take place.

Considerations must include:

1. Current performance
2. Future expectations
3. Viability until end of tenure
4. Estimated losses
5. Turnaround strategy / exit strategy
DEFAULT SCENARIO: SHARIAH RESOLUTION

Interesting fatwa by SAC but not taken in its entirety by the industry.

Stipulates a Wa’d (promise) can be built into the overall structure, where the customer Asset can be “forcibly sold” in the event default.

However, it must be applied fairly without denying the profit and loss sharing element of the contracting party. It also states that if customer is financially incapable of settling the outstanding, the bank shall bear the loss.

Many banks can circumvent this by way of Letter of Undertaking where, upon default, a sale to the customer may be effected (by creating a debt) to shift the above risks to the customer.
1. Musyarakah can be deployed as a “deposit/investment” product where the risk of losing capital can be mitigated as the Bank becomes a partner in the investment pool. However the Mudarabah structure remains popular among Banks.

2. For financing structure, Musyarakah is deemed risky as the Bank will become the “partner” in the financing venture and Bank hold the loss of capital risks based on the equity contribution.

3. With the Musyarakah standard, the recourse to losses remains almost non-existent except where other partners can be proven negligent.

4. The Investment Account Platform also provides a Musyarakah option for investors, which may be further developed.
SHARIAH STANDARDS ON ISTISNA’

Shariah Requirements
Operational Requirements
Specific Requirements
THE ISTISNA’

Istisna’ refers to a contract which a seller sells to a purchaser an asset which is yet to be constructed, built or manufactured according to agreed specifications and delivered on an agreed specified future date at an agreed pre-determined price.

1. One of the main tenets in a valid sale transaction is the “availability of the subject matter where it is in existence, determinable and valuable”. This is to avoid uncertainty of the sale and disputes when the asset is inconsistent with requirements.

2. But the contract of Istisna’ (order to construct) is one of the exceptions to the sale tenets, with very strict Shariah requirements must be met for it to be valid.

3. There are provisions to protect the interest of the buyer if the constructed assets are defective or do not meet specifications.
OBJECTIVES OF THE CONTRACT

Order of Asset to be Constructed

According to Agreed Specifications

Responsibility of Developer prior to delivery

Settlement of Price on Satisfaction of order

ISTISNA’
PERMISSIBILITY OF ISTISNA’

What is not prohibited, is permissible

The following verses of the Quran imply the general permissibility of sales contract including ‘istikna’ contract:

"...whereas Allah SWT has permitted trading and forbidden usury..." (Surah al-Baqarah, verse 275).

"O you who believe! Fulfil (all) obligations..." (Surah al-Maidah, verse 7).

Validity of order sale

Validity of an order sale

Sehle reported that the Prophet (peace be upon him) sent for a woman from the immigrants 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)
TYPES OF ISTISNA’

Istisna’ contracts, while capable as a standalone Islamic contract, is often used as one of the sub-contract in a larger arrangement.

It remains as an equity financing structure as the ownership risks remains with the Bank until the Asset is completed, delivered and accepted to the party.

The Customer may or may not play a significant role in the Istisna’ itself but the specifications of the Asset must be as detailed as possible.
OVERVIEW OF ISTISNA’

1. Customer intends to purchase an Asset which is yet to be constructed. Specifications of Assets is provided by Customer (and method of payment/settlement)

2. IFI appoints a developer to CONSTRUCT the Asset according to the specifications (including delivery time) #

3. IFI supervises the construction. Ownership of the Assets remain with the IFI

4. Construction completed and Developer hands over ownership to IFI

5. IFI, as full owner, delivers the Asset to Customer. Ownership is transferred once Customer is satisfied with specifications. Payment on Price is paid by Customer

# Note: IFI can also appoint the Customer as Developer where Customer is responsible to deliver the Asset to IFI. Customer will then “sub-appoint” a Developer to construct and deliver the Asset to Customer
THE ESSENTIAL REQUIREMENTS

1. Nature of Contract
   - Binding contract: Asset construction, building or manufacturing on specifications

2. Components
   - Contracting parties + Aqad + Asset + Price & Payment Mode + Delivery Date

3. Contracting Parties
   - Seller (Sani’) + Buyer. (Mustasni’) Additional parties may include Developer or Agent (Wakil)

4. Ijab & Qabul (Aqad)
   - Maybe be expressed orally, writing or other acceptable means with evidence

5. Asset & Ownership
   - Based on specifications, compliant with Shariah, with agreed methodology to deliver the asset either constructively or physically

6. Price & Payment
   - Mutually agreed price, revision conditions and other expenses.
   - Settlement method to be determined. Not to be revised upwards

7. Asset Delivery
   - Undertaking to accept Asset if specifications are met
   - Delivery delay treatment / disposal of Asset / Defects / Abandonment treatment
### ISTISNA’ ASSET & OWNERSHIP

#### Key Points

<table>
<thead>
<tr>
<th>Description</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Asset to be constructed = Subject Matter</td>
<td></td>
</tr>
<tr>
<td>To be Constructed, Built or Manufactured by the Seller (Sani’)</td>
<td></td>
</tr>
<tr>
<td>According to Agreed Specifications at the point of entering the contract</td>
<td></td>
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<tr>
<td>Construction must be for Shariah Compliant purposes</td>
<td></td>
</tr>
<tr>
<td>Can be unique or homogeneous that can be constructed, built or manufactured</td>
<td></td>
</tr>
<tr>
<td>If Asset is already in existence and can be identified, it does not qualify as Istisna Asset</td>
<td></td>
</tr>
<tr>
<td>Pending completion and delivery of Asset, ownership remains with the Seller</td>
<td></td>
</tr>
<tr>
<td>Possession must be transferred either Physically (Haqiqi) or Constructively (Hukmi)</td>
<td></td>
</tr>
<tr>
<td>The Buyer (Mustasni’) may enter into another Istisna’ with a 3rd party to sell the Asset, as Parallel Istisna’</td>
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</tr>
</tbody>
</table>
As the Asset is non-existent at the start of the contract, the specifications for the Asset must be made very clear to avoid any defect or non-conformity to specifications.

**Assessment of Istisna Asset**
- The Asset to be constructed & its purpose = Shariah Compliant
- The construction is to be done according to agreed specifications

**Delivery of Istisna Asset**
- Verification that specifications are met by Developer
- Establish procedures for constructive qabd hukmi & physical qabd haqiqi transfer

**Defect of Istisna Asset**
- Establish policy on customers rights due to defect occurring before delivery but discovered after delivery
- Warranty may be provided & right to appoint 3rd party to manage defects
DEFECTIVE ASSETS

1. Any defect on Asset occurring BEFORE the delivery of the Asset but discovered after Asset was delivered must entitled to exercise its DEFECT OPTION

2. Defect Options
   i. Terminate the Istisna’ contract
   ii. Accept the defective Asset, with or without any variations to the terms of the Istisna’

3. Defect Not Meeting Specifications
   i. Reject delivery of Asset
   ii. Accept delivery of Asset at agreed price
   iii. Accept delivery but with new agreed terms (revision of price, extension of time for rectification)

4. A provision of Warranty may be provided
# ISTISNA’ PRICE

## Key Points

- Price must be mutually agreed, payable at spot, progressive, deferred or bullet payments
- To be Constructed, Built or Manufactured by the Seller (Sani’)
- Revision of agreed price due to reduction of reduced cost of constructing allowed
- Any increase in costs may result in revision in price, but requires consent from buyer to the changes
- Without consent from buyer, the seller must bear the construction cost increases.
- Price can also be revised if the Seller fails to meet the Istisna’ agreed specification
- The agreed price must not be priced upwards due to extension of payment period
- Incidental costs or expenses incurred during the construction must be borne by the seller, unless Buyer separately agree to bear such costs.
ARRANGEMENTS WITH OTHER CONTRACTS

1. **Kafalah**
   - Third party guarantee can be arranged for payment or delivery

2. **Takaful**
   - Islamic insurance can be arranged for loss of capacity by buyer

3. **Rahn**
   - Istisna' debt may be secured with a collateral (not Istisna asset unless agreed on “as-is” basis)

4. **Hamish Jiddiyah**
   - Security deposit as undertaking by Customer to enter into Istisna. May form part of the agreed price of the asset

5. **Urbun**
   - Earnest money taken from Customer as partial payment if Istisna is to proceed. To be returned if Istisna is cancelled

6. **Ijarah Mausufah Fi Zimmah**
   - Forward lease where IFI lease the “right of the asset under construction” to the any party

7. **Ibra / Tawidh / Gharamah**
   - As per BNM guidelines. Additionally, compensation mechanism for cancellation and/or late delivery of the Asset

Arrangement with other Contracts
OTHER OPERATIONAL ARRANGEMENTS

1. Parallel Istisna’
   - Contracting parties may enter into another Istisna’ with same specifications of the first Istisna’
   - The parallel Istisna’ must be independently executed

2. Completion of Istisna’
   - Acceptance of the Asset by the purchasers, regardless of whether it meets specifications
   - Full settlement of agreed price by purchaser

3. Dissolution of Istisna’
   - Arrangement of Earnest money with option not to proceed
   - Exercise option to terminate due to defects / not meeting specification / failure to deliver Asset
   - Mutually agreed termination

Other Arrangements
PARALLEL ISTISNA’

**Key Points**

The parties to an Istisna’ contract can enter into a parallel Istisna’ with similar specifications of the first contract

The parallel Istisna’ must be separate contracts independent of each other

Each constructing parties must undertake to deliver the Asset to the Buyer

Seller may also appoint the Buyer as a supervising Agent (Wakil) to oversee the construction is according to the specifications

A guarantee (Kafalah) for delivery/performance can be taken by the Seller if Buyer recommends a preferred Developer

Any guarantee created should be independent from the original obligations of the purchaser
RISKS ASSOCIATED WITH ISTISNA

**Performance**
1. Assess the contractor’s capacity
2. Financial position & track record
3. Back up contractor
4. May request for guarantee

**Project**
1. Internal policy to monitor project (scope, inspection, timeline, accountable parties)
2. Disbursement vs progress
3. Actions on trigger events & risk mitigations

**Delivery**
1. Risk transfer mechanism on deliver or non-delivery of Assets
2. Non-delivery of Assets may be mitigated by Takaful (for example)
DOCUMENTATION REQUIREMENTS

Documentation for Istisna’ is critical as it must be detailed clearly to avoid uncertainty of construction, terms and specifications.

Considerations

- Non-delivery
- Fair dealings
- Disclosures
- Ibra (rebate)
- Defect
- Late delivery charges

Emphasized Points:

- Enforceable
- Documented in Writing
- Specifications & delivery
- Progress Monitoring & Delivery
- No waiver of Seller obligations
- Ownership transfer
- Standalone Contract
- Events of Default
- Combination with other contracts
OVERVIEW ISTISNA’ PRODUCTS

Istisna’ as a standalone product is utilised minimally. In general, Istisna’ is especially structured together with other contracts as complements to the overall structure. Commonly it is seen in Diminishing Musyarakah Home Financing product, where the main contract is Ijarah (leasing).

Istisna’ is still deemed as equity financing and therefore do not have large traction in the banking world mainly because of:

1. Lack of Expertise to manage and monitor a construction project
2. Risk of Completion / Valuation remains with the Bank until delivery and acceptance
3. Risk of abandonment of the project
ISTISNA’ PRODUCTS

There are not many products available in the Islamic Financial market that can be structured with pure Istisna’

Most of the Istisna’ products are embedded into a combination of other Islamic products such as Musyarakah or Ijarah.
Customer agree with IFI on terms. IFI appoints Developer to construct. Developer constructs based on specifications & IFI pays staggered $$ Developer completed construction & delivers Asset to IFI. IFI takes ownership of Asset & Deliver to Customer for Payment. If Customer unable to settle Payment, Customer applies for Financing. IFI approves request to finance & settles the Istisna outstanding amount. IFI enters into Aqad transaction for Selling Price & settlement terms. Customer pays IFI monthly instalment, until settlement.

Asset Ownership = Developer prior to appointment of Developer to construct. Asset Ownership = IFI. Upon completion of each staggered construction, IFI takes ownership (and Risk) upon payment. Asset Ownership = Customer. Upon completion of construction, IFI delivers ownership (and Risk) to Customer.
## ISSUES: ISTISNA’ WITH TAWARUQ

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<td>Possession of the Asset must be in the form of Constructive possession.</td>
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<td>Asset for the Aqad</td>
<td>While the availability of the asset are still under construction, using 3rd party asset will enable the Aqad to be completed cleanly.</td>
</tr>
<tr>
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<td>That is why 3rd party assets such as Commodities Crude Palm Oil can be used to ensure cleanliness of the Shariah contract.</td>
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**STRUCTURING OF ISTISNA’ & IJARAH**

**CONSTRUCTION – ISTISNA’**

- **Customer buys property under construction from Developer**
  - Asset Ownership = Developer prior to appointment of Developer to construct.

- **Customer sells to IFI property under construction, Customer to monitor**

- **Developer completed construction and delivers Asset to Customer**
  - Asset Ownership = Customer. Upon completion of staggered construction, Customer takes ownership (and Risk) upon payment.

- **Customer to settle the purchase Payment price to IFI**
  - Asset Ownership = IFI. Upon completion of construction, Customer delivers ownership (and Risk) to Bank.

**FINANCING – IJARAH**

- **If Customer unable to settle Payment, Customer applies for Financing (Lease)**
  - Asset Ownership = IFI. Upon completion of construction, Customer delivers ownership (and Risk) to Bank.

- **IFI approves request to Lease**

- **IFI enters into Aqad transaction for Ijrah Rental and settlement terms**

- **Customer pays IFI monthly lease, until settlement**
  - Asset Ownership = Customer via Ijrah Munthahiah Bi Tamleek (ending with transfer of ownership to Customer).
## ISSUES : ISTISNA’ WITH IJARAH

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<td>Ownership = Bank</td>
<td>At all times while the Assets are constructed, the ownership of the Asset must be in Bank’s name to enable a lease upon completion of the Istisna (avoidance of the Bai Inah)</td>
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THE SAC RESOLUTION: ISTISNA’ WITH COLLATERAL

One of the main considerations when Banks are involved in a construction of a building or Assets, are the eventual use or purpose of the Asset.

In most requirements, the Assets is to be used for Shariah compliant purposes.

More often than not, the Assets being constructed is used as collateral as and when the Assets are being progressively completed.

However, questions whether non-Shariah compliant assets can be additionally used as collateral for such Istisna’ projects. Guidance from SAC has generally allowed for the collateralisation of non-Shariah compliant assets provided the value used is the principal amount or the initial investment amount.
SUMMARY: ISTISNA’

1. Istisna’ is usually used as one of the key component in a financing arrangement

2. Ownership of the asset remains with the bank until asset is delivered

3. Transfer of ownership must be made once the constructed asset is accepted by the Buyer and according to specifications

4. There are Defect Options available to ensure fairness for the customer
EQUITY BASED PRODUCTS

Summary:
Mudarabah
Musyarakah
Istisna’
1. While there are guidelines issued on the various Equity-based financing contracts, Banks are still reluctant to fully develop such products as part of its offering.

2. The main reason is the risk profile of such products, where traditional banks are not set-up for.

3. To offer such products in its rightful form, major shift in how banking is done needs to happen, including credit, management, and recovery.

4. There are efforts to introduce equity based platforms such as the Investment Account platform, but requires market awareness and acceptance of its risks as well.
THANK YOU FOR YOUR PARTICIPATION