

## **Frequently Asked Question (FAQ) on Investment Account**

**Last updated: 14 July 2016**

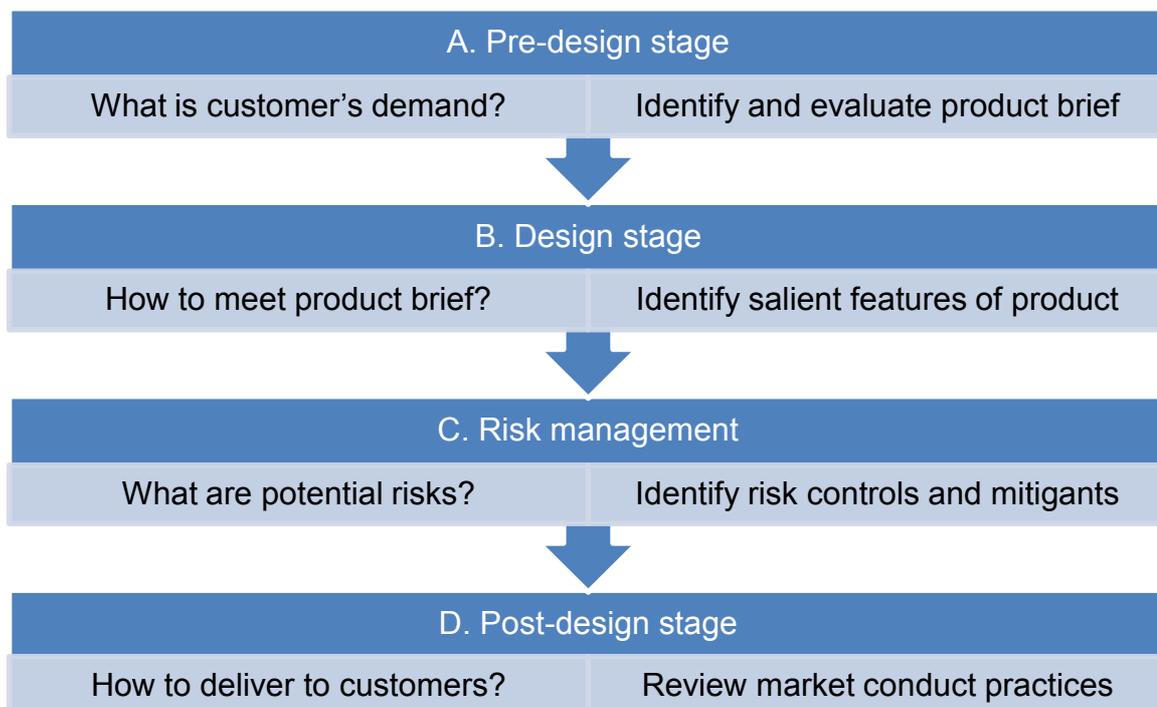
This document supplements the policy document on *Investment Account* (IAF) by addressing common and potential implementation issues and challenges faced by the Islamic financial institution (IFI) in its respective investment account implementation initiative. While the FAQ serves as a guidance to clarify implementation issues, it does not replace the requirements stipulated in the IAF. This document will be periodically updated to provide additional guidance to address new issues that emerge, or clarify existing guidance, where necessary.

## A. PRODUCT STRUCTURING

### 1. What are the expected processes to be established by the IFI in structuring investment account products? [Paragraphs 9 – 15 IAF]

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1.1. When specifying the product structuring requirements, the Bank took cognisance of the different stages of the product development process:



The requirements in paragraphs 9 to 15 IAF are intended to address the expectation during pre-design stage and design stage.

#### A. Pre-design stage

##### Research methodology

1.2. The IFI may adopt prevailing research methodology e.g. customer surveys, market research or customer profiling, that would allow for an expedient and relevant customer analysis. The IFI should put in place appropriate controls within the research process to mitigate undue bias that may impair the results of the analysis.

##### Data reliability

1.3. The IFI may use data/information and other analytical tools which are readily available to it and may consider reviewing or re-performing the customer analysis from time to time prior to introducing a new investment account product particularly if the information does not reflect current market/ economic situation or is outdated.

1.4. The IFI should consider the appropriateness and relevancy of utilising any information that was obtained prior to the IAF coming into effect, since such information may not accurately reflect the customer's preference or behaviour

towards the new investment account under the Islamic Financial Services Act 2013 (IFSA). In particular, the customer may behave differently to the investment account compared to the investment deposit under the repealed Islamic Banking Act 1983 (IBA) due to the unavailability of protection by Perbadanan Insurans Deposit Malaysia (PIDM) and profit smoothing techniques to manage the rate of return.

#### Customer's preference/ behaviour analysis

- 1.5. A depositor's behaviour is not similar to a risk averse IAH. Although a customer (particularly retail) which holds an Islamic deposit account may be deemed to be risk averse, the customer may not necessarily wish to hold an "investment" even if such investment is purportedly of low risk or is designed with capital protection feature.
- 1.6. In conducting the customer's preference or behaviour analysis, the IFI may consider the following parameters, if applicable:
  - (i) different customer segments; and
  - (ii) level of sophistication.
- 1.7. In relation to customer segmentation, the IFI may consider customer's demographic e.g. age, employment status when assessing customer's preference/ behaviour.
- 1.8. Level of sophistication may be assessed based on customer's educational background, working experience or investment experience. However, the IFI should consider all factors collectively and objectively in determining the customer's suitability. For example, the level of customer's knowledge on finance alone without the financial position/ wealth may not reflect suitability as an investor.
- 1.9. The IFI is also expected to validate the customer's preference for investment account due to presumed knowledge on Islamic finance which may influence the customer's decision on product choice. In general, knowledge of product may influence product preference but should not be taken as indication of product suitability (see C. Business and Market Conduct).
- 1.10. Notwithstanding the IFI may innovate investment account products which are designed to address market opportunity (i.e. demand creation) where information to conduct customer or behaviour analysis may not be readily available. In such instance, the IFI is expected to support its analysis by robust and sound assumptions.

#### *B. Design stage*

- 1.11. Requirements specified in paragraphs 9 to 15 IAF represent the minimum key features of an investment account product that must be deliberated and determined by the IFI to ensure an effective product structure.

### Robust analysis

- 1.12. Paragraph 9.1 IAF requires a robust analysis to be carried out as a basis which would support the IFI's decision making process in determining the feasibility of the desired investment objectives.
- 1.13. A robust analysis considers the effect of sufficient key input variables to the intended outcome. For example, when analysing the expected return on investment of the underlying assets, the IFI should consider key input variables such as the profit sharing ratio, asset portfolio mix, impairment rate, measurement/ valuation basis and etc. Where the product offers flexible redemption condition, the IFI should also consider the potential redemption rate as a key input variable to assess the availability of investment account funds to meet the demand for withdrawal or liquidity management. The IFI is expected to consistently apply internal policies and procedures governing the process undertaken in the estimation or exercising judgement in the analysis.

### Stress testing

- 1.14. Stress testing assesses the vulnerability of the investment strategy to certain risk factors or extreme scenarios. Stress testing results will enable the IFI to assess the feasibility of investment and risk management strategies based on a range of values rather than a single best projected result.
- 1.15. Stress testing may be conducted at the entity level as part of the IFI's stress testing programme for the overall banking business or conducted at the investment account fund level. Stress testing at the fund level is expected to provide a more accurate analysis since input variables are tailored to the fund.
- 1.16. The IFI should validate the suitability of conducting the stress testing at the entity level or the fund level depending on the nature and complexity of the investment account. For example, in the case of UA, the difference in the stress testing results may not be significant where the underlying assets of the investment account represent a proportionate share of the financing portfolio. However, in the case of RA, the difference may be more significant when the underlying assets are atypical and not within the IFI's risk appetite.
- 1.17. Notwithstanding, the IFI may apply the methodology specified in the *Guidelines on Stress Testing* or any other recognised methodology which is reasonable and suitable to assess the feasibility of investment and risk management strategies.

### Minimum amount of investment

- 1.18. The requirements specified in paragraph 10 IAF are intended to ensure that the IFI has sufficient mandate in respect of managing the investment account funds in situations where surplus of funds exist above the maximum amount or shortage of funds below the specified minimum amount.
- 1.19. Paragraph 10.4 IAF provides options to the IFI to design either a close-ended fund (which means that a particular investment account product would be closed for offering once the maximum fund size limit is achieved) or an open-ended fund (which means that the IFI has not set a maximum fund size limit). Setting a maximum limit for the amount invested by the IAH is intended to mitigate redemption risk arising from the concentration to a single customer. In addition,

setting maximum fund size limit would also mitigate the dilution of rate of return (ROR) to the IAH as a result of excess funds not being able to be invested in assets with targeted return.

- 1.20. The IFI is expected to assess the impact of not requiring any minimum amount of investment on achieving the investment objectives and the targeted rate of return to the IAH. Notwithstanding that, the Bank takes cognisance that the IAH may continue to maintain an account with negligible balance to facilitate the IAH's future investments.
- 1.21. Where the investment account funds are invested in proportion of a portfolio of financing assets, the IFI is expected to validate the presumption that the investment account funds need not require a minimum (or maximum) fund size limit. The IFI should assess its capability to fund the financing portfolio in the event that the IAHs fully withdraw their investment amount.

#### Redemption of investment

- 1.22. The operational aspect of the redemption of an investment account may differ from that of an Islamic deposit. Unlike Islamic deposits, the IAH is required to share in the profit and bear any losses associated with the underlying assets and hence the IFI is expected to put in place effective controls that will ensure fair and equitable allocation of profit or loss to the IAHs over different periods.
- 1.23. The Bank takes cognisance that in UA, the IAHs are exposed to the inter-generational issue which arise due to the differences in the timing of entry or exit from the investment account fund. Due to the inter-generational issue, the IAH may find himself in either a more favourable or unfavourable position depending on the performance of the underlying assets. For example, the IAH who exits early may not receive any profit whilst the IAHs who enter later may benefit from the profit distribution. In this regard, paragraph 26.1 IAF requires the terms of redemption as outlined in paragraph 12.2 IAF to be incorporated into the terms and conditions and agreed upon by the IAH and this would provide sufficient mandate to the IFI.
- 1.24. For operational efficiency, the IFIs may utilise existing facilities/ services to facilitate redemption/ withdrawal by the IAHs e.g. ATM, online banking etc. Notwithstanding, the IFI is still required to ensure that existing systems, policies and procedures and processes are adequate and are able to sufficiently accommodate the peculiarity of the investment account operations as specified in paragraph 19 IAF. For example, the investment account balances should reflect the current valuation of the investment account funds. Hence, the IFI should consider the timing of profit and/ or loss distribution, limits to redemption/ withdrawal, regular disclosure of ROR to the IAH, and any other suitable operational mechanisms that would allow the IFI to effectively monitor and manage the redemptions in an orderly and fair and equitable manner.

#### Valuation of investment asset

- 1.25. In line with paragraph 14.1(b) IAF, the IFI shall consider the redemption features in determining the appropriate timing and frequency of valuation.

- 1.26. The Bank takes cognisance that due to the payment nature of a typical financing asset, there would be time lag in the conduct of the valuation in order to capture all required data. For example, when payment due dates are at month-end, the IFI may only obtain payment information on the following day or later (depending on the mode of payment). Hence the IFI's may only provide an adequate valuation of underlying assets in the following month. In this regard, when establishing the policy to calculate profit distribution, the IFI may adopt the valuation of the underlying asset in the preceding month.
- 1.27. Notwithstanding that, when a more frequent redemption is allowed, the IFI shall improve the efficiency of its valuation process in line with the requirements specified in paragraph 14.1(b) IAF. When determining current valuation, data used in the measurement of impairment loss should reflect most recent information. The IFI should assess the appropriateness of utilising average impairment loss data which is older than the preceding 12-month period.
- 1.28. The following table provides an example of some of the considerations that the IFI should undertake in structuring investment account products.

***Investment objective – Provide principal protection feature with flexible redemption***

<i>Product feature</i>	<i>Considerations</i>
<i>Underlying assets</i>	<ul style="list-style-type: none"> <li>▪ <i>The IFI should consider the type of assets which would generate a positive and stable return on investment.</i></li> <li>▪ <i>If investment in financing assets is made, the IFI should consider the type of financing that is suitable since the impairment loss rate is affected by the credit quality of the financing customers. For example, the impairment loss rate of personal financing may be higher than that of house financing. The IFI may also consider the fluctuation of “Base Rate” or the “Overnight Policy Rate” on the projected return on assets.</i></li> <li>▪ <i>If investment in securities is made, the IFI should consider the credit rating of the issuer of the securities since this would reflect the credit quality of the instrument including changes to credit rating over the holding period of those securities as underlying assets.</i></li> <li>▪ <i>If investment in sukuk is made, the IFI should consider the volatility of profit rate or rental income. In addition, sukuk denominated in foreign currency will be exposed to foreign currency exchange rate risk.</i></li> </ul>
<i>Investment tenure</i>	<ul style="list-style-type: none"> <li>▪ <i>In specifying the investment tenure, the IFI should consider the return profile of the underlying assets. For example, profit generated from financing assets in general would reduce through-out time (due to the income recognition basis and impairment loss rate).</i></li> </ul>

	<i>Hence, the IFI would need to consider appropriate investment strategies to ensure that the financing portfolio can be replenished through-out the investment tenure.</i>
<i>Redemption</i>	<ul style="list-style-type: none"> <li>▪ <i>If the IFI would like to provide flexible redemption conditions such as on-demand basis, the IFI should consider the nature of the underlying assets.</i></li> <li>▪ <i>If there is mismatch between the duration of the underlying assets arising from flexible redemption condition, the IFI would need to consider establishing appropriate liquidity risk management tools.</i></li> <li>▪ <i>The IFI should employ sound valuation basis of the underlying assets to facilitate timely redemption consistent with the redemption condition.</i></li> <li>▪ <i>The IFI should also consider any operational mechanisms that should be established to facilitate the orderly and fair and equitable redemption.</i></li> </ul>
<i>Profit distribution</i>	<ul style="list-style-type: none"> <li>• <i>While the investment in low risk underlying assets would facilitate the objective of providing principal protection investment, the rate of return generated from the investment would be generally low. Hence, the IFI should consider setting appropriate profit sharing ratio given the expected lower rate of return and the cost of liquidity risk management by the IFI to facilitate the flexible redemption feature.</i></li> </ul>
<i>Valuation</i>	<ul style="list-style-type: none"> <li>• <i>The IFI should consider the complexity of performing the valuation of the underlying asset in the valuation policy and the impact of facilitating timely redemption. For example, the valuation of financing assets would be more complex compared to securities which are mark-to-market.</i></li> </ul>

***Investment objective – Provide principal protection feature with competitive return***

<i>Product feature</i>	<i>Considerations</i>
<i>Underlying assets</i>	<ul style="list-style-type: none"> <li>▪ <i>The IFI should consider the trade-off between obtaining competitive return and principal protection.</i></li> </ul>
<i>Investment tenure</i>	<ul style="list-style-type: none"> <li>▪ <i>The IFI should consider setting a tenure i.e. investment with maturity in order to provide sufficient time for the investment to generate the targeted return.</i></li> </ul>
<i>Redemption</i>	<ul style="list-style-type: none"> <li>▪ <i>The IFI should consider limiting redemption to enable maintenance of the underlying asset until maturity in order to achieve the targeted return.</i></li> </ul>
<i>Profit distribution</i>	<ul style="list-style-type: none"> <li>▪ <i>The IFI should consider the appropriate profit sharing ratio that commensurate with the customer's investment period.</i></li> </ul>
<i>Valuation</i>	<ul style="list-style-type: none"> <li>▪ <i>The IFI should consider the complexity of performing</i></li> </ul>

	<p><i>the valuation of the underlying asset in the valuation policy and the impact of facilitating timely redemption. For example, the valuation of financing assets would be more complex compared to securities which are mark-to-market.</i></p>
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**B. MANAGEMENT OF INVESTMENT ACCOUNT**

**2. Is the IFI expected to conduct one-to-one tagging of the underlying assets to the respective unrestricted investment accounts (UA)?**  
 [Paragraph 16.1(a) IAF]

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2.1. As specified in paragraphs 9 of policy document on *Rate of Return* (ROR), for UA, the IFI has the option to tag the underlying assets on a one-to-one basis or on a proportionate basis. Tagging on a one-to-one basis could be conducted on a portfolio basis and need not necessarily be at an individual account level. For example, the IFI may tag a number of financing accounts (with identified account numbers) which commensurate with the funding size of the investment accounts.

**3. What is the Bank’s expectation on proportionate tagging?**  
 [Paragraph 16.2 IAF]

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3.1. In line with paragraph 16.2 IAF, the IFI is required to put in place appropriate policies and procedures and systems for separate management of investment account funds and investment assets. In respect of proportionate tagging, these policies and procedures are expected to include the following:

- (i) identification of underlying assets;
- (ii) identification of income and expenses; and
- (iii) portfolio rebalancing, if applicable.

*Identification of underlying assets*

3.2. In line with paragraph 9.1 IAF, the policies and procedures regarding identification of underlying assets are expected to outline the following:

- (i) investment acquisition strategy;
- (ii) specification of the types of underlying asset; and
- (iii) in the case of a portfolio mix, the investment limits of the respective type of underlying asset.

For example:

*Bank ABC has structured an UA product with an investment objective to provide principal protection with potential competitive return. Bank ABC has put in place the following policies and procedures:*

- (i) *types of underlying asset will include retail property financing, personal financing and investment grade sukuk only; and*
- (ii) *the respective investment acquisition strategy and investment limits are provided below:*

<i>Investment acquisition strategy</i>	<i>Investment limits</i>
<i>1. Retail property financing</i>	<i>Up to 100%</i>
<i>2. Personal financing</i>	<i>Up to 30%</i>
<i>3. Investment grade sukuk</i>	<i>Up to 15%</i>

- 3.3. For avoidance of doubt, broad specification of underlying assets such as “the IFI’s retail financing portfolio” or “the IFI’s balance sheet” would not be in line with the expectation described above.

*Identification of income and expenses*

- 3.4. In line with paragraph 9.5 ROR, the income and expenses are expected to be allocated on a proportionate basis. The policies and procedures at minimum are expected to clearly articulate the method to ascertain proportion of income and expenses taking into consideration the following:
- (i) frequency of profit distribution;
  - (ii) movements in total fund balances in the particular profit computation period; and
  - (iii) changes in the composition of asset arising from portfolio rebalancing, if applicable.

For example:

*Bank ABC is mandated by the IAH to invest the UA funds in retail property financing and personal financing. Bank ABC has put in place the following policies and procedures:*

- (i) total fund balances will be based on the average daily balance of UA fund for a one-month period; and*
- (ii) portfolio rebalancing is conducted after the month-end reporting period.*

*The proportion of underlying assets and share of income net of impairment for a particular one-month period are provided below:*

<i>Type of asset</i>	<i>Total asset size (RM'million)</i>	<i>Average daily balance of UA funds</i>		<i>Income net of impairment (RM'million)</i>	<i>UA share of income (RM'million)</i>
		<i>(RM'million)</i>	<i>(%)</i>		
<i>Retail property financing</i>	<i>10,000</i>	<i>600</i>	<i>6</i>	<i>42.5</i>	<i>2.5</i>
<i>Personal financing</i>	<i>5,000</i>	<i>100</i>	<i>8</i>	<i>29.7</i>	<i>2.4</i>

*Portfolio rebalancing*

- 3.5. In line with paragraph 20.4(d) IAF, the IFI’s risk management policies and procedures on investment asset rebalancing are expected to outline the following:
- (i) governance arrangement and approving authority;
  - (ii) methodology and timing/frequency of rebalancing e.g. calendar rebalancing, corridor ranges etc.; and
  - (iii) financial reporting and disclosure to IAH.
- 3.6. In respect of governance arrangement, the factors considered for decision making on portfolio rebalancing must not disregard the interest of the IAH in favour of the IFI as specified in paragraph 17.2 IAF.

- 3.7. The portfolio rebalancing is expected to be in line with the investment mandate and investment objective agreed between the IFI and the IAH. For example, where the investment objective is to achieve principal protection, the IFI may decide to rebalance the underlying assets of the investment account portfolio by replacing assets which have shown an increased risk profile by acquiring assets with lower or stable risk profile.
- 3.8. The IFI is expected to ensure that the established policies and procedures on portfolio rebalancing do not lead to profit smoothing practice which is prohibited in paragraph 13.5 IAF. For example, policies which allow intermittent portfolio rebalancing prior to profit computation period could lead to profit manipulation. The IFI's policies which do not consider movements in total fund balances may also result in incorrect valuation and profit distribution computation.
- 3.9. In conducting the risk analysis for investment asset rebalancing, the IFI is expected to consider the implication to IFI's capital adequacy (see G. Capital Adequacy).

## **C. BUSINESS AND MARKET CONDUCT**

### **4. Could the IFI use a simplified Customer Suitability Assessment form for an investment account product that allows for a wider type of IAH to be eligible? [Paragraph 23.3 IAF]**

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- 4.1. In general, the IFI is required to comply with the minimum requirements specified in paragraph 23.3 IAF. Despite setting-up the criteria that enables for a wider type of IAH to be eligible for the investment account product, it is critical for the IFI to identify the customer's need for investment to ensure suitability of the investment account product and mitigate mis-selling.
- 4.2. The IFI is expected to ensure that the IFI's decision matrix to provide recommendation to the potential IAH is not biased because of the predisposition that the investment account product has a broad criteria that would allow for a wider type of IAH to be eligible. For example, a decision matrix with a low threshold which was designed to allow wider IAH to be recommended could indicate a biased assessment.
- 4.3. The decision matrix is expected to be robust and assigns weightage in a reasonable and equitably manner that takes into consideration the information specified in paragraph 23.3 IAF. For example, a decision matrix which puts greater weightage on customer's need without considering the financial capacity or knowledge of IAH would result in a biased recommendation.
- 4.4. Marketing strategy which inappropriately equates an investment account product with an Islamic deposit product without sufficient information and emphasis on the risks of the investment account product is not in line with paragraphs 23.1 and 23.2 IAF.

## D. LIQUIDITY

### 5. What are the main approaches accorded under the policy document for maintaining liquefiable assets for UA? [Paragraphs 22.4 and 22.7 IAF]

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5.1. The IFI may consider adopting the following strategies:

- (i) 'Dedicated liquefiable assets' – a proportion of underlying assets in a UA fund consists of liquefiable assets sufficient to meet the IAH's redemptions. For example, a proportion of UA fund A is invested in highly liquid assets such as government securities. In stressed conditions, the UA fund is self-sufficient as such underlying assets can be liquidated to meet the IAH's redemption;
- (ii) 'Pooled liquefiable assets' – liquefiable assets can be maintained on a pooled basis<sup>1</sup> using the IFI's own funds, to buffer against liquidity shortfall of UA funds. For example, UA fund B is invested in home financing and liquidity buffer is maintained at the pooled level. In stressed conditions, a proportion of the pooled liquefiable assets can be liquidated to meet the IAH's redemptions which is based on the prevailing value of the underlying assets of UA fund B; and
- (iii) Combination of 'dedicated' and 'pooled' liquefiable assets – Both 'dedicated' and 'pooled' liquefiable assets may be used to manage the IAH's redemptions. For example, UA fund C maintains dedicated liquefiable assets which may firstly be used to manage redemptions. Consequently, the pooled liquefiable assets may be utilised to further manage redemptions.

To enable strategies (i) and (ii), methods as described in Question 6 of this FAQ may be applied.

### 6. How would the transfer of liquidity from 'pooled liquefiable assets' to a UA fund be operationalized to meet redemption by the IAH?

[Paragraph 22.9 IAF]

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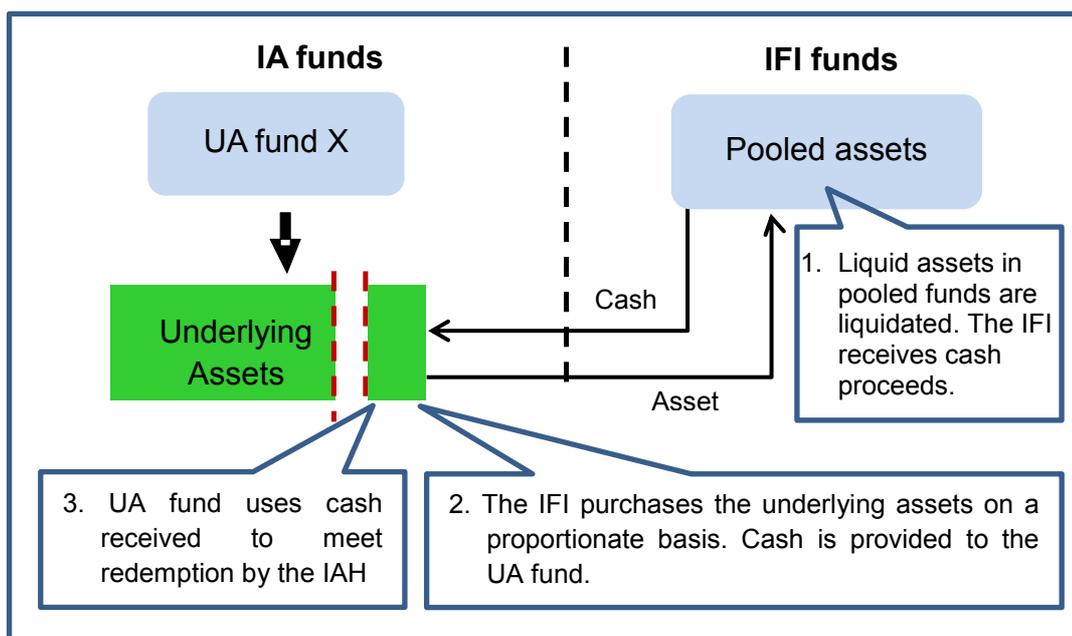
6.1. The usage of 'pooled liquefiable assets' would effectively cause liquidity transfer from the IFI's<sup>2</sup> own funds to the UA fund. This may be done via the IFI's purchase of the underlying assets of the UA fund. In the following illustration, the IFI purchases the underlying assets proportionately to maintain the portfolio mix of the UA fund in line with paragraphs 9.4 and 9.5 ROR:

#### **Illustration of liquidity transfer from "pooled liquefiable assets"**

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<sup>1</sup> Subject to fulfilling requirements in paragraph 22.8.

<sup>2</sup> Hereafter, any reference to the IFI as *mudarib* would also include *wakeel*.



6.2. Under business-as-usual, the IFI's involvement in providing liquidity is expected to be temporary until there are funds received from the IAH<sup>3</sup> or if the IFI reduces the size of the UA fund.

6.3. In stressed conditions, the IFI's involvement may further increase the needs of effective liquidity risk mitigation such as liquidity buffer or additional liquidity tools<sup>4</sup> where in such situation, the IFI shall comply with paragraphs 22.10 to 22.15 IAF.

**7. Can surplus from a UA fund be transferred to the IFI or to other UA funds?**  
[Paragraphs 22.5 and 22.6]

7.1. Subject to the requirements in paragraphs 22.5 and 22.6 IAF, surplus liquefiable assets may be transferred and utilised by the IFI or other UA funds. In this regard, transfer of funds can be deemed to be conducted on an arm's length basis when the following conditions are met:

- (i) Any surplus transfer and usage will not change the investment objective and risk and reward profile of the UA fund;
- (ii) Applicability of the surplus transfer is disclosed up-front in the agreement with the IAH;
- (iii) The surplus transfer is limited to the amount of surplus liquidity above the liquidity requirements<sup>5</sup> calculated without taking into account the effect of inflows resulting from any previous surplus transfers (as per Question 8 of this FAQ);
- (iv) Identification of the terms of surplus transfer, which includes –

<sup>3</sup> Replacement of the IAH or additional funds received from the existing IAH.

<sup>4</sup> Such as longer notice period, lock-in period or gating mechanism.

<sup>5</sup> The liquidity requirements applicable to development financial institutions refer to paragraph 30 IAF, and to licensed banks, licensed Islamic banks and licensed investment banks refer to paragraph 27 LCR.

- a. mechanisms and Shariah contracts used in executing the surplus transfer<sup>6</sup>;
  - b. withdrawal or redemption terms;
  - c. profit calculation or costs involved; and
- (v) The surplus transfer transaction is recorded accordingly.

7.2. The IFI is also expected to periodically conduct a review on the transactions involving a surplus transfer from a UA fund to validate that the above conditions are met.

**8. For the calculation of liquidity requirements<sup>7</sup>, cash inflows are recorded for a UA fund that transfers liquidity surplus to another fund or the IFI. Would this result in the creation of additional surplus for the UA fund as the surplus provider? Can the additional surplus be transferred to another fund or the IFI? [Paragraph 22.5 IAF and paragraph 27.3 Liquidity Coverage Ratio (LCR)]**

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8.1. Yes, additional surplus would be created due to the recording of cash inflows. Nevertheless, this additional surplus cannot be further transferred as this will deplete the HQLA/liquefiable assets of the surplus provider and heighten reliance on cash inflows arising from surplus transfer arrangements. In this regard, the IFI is expected to ensure that the amount of the surplus transfer is not more than the surplus HQLA/liquidity calculated without taking into account the effect of inflows resulting from any previous surplus transfers.

Illustration is given in Appendix 1.

## **E. CAPITAL ADEQUACY<sup>8</sup>**

**9. The IFI as *mudarib* is not required to absorb credit and market risks of the underlying assets funded by IA. However, the IFI may be re-exposed to such risks arising from the IFI's potential purchase<sup>9</sup> of the underlying assets in the UA fund to facilitate redemption by the IAH or from portfolio rebalancing exercise. How would capital adequacy be ensured? [Paragraph 31.2 IAF]**

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9.1. For capital adequacy purposes, the IFI is expected to ensure the following:

- (i) Credit and market RWA of the underlying assets in the UA fund is recorded in a timely manner as and when the IFI purchases the underlying assets. Such amount is no longer recognised as risk absorbent and must be risk weighted as the IFI's exposure under Pillar I; and
- (ii) In line with promoting a forward-looking approach to capital management, capital should be allocated at all times under Pillar II for the potential re-exposure to credit and market risks of the underlying assets in the UA

<sup>6</sup> For example, cash placement to the IFI based on *commodity murabahah*

<sup>7</sup> Under *LCR (licensed banks, licensed Islamic banks and licensed investment banks)* and the *Liquidity Framework (for development financial institutions)*.

<sup>8</sup> Under *Capital Adequacy Framework for Islamic Banks (CAFIB)* and *Capital Adequacy Framework (CAF)*.

<sup>9</sup> Also includes investment in underlying assets.

fund arising from the IFI's purchase of the underlying assets to meet the IAH's redemption and from portfolio rebalancing exercise. The IFI is expected to have in place an Internal Capital Adequacy Assessment Process (ICAAP) that factors in the IFI's potential risks to such re-exposure, including under stressed conditions. Factors to be considered include the following:

- (a) in facilitating redemptions – the IAH's redemption profile, liquidity of underlying assets and adequacy of liquidity buffer dedicated within a UA fund; and
- (b) in portfolio rebalancing exercise – potential change in the performance of underlying assets and flexibility in the mandate of investment including ability to change type of underlying assets.

**Illustration on additional surplus creation due to transfer of surplus from a UA fund to the IFI or other UA funds**

Scenario: Surplus transfer from UA Fund 1 to the IFI.

