AIFC

GUIDELINES

FOR ISLAMIC BANKING AND FINANCIAL PRODUCTS

Astana International Financial Centre (AIFC)

CONTENTS

LIST OF KEY ABBREVIATIONS AND ACRONYMS

AAOIFI	Accounting and Auditing Organisation for Islamic Financial Institutions
AIFC	Astana International Financial Centre
CPIFR	Core Principles for Islamic Finance Regulation
CSB	Central Shariah Board
DCR	Displaced Commercial Risk
EPR	Expected Profit Rate
IFSB	Islamic Financial Services Board
IFSPs	Islamic Financial Services Providers
IsDB	Islamic Development Bank
IRR	Investment Risk Reserve
ISF	Internal Shariah Function
LC	Letter of Credit
PER	Profit Equalization Reserve
PRA	Profit Reserve Amount
SA	Shariah Audit
SNCR	Shariah Non-Compliance Risk
SSB	Shariah Supervisory Board

LIST OF FIGURES

1. PREAMBLE

- The Guidelines for Islamic Banking and Financial Products (Guidelines) have been designed to facilitate the development and growth of the Islamic banking and finance market in Kazakhstan.
- Islamic Financial Services Providers (IFSPs) including full-fledged Islamic institutions and Islamic windows[1] of conventional institutions can benefit from the Guidelines. IFSPs could be banks and non-banking financial institutions.
- The Guidelines provide key information on most common Islamic depositing and financing products including underlying structures, main conditions and features, process-flows, list of legal agreements etc.
- The structures listed in the Guidelines have been devised, where applicable, in line with the Shariah Standards of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).
- IFSPs should ensure that any Islamic financial product they develop is in line with the relevant laws and regulations and the related Shariah requirements as defined by the designated authority(ies) including their Shariah advisers. IFSPs should not solely rely on the information provided in the Guidelines in structuring their products.

[1] Conventional financial institutions that want to offer both conventional and Islamic products typically establish an Islamic window to facilitate the offering of Shariah compliant products to their clients subject to complying with certain Shariah related requirements

2. INTRODUCTION TO ISLAMIC FINANCE

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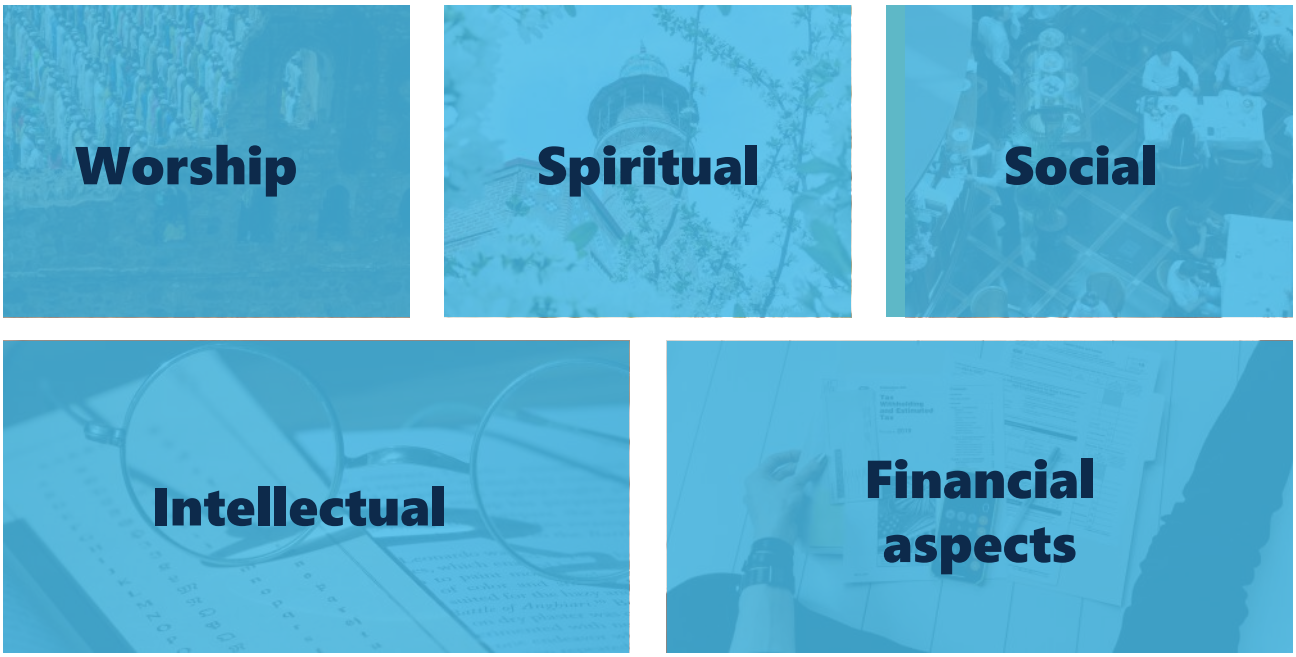
Islamic finance is an alternative financial system that is subject to a distinctive set of rules drawn from Shariah (Islamic law), that apply to financial institutions offering Islamic financial products, in addition to the standard industry rules and regulations. Islamic finance is open for all, Muslims and non-Muslims alike.

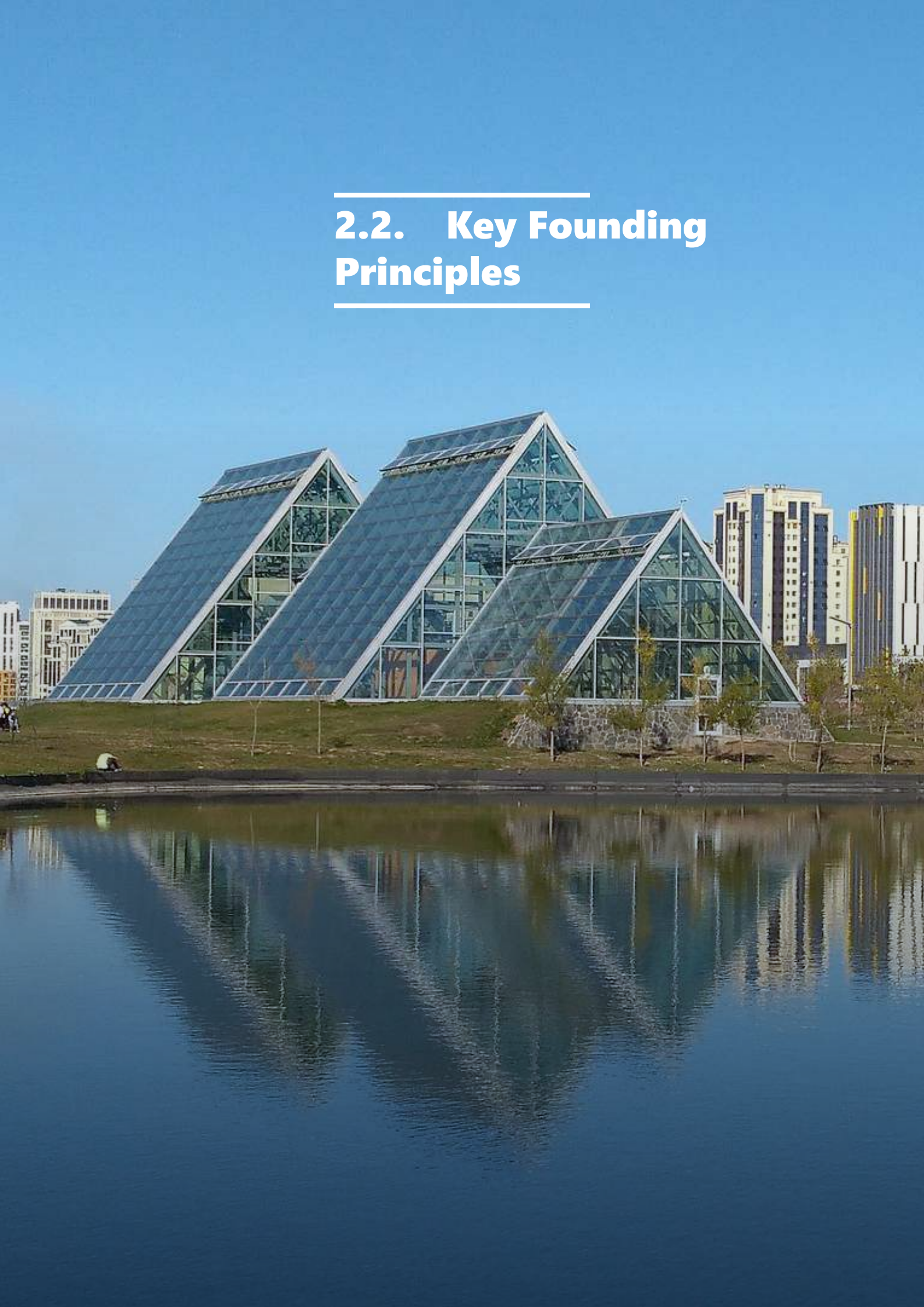
2.1. Shariah

- Shariah provides a governing framework that covers all parts of Muslims' lives, including, among others, **worship, spiritual, social, intellectual, and financial aspects.** Shariah rules and principles are mainly derived from the Holy Quran and the Sunnah (teachings of the Prophet Muhammad, Peace and Blessing Be Upon Him).



- Based on the abovementioned two primary sources, Muslim scholars have developed the tools of Islamic jurisprudence expressed through different processes including interpretation, analogical reasoning and general consensus to opine on contemporary issues including financial matters.
- It is generally believed by the majority of scholars that Shariah primarily aims to achievement of benefit and prevention of harm or corruption in relation to faith, life, intellect, lineage and wealth.
- Consequently, Islamic financial transactions have to comply with Shariah requirements, and the outcome of these transactions should contribute positively to achieving the objectives of Shariah by protecting the wealth and promoting the well-being of all creatures and greater justice in human society.

2.2. Key Founding Principles



2.2.1. Prohibition of Interest

Shariah scholars generally consider money as a 'medium of exchange', not a 'commodity'. Money has no intrinsic utility, but rather used to purchase or acquire goods and services. Based on that, money cannot be sold for more or less than its face value[2].

When money is used to generate money, as in the case of extending a loan for a certain period of time in return for an additional amount of money, this increment is considered interest (Riba[3]) which is prohibited in Shariah, regardless of whether this addition is excessive or not.

2.2.2. Prohibition of Excessive Uncertainty and Gambling

Commercial arrangements and contracts that entail excessive uncertainty, ambiguity, or risk (Gharar[4]) are prohibited in Islamic finance. Prohibited levels of Gharar are typically manifested when there are detectable, preventable, and disputable high ambiguities, uncertainties, and risks in the fundamental conditions of a commercial transaction at the time of executing the contract (e.g., subject matter, price, or date of delivery/performance are not clearly specified/defined in a sale contract).

Therefore, Islamic financial transactions should be clear, and transparent with full disclosures by all the contracting parties on the key terms and conditions of the underlying agreement.

Islamic finance also prohibits commercial transactions that are based on gambling (Maysir[5]), chance or speculation or sometimes referred to as zero-sum transactions where one party's gain in a transaction must lead to the other's loss, rather than creating a mutually beneficial outcome.

[2] Except in currency exchange that is subject to certain Shariah conditions
[3] Riba is an Arabic word which could be loosely translated as interest/usury
[4] Gharar is an Arabic word for ambiguity, uncertainty, or risk
[5] Maysir or Qimar are Arabic words for gambling

2.2.3. Creation of Asset-Backed Financial Transactions

In Islamic finance, money is considered as a lubricant to the engine of the real economy to facilitate the production and exchange of assets, goods, and services.

Therefore, money can only grow and generate a return if deployed into real economic activities such as trading, leasing, investing and other Shariah compliant transactions that are backed, based, or linked to real assets, goods, and services.

Based on the above, Islamic finance is essentially believed to be an asset-backed form of finance that assists in connecting the financial sector with the real economy.

2.2.4. Promotion of Participation and Risk Sharing

The prohibition of interest does not necessarily create a cost-free Islamic financing system, but rather necessitates linking profitability in Islamic finance with involvement in asset-backed commercial transactions that may, as in the case of certain participatory products, require sharing of the resulting rewards and risks related to such transactions and their underlying assets.

Thus, Islamic economists stress that sharing risks and rewards is one of the key foundations of a fair and functional Islamic financial system. Moreover, Islamic finance encourages having prudent risk management measures in commercial transactions to duly mitigate any underlying risks and accordingly preserve the wealth in accordance with the objectives of Shariah.

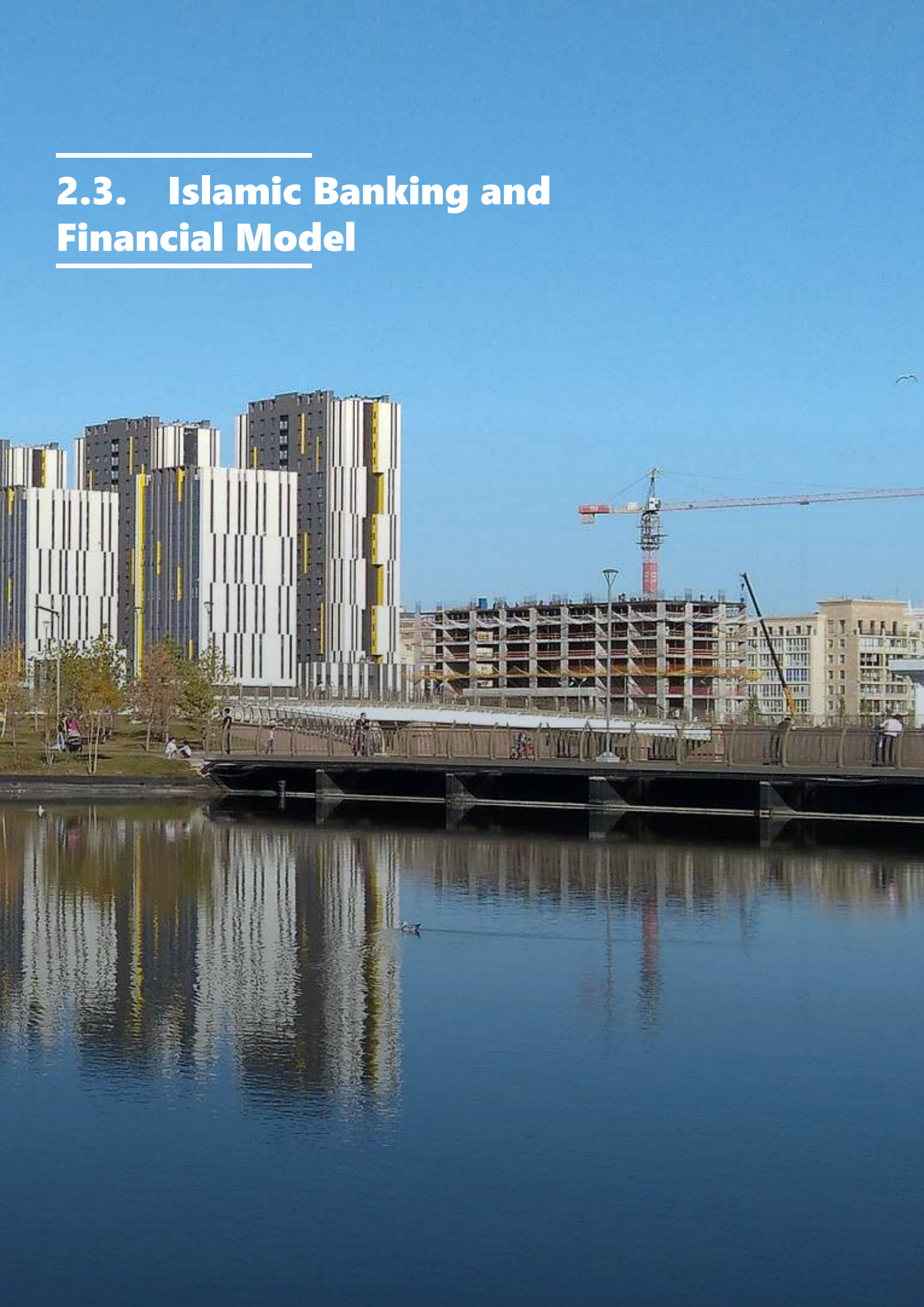
2.2.5. Abiding By a Comprehensive Ethical Framework

Islamic finance is said to promote ethical financial transactions that encourage trade, labor, entrepreneurship, transparency, honesty, righteousness, integrity, and fairness. Although Islamic finance is not a charity finance, it encompasses tools for serving deprived populations such interest-free loans (Qard Hasan), obligatory annual almsgiving (Zakat), optional donations (Sadaqa), Islamic endowment (Waqf) etc.

Therefore, IFSPs cannot offer interest-based or speculative financial products, have excessive uncertainty in their activities that may lead to disputes with their clients, omit or avoid necessary disclosures, present wrong declarations, provide misleading information, or engage in other types of unethical practices.

IFSPs cannot undertake any transaction that is deemed unlawful in Shariah. For example, any transactions that are detrimental to society, environment, animals (e.g. funding businesses that trade in alcoholic beverages, tobacco, gambling, pornography, animal poaching or weaponry etc.).

2.3. Islamic Banking and Financial Model



2.3.1. Overview

- IFSPs include full-fledged Islamic institutions and Islamic windows of conventional institutions.
- IFSPs are licensed by the relevant regulatory authorities and are subject to a certain degree, to similar regulatory requirements as their conventional counterparts. However, IFSPs operate in a distinctively different way due to the Shariah requirements that they need to comply with as an additional component to their governance, compliance, risk management, and audit frameworks.
- Unlike conventional financial institutions that mainly operate based on borrowing and lending with interest-based loan contracts, IFSPs operate using a set of Shariah compliant contracts and arrangement.
- IFSPs do not usually lend money to their clients, but rather they buy and sell or lease assets and/or services. They also invest with their clients and share profit and loss with them. IFSPs do not pay interest to their depositors, instead, they invest the deposits into different types of Shariah compliant assets/pools/ projects and share the generated profit with their depositors.
- As the case with conventional financial institutions, IFSPs also provide certain services to their clients and charge fees (e.g., money transfer, money exchange, online bills' payment through mobile banking application etc.).
- The sources of IFSPs' income mainly include profit generated by their trading and investment activities, rent received on their leased assets and fees paid for their services. IFSPs are not allowed by Shariah to have any interest-based income. Any such impermissible income made inadvertently needs to be isolated and donated to charity.

2.3.2. Main Contracts

- As it is forbidden in Islamic finance to pay or receive interest, money should be used to create real economic value where it may earn a return by having it invested in permissible commercial transactions and activities.
- Accordingly, there are different types of Shariah compliant contracts that can be used by IFSPs to structure products and services to meet various financial needs. The following contracts are the mostly used in Islamic banking:

CATEGORY	NAME	DESCRIPTION
Sales contracts	Murabaha	Profit-disclosed sale of an existing asset.
	Salam	Sale of a commodity with full spot payment for future delivery.
	Istisna	Sale of an asset to be manufactured.
Lease contract	Ijarah	Islamic lease (could be structured as operational or financial lease).
Loan contract	Qard Hasan	Interest-free benevolent loan.
Participatory contracts	Murabaha	Partnership where one party (or more) provides the funds, and the other party provides expertise in deploying the funds in a Shariah compliant business activity for profit generation that will be shared between both parties in accordance with a pre-agreed ratio. Any financial loss will be borne by the fund provider unless the other party is guilty of negligence, misconduct, or failure in following the contractual conditions, in which case they will bear the loss.
	Musharaka	Partnership where two or more parties co-fund a specific Shariah compliant project/asset and share the profit in accordance with a pre-agreed ratio and loss in accordance with their capital participation ratios.
Services contracts	Wakala	Wakala is an agency contract where one party (principal) appoints another party (agent) to carry out a Shariah compliant activity on their behalf.
	Kafala	Guarantee that is intended to secure fulfilment of contractual and/or financial obligations.

2.4. Standardisation

- Over the years, the Islamic finance industry has developed its offering and products in many legal and taxation systems across diverse societies and communities with different cultural fabrics, and various religious practices.
- As a result of such globalisation and growth, an urgent need for harmonisation and standardisation has emerged in the industry to achieve the following key objectives:

  - Maintain the integrity of the Islamic finance industry and protect its reputation from any controversial practices.
  - Boost stability of the Islamic finance industry.
  - Provide internationally recognised benchmarks, standards, and best practices for the stakeholders of the industry.
  - Create uniformity and consistency in the operations of IFSPs focusing on structures of products, processes and procedures, Shariah governance and compliance requirements, accounting and auditing, risk management, liquidity management etc.
  - Boost cross-border investment transactions and international cooperation in the Islamic finance field.
  - Reduce the overall operational costs, streamline the day-to-day business activities and improve efficiency of IFSPs.

- Hence, the industry stakeholders have established the following leading standard-setting bodies to take the industry to the next level:

Shariah

Governance

Auditing

Accounting

Ethics

2.4.1. Accounting and Auditing Organisation for Islamic Financial Institutions

- AAOIFI was established in 1991 in Bahrain as an international, autonomous, and not-for-profit industry standard-setting body. AAOIFI's primary objective is to ensure consistency and uniformity of practices across all sectors of the Islamic finance industry.
- Till the date, AAOIFI has issued more than 100 standards in the following technical areas:

  - Shariah.

  - Governance.

  - Auditing.

  - Accounting.

  - Ethics.

- The standards of AAOIFI are mandatory regulatory requirements in dozens of jurisdictions and are also partially adopted or used for guidance in many others. The Shariah standards of AAOIFI are the unanimous opinion of Shariah scholars representing different schools of Islamic jurisprudence and regions of the world.
- Apart from governments and regulatory bodies, the Shariah standards of AAOIFI are voluntarily implemented and followed by the Islamic Development Bank (IsDB) and numerous well-known Islamic finance consultancies, auditing firms, Islamic banks, Takaful[6] companies, non-banking credit institutions, capital market firms, educational/training institutions, Shariah scholars and professionals around the globe.

[6] Islamic insurance

2.4.2. Islamic Financial Services Board

IFSB was formed in 2002 in Malaysia as an international standard-setting organisation for regulatory and supervisory agencies, multilateral organisations and market players that have a vested interest in developing a sound and stable Islamic financial industry.

IFSB promotes the development of a stable, prudent and transparent Islamic finance industry by introducing new bespoke standards or adapting existing international standards consistent with Shariah principles and recommending them for IFSPs, capital market participants and insurance providers.

To date, IFSB has issued over 37 standards, guidance notes and technical notes primarily focused on prudential and regulatory areas including risk management, capital adequacy, solvency requirements, supervisory review process, liquidity management, corporate governance etc.

In May 2018, the IMF Executive Board formally adopted the use of the IFSB's Core Principles for Islamic Finance Regulation for Banking (CPIFR)[7] in its financial sector assessments methodology. The CPIFR will be applied by the IMF in its financial sector assessments undertaken in fully Islamic banking systems and, as a supplement to the Basel Core Principles for Effective Banking Supervision, in dual banking systems where Islamic banking is systemically significant. Such decision has assisted in complementing the international Islamic financial architecture for financial stability, whilst also providing incentives for regulators across many jurisdictions to improve their prudential frameworks for the Islamic banking industry.

[7] The CPIFR are intended to provide a set of core principles for the regulation and supervision of the Islamic banking providers taking into consideration their specificities and unique requirements

2.5. Shariah Governance

- The Islamic banking industry should have a Shariah governance framework and supporting infrastructure that ensure a proper conduct of business for IFSPs based upon strong conviction, ethical principles, and practices in line with legal, regulatory and Shariah requirements.

2.5.1. Shariah Non-Compliance Risk

- Shariah Non-Compliance Risk (SNCR) is defined as the risk of reduction in earnings or value, through financial or reputational loss resulting from IFSPs being Shariah non-compliant. Hence, SNCR arises from failure to comply with Shariah rules, principles, and requirements, as set out by the respective authorities/bodies nominated for such purpose on both national and/or institutional levels (where applicable)[8].
- Such non-compliance may arise from breach of regulations, policies, processes, procedures, contracts and any other documentation, arrangements and activities that are related to IFSPs and their products and services.
- The probability and the impact of this unique risk can be both high and significant, so it needs to be carefully managed and mitigated as it may have severe consequences as follows:

IMPACT	RAMIFICATION
Financial impact	Non-compliant transactions are considered void by Shariah. Thus, any income generated from the same would not be permissible for IFSPs and will be subject to purification (i.e., to be donated to charity and accounted as an expense instead of income).
Non-financial impact	Shariah non-compliance issues can heavily tarnish the reputation of the Islamic finance industry and may create impairment in the confidence of the stakeholders in any Islamic financial proposition.

- Therefore, SNCR is a systemic risk in Islamic finance and mitigating such risk at all levels (global, national, and institutional) is essential for building a functional and competent Islamic financial industry.

[8] The appointed authorities/bodies responsible for issuing rules on Shariah compliance for IFSPs on national and/or institutional levels will depend largely on the jurisdiction

2.5.2. Shariah Governance Framework

- Shariah governance framework is a comprehensive system that defines a set of appropriate national and/ or institutional measures (as applicable), arrangements, requirements, organs, and policies for Shariah compliance in the Islamic finance industry. The overall objective is establishing an effective and independent oversight of Shariah compliance over IFSPs' activities to duly mitigate their exposure to SNCR.
- It is critical to emphasise that the requirements of the Shariah governance framework should go hand in hand with, and in addition to other relevant statutory requirements that apply to financial institutions in any market. Accordingly, IFSPs have a dual governance model to satisfy both Shariah and statutory requirements.
- Policy makers and regulators in different jurisdictions have adopted different models of Shariah governance to ensure that IFSPs are functioning in line with Shariah principles. Such varied regulatory perspectives on Shariah governance are due to the diverse nature of legal systems, cultures, and religious fabrics in different countries where IFSPs operate.

2.5.3. Key Components of the Shariah Governance Framework

- Key components of the Institutional Shariah governance framework are as follows[9]:
  - Institutional Shariah Supervisory Board (SSB) – an independent group of Shariah scholars specialised in Islamic commercial jurisprudence and experts in Islamic finance. SSB members are entrusted with the duty of providing guidance, supervision and certification for Islamic financial products and services for an individual IFSP to ensure their compliance with Shariah rules and principles.
  - Internal Shariah Function (ISF) – an independent function/ department for day-to-day advice on Shariah related matters. The members of such function are employees of the IFSP with independent role reporting directly to the SSB and indirectly to the IFSP management. The objective of this function is to ensure that the SSB's directives and decisions are being correctly and accurately implemented within the IFSP business and activities.
  - Shariah Audit (SA) – an engagement to provide independent reasonable assurance that an IFSP complies with the Shariah principles and rules applicable to their financial arrangements, contracts and transactions during a specific time period based on a certain set of Shariah principles and rules contained in the agreed criteria (e.g., the resolutions of the SSB). There are mainly two types of SA that complement each other in terms of objectives and scope:
    - Internal - conducted by an independent function/ department of an IFSP[10].
    - External - completed by an independent and qualified firm.
- In addition to the aforementioned components at the institutional level, some countries establish Central Shariah Board(s) (CSB) at the national level.
- CSB is a national-level independent body of a specific country/regulator, appointed by the relevant authority, to act as the highest Shariah authority in the country's Islamic finance industry (or any of its sectors). The overall objective of the CSB is ensuring Shariah compliance at all times by working closely with the industry stakeholders including the institutional SSBs to duly manage the Shariah non-compliance risk in a systematic manner, and accordingly provide the industry with the required financial stability.

[9] The names/terms used to describe these components can vary among different jurisdictions, but the functions remain largely similar

[10] Internal Shariah audit may be part of IFSP's internal audit function (subject to capability)

3. ISLAMIC LIABILITY AND INVESTMENT PRODUCTS

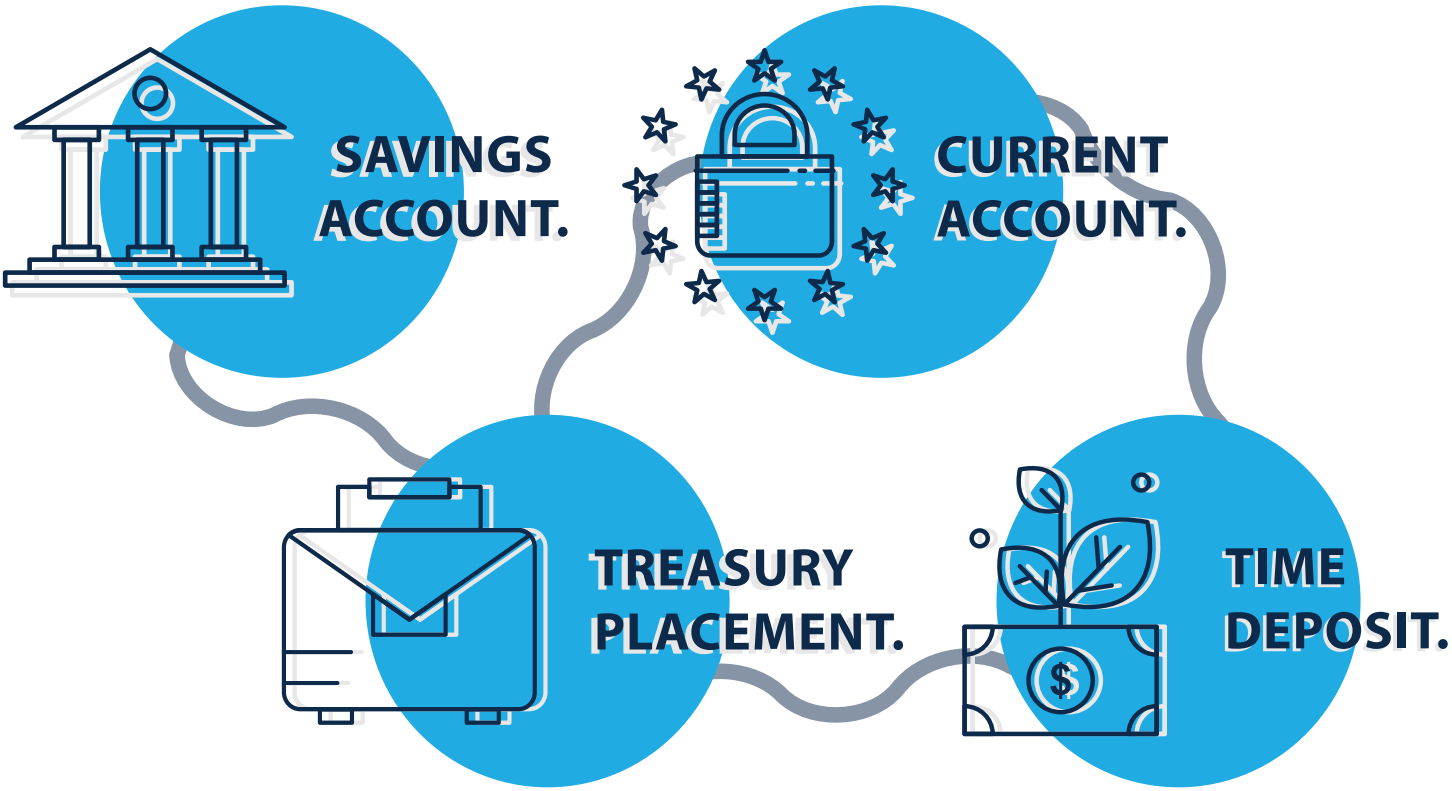
3.1. Introduction

- This section explains how the following liability/investment products can be structured in a Shariah compliant manner:

  - **Current account.**
  - **Savings account.**
  - **Time deposit.**
  - **Treasury placement.**

- A number of Shariah compliant contracts have been selected to showcase the structuring of the above-listed Islamic financial products in line with the industry's standards and practices. However, it is important to note that other contracts can be used to structure these products.

Figure 1. Islamic Liability and Investment Products



3.2. Current Account

3.2.1. Definition

Islamic current accounts are typically structured based on Qard Hasan where the client is the lender, and the IFSP is the borrower.
Qard Hasan is an Islamic loan without pre-agreed benefits to the lender (financial benefits or other), involving the transfer of ownership of fungible wealth (money) from one person to another who has the obligation to return, at the end of the contract term and/or upon demand, the exact initial loan value taken.

3.2.2. Salient Features and Conditions

- Client deposit their money into the current account as interest-free loans extended to the IFSP without receiving any financial returns on the same.
- Overdraft facilities are usually disabled on Islamic current accounts or may be offered to clients (as an interest-free loan from the IFSP to the client) for a very short period of time at no cost (no payment of interest).
- The IFSP carries the total responsibility of the deposits and must repay the entire amounts deposited on demand in all circumstances.
- The IFSP can use the deposited sums at its own risk strictly in Shariah compliant activities.
- Client cannot receive any form of remuneration and do not share any risks with the IFSP.
- The IFSP keeps any revenue generated from investing the funds deposited in the current accounts, but it also bears all the loss (if any).
- Client will have the typical safe keeping and payment services provided by a bank to its current account holders (e.g., chequebook, payments, online/mobile/app etc.).
- The IFSP may charge fees for the aforementioned services provided to the current account holders, subject to approval by the SSB.

3.3. Savings Account

3.3.1. Definition

Islamic savings accounts are instant-access accounts or on-demand accounts where clients can access their funds at any time and profit is calculated/accrued daily and paid periodically (typically on a monthly basis but it could be any agreed interval).

This section explains how an Islamic savings account can be designed based on Investment Wakala.

The basic Shariah characteristics of Wakala include the following:

- Wakala is an agency contract where one party (principal) delegating to another party (agent), the responsibility to undertake a defined Shariah compliant action on their behalf (usually for an agreed remuneration/fee).
- Wakala can be Unrestricted[11] or Restricted[12].
- The principal must be the owner or has the right to make decisions in relation to the subject matter of the Wakala contract.
- The underlying agency actions/services/activities should be Shariah compliant.
- The agent has a fiduciary responsibility and hence acts as trustee in executing the underlying agency activities.
- Investment Wakala is one of the most common forms of Wakala in the Islamic finance industry where the defined agency action is ''Investment of Funds''.

[11] A type of agency contracts wherein the principal does not place any restrictions on the acts or discretion of the agent. For example, it may involve a principal requesting their agent to buy an office building without going into any details as to its location, features, etc.

[12] A type of agency contracts wherein the principal restricts the acts or discretion of the agent. For example, it may involve a principal requesting their agent to buy a car that has a specific color and model and at a price not exceeding a specific amount

3.3.2. Salient Features and Conditions

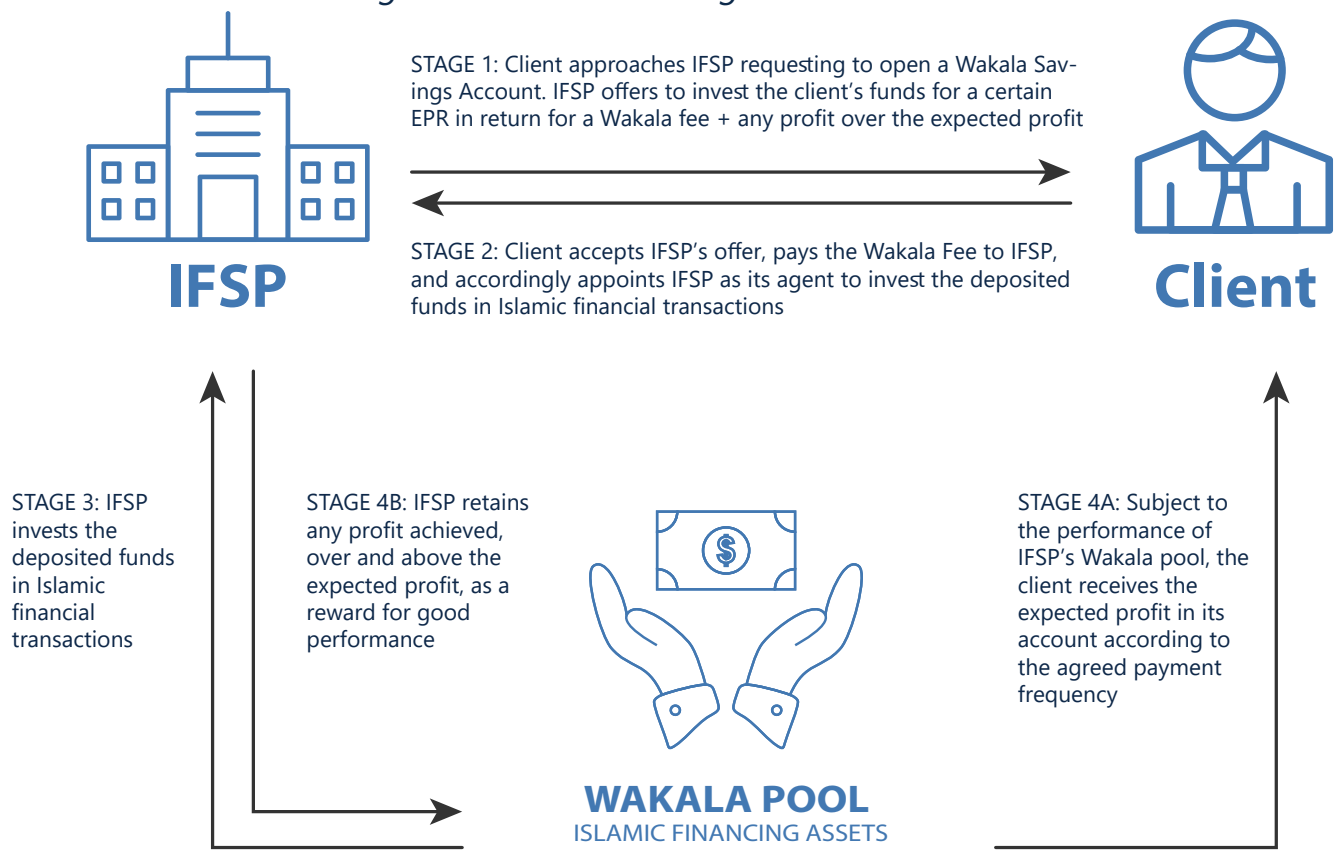
- IFSP acts as an investment agent of the client to invest the deposited funds in Shariah compliant investment pool with the aim of generating profit.
- IFSP has the right to charge a Wakala fee upon opening the savings account and that fee is guaranteed to the IFSP and does not depend on the investment performance. Such Wakala fee is typically symbolic (e.g., $1) so the IFSP may drop this at its own discretion. In all cases, all fees/ charges for the account should be approved by the SSB.
- The IFSP invests the deposit in its own or other Shariah compliant investment pools (typically financing assets) and the profit payable to the client is based on the actual performance of the underlying pool.
- The profit is generally capped at the Expected Profit Rate (EPR)[13] that should be agreed with the client upon opening the account.
- The deposit amount, tenor, EPR and Wakala fee should be defined and agreed before the commencement of the Wakala arrangements.
- The client bears the risk of loss of the deposit (deposit amount should not be unconditionally guaranteed by the IFSP). However, IFSP should bear any losses in cases of the IFSP's gross negligence, wilful default, fraud, misconduct, or breach of the agreed Wakala terms and conditions.
- At the end of every month, the IFSP shall calculate and determine the actual profit rate achieved and:
  - If the investment pool achieved an actual profit rate that is equal to, or higher than, the agreed EPR, the client will receive the expected profit, while the IFSP will be entitled to retain any profit amount exceeding the expected profit as an incentive for good performance[14].
  - If the investment pool achieved an actual profit rate that is less than the agreed EPR, the client will receive the actual profit which, in this case, will be less than the expected profit, while the IFSP will receive nothing. However, the IFSP could top up the actual profit to reach the expected profit (this is optional as a gift to clients and shall not be a contractual obligation). IFSPs would typically do this to avoid a run on their deposits or losing trust of their clients. This is called Dsplaced Commercial Risk (DCR)[15].

[13] EPR is an annual percentage rate that represents the return rate that a client is expected to receive on their deposit/investment amount
[14] The difference between the actual profit rate achieved on the IFSP's investment portfolio and the EPR paid to clients is the net profit margin for the IFSP
[15] DCR is named as such because of the commercial pressure on the management to transfer the risk from the clients to the IFSP's shareholders as the profit paid to the clients are higher than actual profit. The difference is generally drawn from shareholders' part of the profit or in rare occasions from equity

- In order for the IFSP to properly discharge their obligation under the Investment Wakala structure, achieve the EPR, and provide their clients with the benefit of capital protection, the IFSP shall maintain a healthy net profit margin at all times, advertise realistic EPRs, have a prudent investment strategy, diversification in investments in line with the relevant regulatory requirements, and most importantly monitor the investment pool's performance on a regular basis.
- The IFSP shall aim to monitor the performance of their Islamic investment pools daily. If at any time, the IFSP anticipates that the EPR is no longer achievable, the IFSP shall send a notice to the client (1-month notice should suffice), proposing a revised EPR. The client has the option of either accepting this new EPR or terminating the account.
- If the client terminates, the IFSP shall return the deposited funds in the savings account plus any accrued but unpaid profit up to the termination date.
- The aforementioned contractual responsibility of the IFSP to actively monitor the performance of the pool and keep the clients informed at all times is a Shariah compliant deposit-protection arrangement. Hence, any failure in this will be construed as negligence from the IFSP's part.

3.3.3. Process Flow

Figure 2. Wakala Savings Account Process



3.4. Time Deposit

3.4.1. Definition

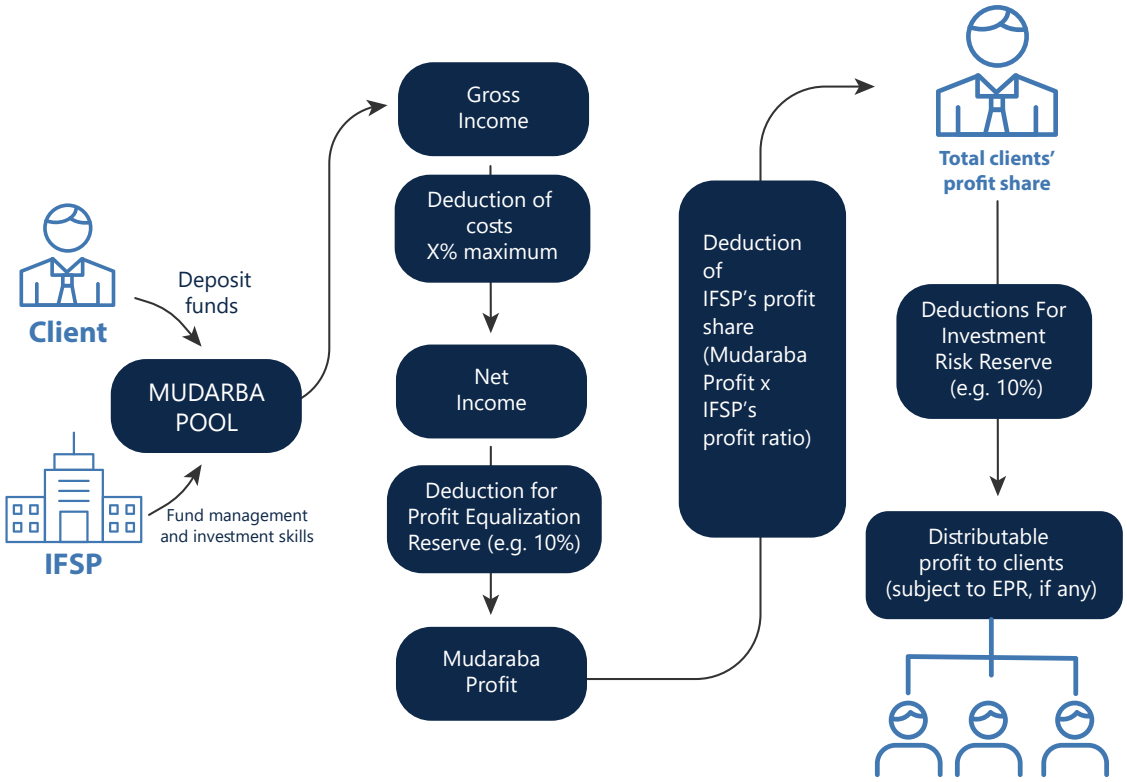
- Islamic time deposits can be referred to as fixed term deposits where clients typically have no access to their deposited funds until the agreed maturity date (end of term).
- This section explains how a time deposit can be structured based on Mudaraba.
- The basic Shariah characteristics of Mudaraba include the following:
  - Mudaraba is a type of partnership arrangement where one party provides the work/ expertise and the other(s) provide(s) the capital.
  - The underlying partnership project/assets/investments should be Shariah compliant.
  - The Mudaraba profit generated to be shared between the partners in accordance with a pre-agreed profit-sharing ratio.
  - Financial losses (if any) to be borne by the fund provider(s) unless the managing partner is guilty of negligence, fraud, misconduct, or failure in following the agreed contractual conditions, in which case they will bear the loss.

3.4.2. Salient Features and Conditions

- The IFSP and the client enter a Mudaraba agreement where the client will provide the funds and the IFSP will provide the expertise to invest the client's funds in Islamic investment pool with the aim of generating profit.
- The profit generated by the underlying investment pool is to be shared between the client and the IFSP according to an agreed profit-sharing ratio.
- The deposit amount, term, and profit-sharing ratio should be defined and agreed before commencement of the time deposit.
- The profit payable to the client will be based on the actual performance of the IFSP's investment pool (which could be the same as the IFSP's consolidated pool of Islamic financial assets).
- Both parties may agree to cap the client's profit with an EPR to be agreed with the IFSP upon opening the deposit account where any profit exceeding the expected profit will be given to the IFSP as an incentive for good performance and for achieving the EPR.
- The IFSP cannot unconditionally guarantee the client's funds under the Mudaraba time deposits as such guarantee is Shariah non-compliant (except in cases of the IFSP's negligence, misconduct, fraud, or non-compliance with the agreed Mudaraba terms and conditions).

- In order for the IFSP to properly discharge their obligation under the Mudaraba agreement, achieve the EPR, and provide their clients with the benefit of capital protection, the IFSP shall maintain a healthy net profit margin at all times, advertise realistic EPRs, have a prudent investment strategy, diversification in investments in line with the relevant regulatory requirements, and monitor the investment pool's performance on a regular basis.
- IFSPs also create reserves to protect Mudaraba deposits. Such reserves can help to smooth and stabilise profit payable to clients and compensate the latter in cases of losses.
- Profit allocation for Mudaraba time deposit can be done as follows:

Figure 3. Profit Allocation – Mudaraba Time Deposit



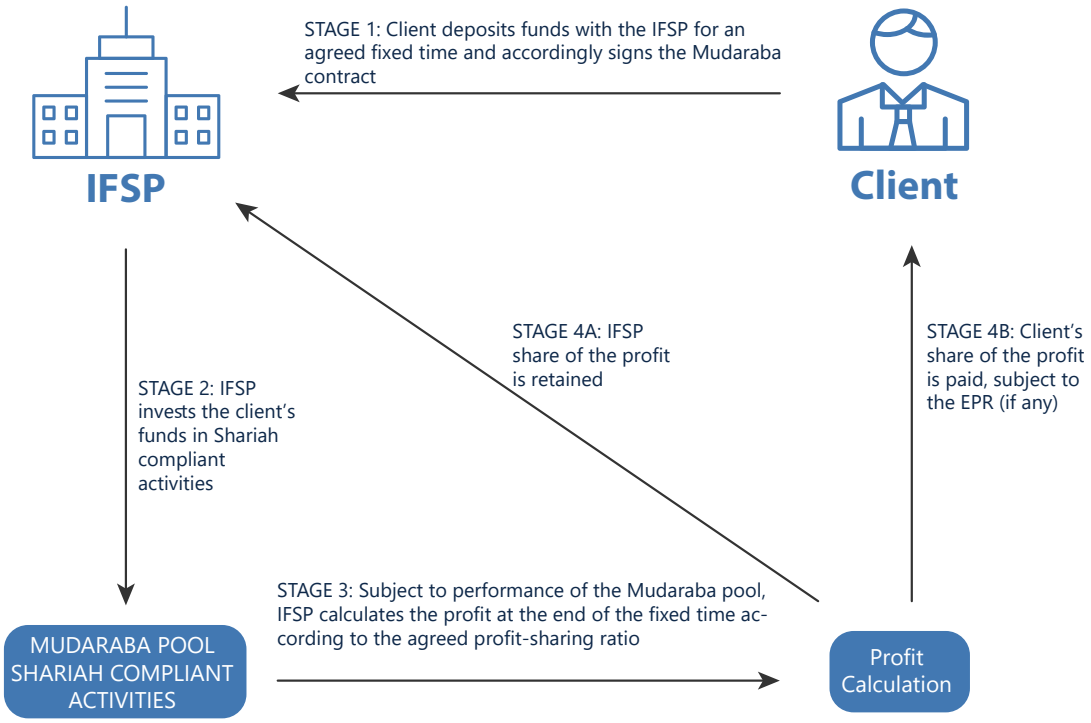
- There are typically two types of reserves the IFSP establishes for the purposes of Mudaraba time deposits:

PER	• Profit Equalization Reserve (PER): The sums added into this reserve are deducted from the net income and are contributed by the IFSP and all clients placing funds in the Mudaraba deposits on a mutual basis in support of maintaining a certain level of profitability. The primary aim of PER is to stabilise profit payments over time.
IRR	• Investment Risk Reserve (IRR): The sums added to this reserve are deducted from the clients' share of the Mudaraba profit. The primary aim of IRR is to cover any future losses for the client's nominal deposit.

- If the IFSP's investment pools suffer a genuine loss without any proven misconduct, fraud or non-compliance with the agreed contractual terms and conditions by the IFSP, such losses could be mitigated in the following manner (where the deposit structure includes reserves):
  - The IFSP may draw upon any available balance in the IRR to compensate the depositors for their losses.
  - If the sums available in the IRR are not enough, the IFSP may draw upon any available balance in the PER.
  - If the combined funds available in the IRR and PER are not adequate to cover all losses related to clients' deposits, clients will have to accept the remainder of losses. However, the IFSP, at its own discretion, may cover such losses (partly or fully) in the form of gifts given to clients. Nevertheless, such gifts shall not be mandated in the Mudaraba contract.
  - Finally, the client may be eligible to get the funds from a Shariah compliant deposits' protection scheme (if available in the country).
- The client may request early termination of a Mudaraba time deposit at any time prior to the agreed maturity.
- IFSP, at its discretion, may accept such termination without imposing early termination penalties[16]. However, the IFSP has the right to negotiate with the client a reduced EPR payable to the client in such circumstances.
- If the client refuses to accept the reduced EPR, then the IFSP may decline the client's request for early termination.

3.4.3. Process Flow

Figure 4. Mudaraba Time Deposit Process



[16] Penalties mean in this context deduction from the capital or principal deposit amount

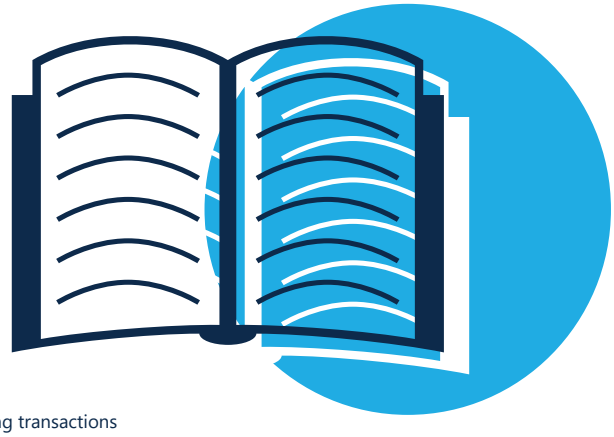
3.5. Treasury Placement

3.5.1. Definition

- Islamic treasury placements can be referred to sometimes as inter-bank placements. Such placements typically function like time deposits, but they are negotiated directly between the treasury/finance department of an IFSP and certain segments of clients.
- Treasury clients are usually wealthy individuals, financial institutions, corporations, and other counterparties who are usually looking for a fixed and guaranteed return on their deposits and will, most likely, negotiate the profit rate that will be paid by the IFSP.
- This section explains how a treasury placement can be structured based on Commodity Murabaha (sometimes known as Banking Tawarruq or Organised Tawarruq).
- Murabaha is a profit-disclosed sale i.e., a sale transaction where the cost of the underlying asset and the profit realised by the seller are disclosed to the buyer.
- The payment of the price can be immediate or deferred to a future date (most commonly used by IFSPs in combination with deferred payment).
- The underlying Murabaha asset should be:
  - Shariah compliant, exists at time of sale, valuable and deliverable.
  - Described, quantified, and clearly priced.
  - Owned by the seller (physically or constructively) prior to concluding the sale (the seller may have the mandate from the owner to sell as their agent).
- Commodity Murabaha is a form of Murabaha i.e., a profit-disclosed sale using a commodity. However, unlike the vanilla Murabaha, the buyer does not need the commodity itself so the buyer will purchase the commodity on a deferred payment basis from the seller and then sell the same to a third party for spot cash (i.e., a cash-generating arrangement).

3.5.2. Salient Features and Conditions

- The traded commodity is typically a raw material (e.g., crude palm oil, timber etc) or base metal (i.e., Copper, Zinc etc.) which must be non-perishable, freely available, and uniquely identifiable.
- Warrants (also known as metal holding certificates) are typically used with the sale of base metals as proof of ownership. A warrant is a certificate for a specific metric tonnage of an approved commodity stored in a defined warehouse(s).
- Commodity Murabaha transactions attract additional costs associated with the purchase and sale of the commodities through brokers who issue warrants.
- Profit for Commodity Murabaha Islamic treasury placements is agreed and fixed at the outset and will be paid according to the agreed payment terms.
- Maturities of Islamic treasury placements are negotiable ranging from 1 day to 5 years.
- The client[17] would typically purchase the commodity from a broker and accordingly own it, before selling the same on a Murabaha basis with deferred payment to the IFSP.
- The IFSP should not sell the commodity to itself on their own i.e., the Murabaha sale to the IFSP is concluded by exchanging a separate offer and acceptance with the client to duly conclude the Murabaha transaction.
- After purchasing the commodity from the client on Murabaha basis and deferred payment[18], the IFSP will sell the commodity to a second broker to generate the needed cash which could be invested in the IFSP's investment pool.
- Time intervals should be allowed for the series of purchase/sale transactions between the IFSP, the client, and the brokers.
- The involvement of the brokers that are independent from each other and from the client and the IFSP is a Shariah requirement in Commodity Murabaha.
- The sale price (deposit amount and the profit) under Commodity Murabaha is fixed and guaranteed by the IFSP as this is a sale arrangement and the IFSP is legally bound to pay the agreed sale price which becomes a debt payable by the IFSP to the client.
- Commodity Murabaha has been subjected to criticism at various levels and on many occasions in the Islamic finance industry. However, it remains widely used in the industry, particularly to offer guaranteed fixed-rate products and tackle legal and taxation hurdles in some jurisdictions.



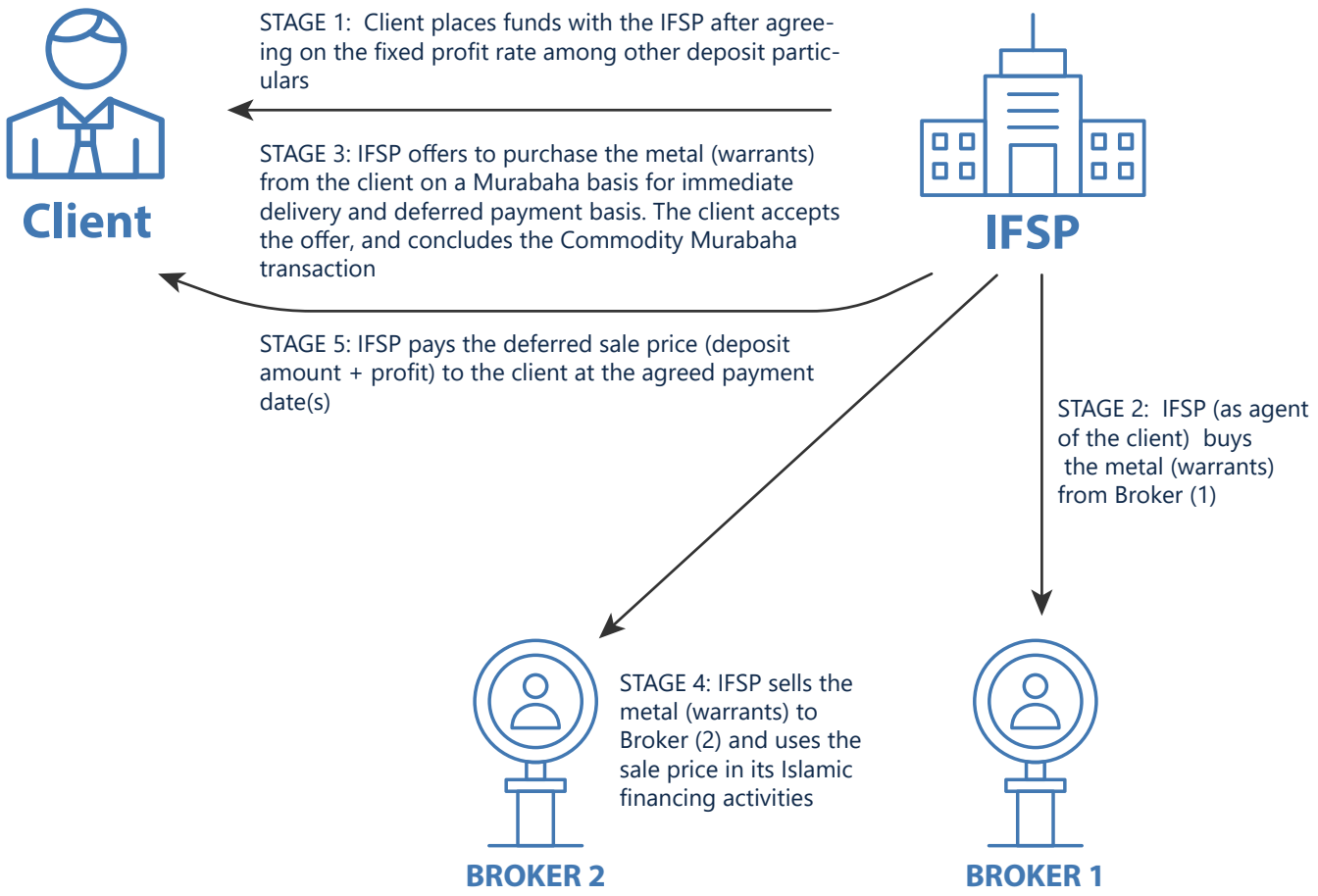
[17] The IFSP would usually act as an agent of the client to complete the needed commodity trading transactions
[18] The deferred payment will include the deposit amount and the profit agreed with the client

3.5.3. Shariah Analysis

- AAOIFI Shariah Standards reports that Commodity Murabaha is not a mode of investment or financing. It has been permitted when there is a need for it, subject to specific terms and conditions. However, many Shariah scholars have approved Commodity Murabaha strictly subject to certain conditions as follows:
  - When other Islamic financial structures are difficult to implement or not possible, particularly due to legal and taxation issues.
  - Having an auditable trail of events with clear ownership transfer of the commodity.
  - Separation of the purchase and sale arrangements (i.e., having independent brokers).

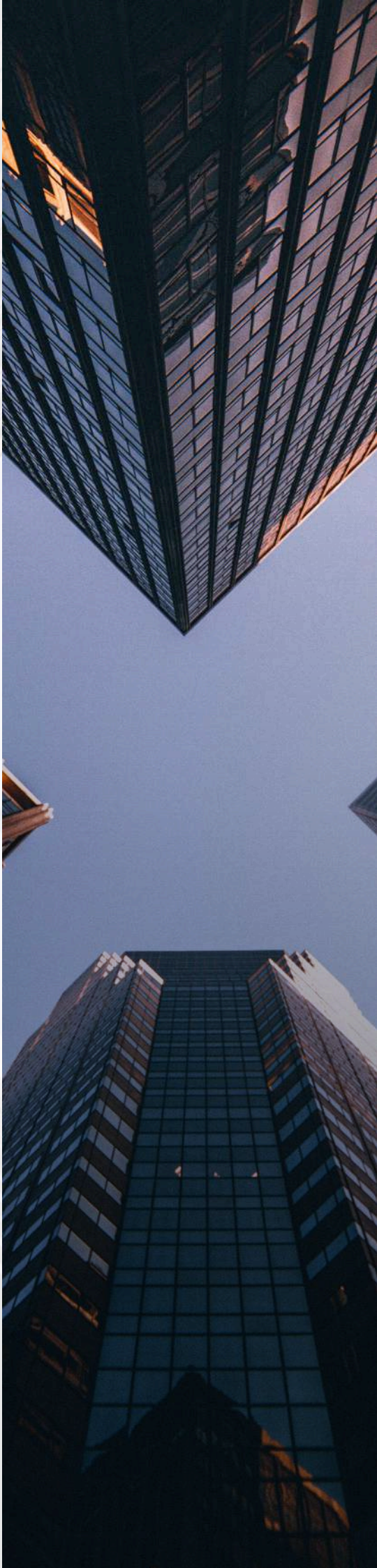
3.5.4. Process Flow

Figure 5. Treasury Placement Process



3.6. Key Considerations

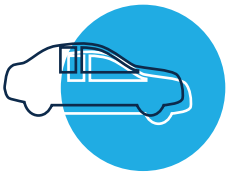
- Depending on the underlying structure, legal documentation for the aforementioned products may include the followings:
  - Current account - Islamic General Terms and Conditions.
  - Savings account - Wakala Special Terms and Conditions.
  - Time deposit - Mudaraba Special Terms and Conditions.
  - Treasury placement - Commodity Murabaha Master Agreement (including legal appendices to be executed for each placement transaction under the Master Agreement such as notice of intent form, promise to sell form, offer and acceptance etc.).
- Operational documentation includes product manuals, processes and procedures, etc.
- All legal and operational documentation for the abovementioned Islamic liability and investment products must be reviewed and approved by the IFSP's SSB.
- Treatment of Islamic liability and investment products in terms of capital adequacy, accounting, taxation, and other areas are defined in the relevant rules and regulations.



4. ISLAMIC ASSET AND FINANCE PRODUCTS

4.1. Introduction

This section explains how the following asset/financing products can be structured in a Shariah compliant manner:

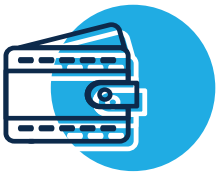


Auto Finance

Personal Finance

Machinery Finance

Agricultural Finance



Working Capital Finance

Property Finance

Trade Finance

A number of Shariah compliant contracts have been selected to showcase the structuring of the above-listed Islamic financial products in line with the industry's standards and practices. However, it is important to note that other contracts can be used to structure these products.

4.2. Auto Finance

4.2.1. Definition

- This section explains how an Auto Finance product can be designed based on Murabaha.
- The definition and basic Shariah characteristics of Murabaha have been explained in section 3.5.1 of the Guidelines.

4.2.2. Salient Features and Conditions

- Under a Murabaha Auto Finance Product, the IFSP, usually upon the client request/ promise, purchases a certain automobile from a vendor (full spot cash payment) and on sell the same to the client with an agreed/disclosed profit with deferred payment basis (the client typically pays periodic instalments to the IFSP e.g., monthly, quarterly, etc.).
- The IFSP should buy and own the relevant automobile (either directly or through an agent) before selling it to the client.
- The client should NOT accept an offer to purchase the automobile directly from the vendor but rather get a formal quote so the IFSP can complete the purchase transaction.
- The IFSP must ensure that the vendor from whom the automobile is bought is independent from the client (in terms of ownership)[19].
- The client should not be appointed as the agent of the IFSP to purchase the automobile from the vendor except in case of dire need[20]. Where the client is appointed as agent, the IFSP must ensure that:
  - IFSP pays the purchase price directly to the vendor and not to the client/agent.
  - IFSP obtains documents from the vendor evidencing that the purchase transaction has taken place (issued in the name of the IFSP, not the agent).
  - A time interval exists between the execution of the purchase contract with the vendor and the Murabaha contract between the IFSP and the client.
- Where the client suggests a particular vendor, the IFSP can request a personal guarantee from the client regarding the good performance of the vendor.

[19] Minority shareholding could be tolerated, subject to the SSB approval

[20] According to AAOIFI Shariah Standards, appointing the client as an agent should be limited to situations where the IFSP is unable to undertake the Murabaha contract directly or through an independent agent with the vendor

- The IFSP can stipulate that it is not responsible for any defects in the automobile after the sale is completed (sale on 'as is' basis). In that case, the IFSP usually assigns to the client the right of recourse to the vendor to obtain any compensation for any defects.
- Murabaha contract is concluded when explicit offer and acceptance are exchanged/ signed between the client and the IFSP.
- The IFSP should disclose to the client the original cost price, details of shipping, storage, insurance[21] and other expenses incurred (if any), and the profit.
- The client becomes the owner of the automobile and assumes full responsibility thereof after signing the Murabaha contract.
- The obligations of the IFSP are discharged upon receipt of the automobile by the client.
- The seller/buyer relationship between the IFSP and the client becomes that of a creditor/debtor after signing the Murabaha contract.
- The client has the obligation to pay off all their debt according to the payment plan agreed upon by the two parties.

Pricing and Fees

- A profit rate[22] shall be agreed with the client to be used by the IFSP for calculating the profit which may vary for various finance tenors/amounts/clients/automobiles.
- Sale price (cost price + profit) cannot be increased once the Murabaha contract is signed.
- If the IFSP receives a discount from the vendor, it should be passed to the client.
- IFSP may charge the client fees/charges similar to certain fees/charges imposed on conventional auto finance products subject to Shariah compliance (SSB's approval is required for all fees/charges).

Early Settlement and Default

- IFSP shall not charge any early settlement fees/charges/penalties. However, admin charges to cover the relevant admin cost could be accepted subject to the SSB approval.
- IFSP may grant the client a rebate on the final sale price (though it cannot be pre-agreed with the client or stipulated in the Murabaha contract).
- The client could default on the agreed payments under two scenarios:
  - Genuine difficulties, in which case the IFSP is advised to support the client and provide grace period to the client to be able to overcome the difficult circumstances and be in a position to resume payments without any extra charges/penalties/fees etc. The IFSP may also consider rescheduling the payment of the outstanding amount of the sale price by extending the finance tenor and reducing the instalment amount, subject to NOT increasing the outstanding amount of the sale price.
  - No adequate justification/reason, in which case the IFSP can levy a penalty (which shall be donated to charity and not accounted as part of the IFSP's income) to deter the client from missing payments as per the agreed schedule. The IFSP can send also a notice to the client demanding the payment of all outstanding instalments which shall become immediately due. In addition, the IFSP may enforce any security documents (e.g., guarantee).

[21] Islamic insurance if available

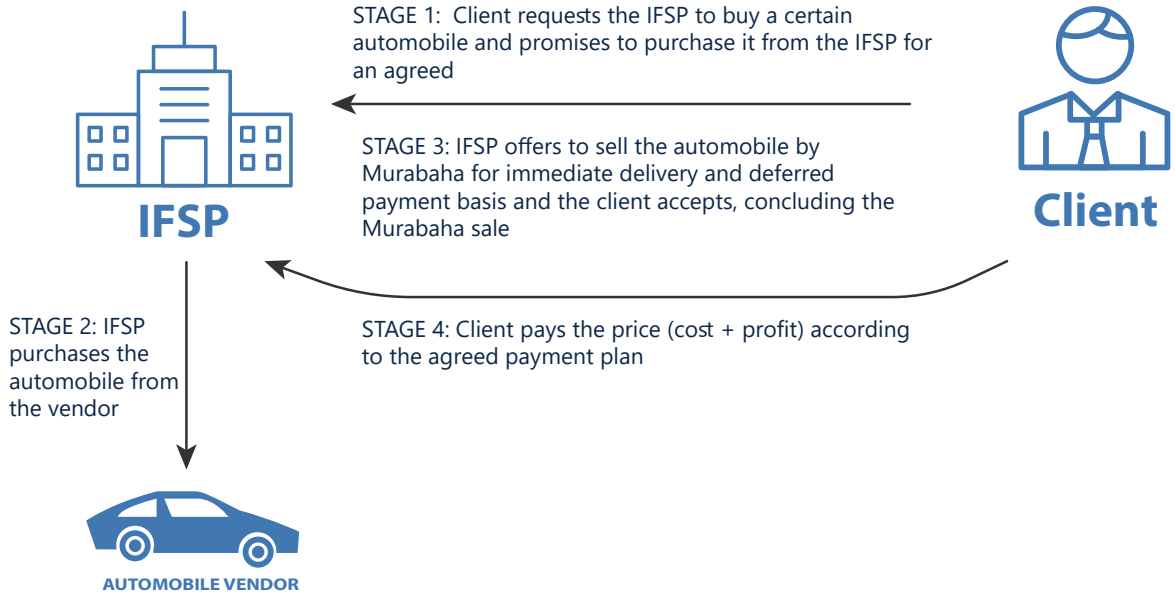
[22] The profit rate is an annual percentage rate that represents the return rate that the IFSP wants to make on their finance/investment amount (cost price) deployed in purchasing the automobile

Security and Risk Mitigation

- The client could be asked to sign a Promise to Purchase Form so that the IFSP will not be left with an asset that is difficult to dispose of after purchasing it. This is a unilateral promise binding on the client only.
- The IFSP may ask the client to pay a security deposit (Hamish Al-Jeddiya[23]) upon signing the Promise to Purchase Form to ensure the client's good faith and seriousness in his order for the automobile. If the client fulfils their binding promise, then this security deposit could be refunded in full (if agreed, it can be considered an advance payment towards the Murabaha instalments).
- If the client does not fulfil their binding promise and the IFSP incurs a loss as a result of the client declining the purchase of the automobile, then the actual loss (mainly the difference between the cost price of the automobile and the sale price to a third party[24]) shall be covered by the security deposit as follows:
  - If the actual loss equals the security deposit, then the IFSP shall use it to cover the loss and the client will not get any refund.
  - If the actual loss is more than the security deposit, then the IFSP may raise additional claim.
  - If the actual loss is less than the security deposit, the remaining balance after settling the loss shall be refunded to the client.
- The IFSP may ask for other types of security as per their relevant credit policies and subject to the SSB approval, where applicable.

4.2.3. Process Flow

Figure 6. Murabaha Auto Finance Process



[23] It is important to not confuse Hamish Al-Jeddiya (security deposit) with Urboun (earnest money). Urboun is an amount of money paid by the buyer upon signing the Murabaha contract in order to secure the sale. If the buyer chooses to proceed with the deal by taking the automobile, then this amount will be considered as part of the sale price. Otherwise, if the buyer decides to terminate the sale (during a certain agreed period) Urboun can be retained by the seller and the buyer will expect no refund whatsoever

[24] Excluding any opportunity cost

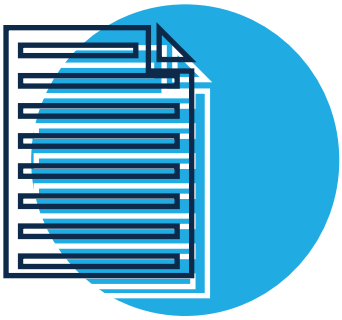
4.3. Personal Finance

4.3.1. Definition

- Personal Finance facilities are designed to help individuals in fulfilling various personal financial needs.
- This section explains how a Personal Finance product can be structured based on Commodity Murabaha.
- The definition and basic Shariah characteristics of Commodity Murabaha have been explained in section 3.5.1 of the Guidelines.

4.3.2. Salient Features and Conditions

- Under a Commodity Murabaha Personal Finance Product, the IFSP, usually upon the client request, purchases a certain commodity from a broker and on sell the same to the client with an agreed/disclosed profit with deferred payment basis (the client typically pays periodic instalments to the IFSP e.g., monthly, quarterly, etc.).
- However, the client needs cash to fulfil their personal needs and not the commodity so they would sell the commodity, either directly or through an agent (which is typically the IFSP), to a second broker and get the needed cash.
- The key Shariah requirements and conditions of Murabaha and Commodity Murabaha that have been explained in section 3.5.2 and 4.2.2 of the Guidelines are applicable to this product.

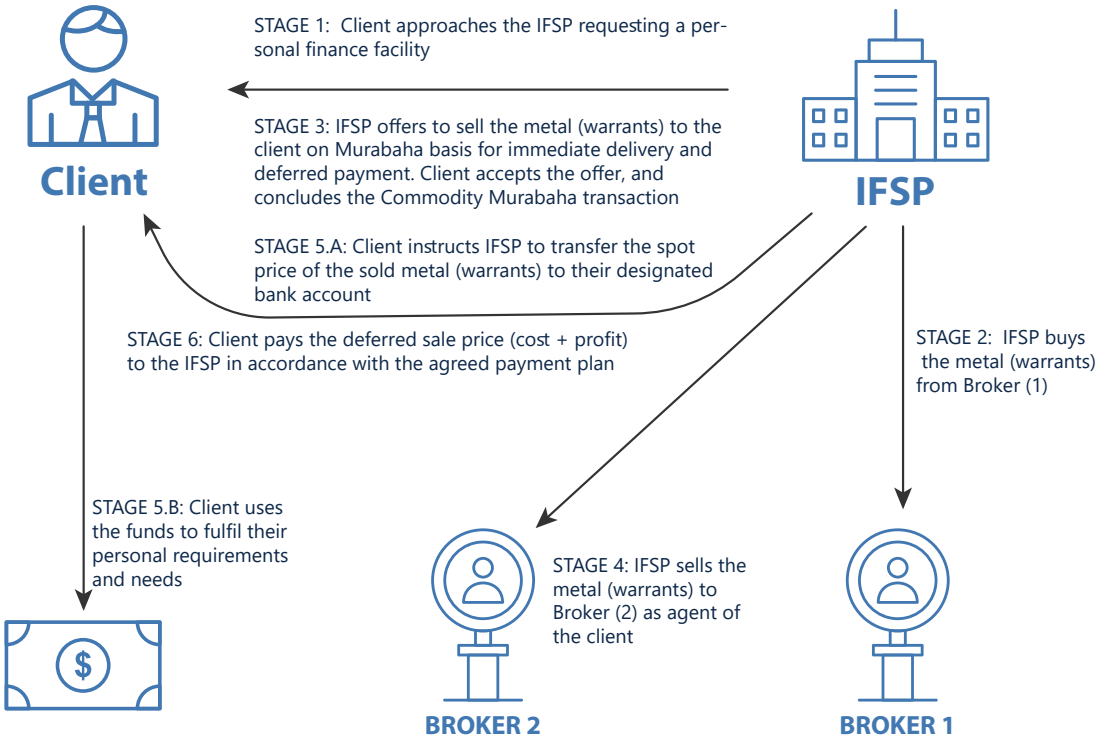


4.3.3. Shariah Analysis

- The Shariah analysis of Commodity Murabaha have been explained in section 3.5.3 of the Guidelines.
- While Commodity Murabaha Finance Products may appear as synthesised interest-based loans. There are, however, a number of major differences between a Commodity Murabaha and an interest-based loan of money as follows:
  - Actual ownership of the underlying commodity.
  - The finance and sale transactions are fully integrated.
  - The finance tenor for a Commodity Murabaha transaction may be extended but no increase in the profit.
  - If a payment is late, no form of penalty may be charged for the profit of the IFSP.
  - Early payment discounts cannot be stipulated in a Commodity Murabaha contract though may be offered at the IFSP's sole discretion.

4.3.4. Process Flow

Figure 7. Commodity Murabaha Personal Finance Process



4.4. Machinery Finance

4.4.1. Definition

- Machinery Finance is a finance facility that can help clients in acquiring bespoke machine(s) that they need to be manufactured according to certain specifications.
- This section explains how a Machinery Finance product can be designed based on Istisna.
- Istisna is a sale contract where the seller, based on the request of the buyer, manufactures/constructs an asset (in this case the machinery) to be delivered on a specific future date.
- Upon delivery, if the quality of the machinery:
  - Matches the agreed specifications, the buyer is compelled to accept it.
  - Is better than the agreed, the buyer is not under an obligation to pay more money to the seller for such extra specifications.
  - Is less than the agreed, then the buyer may:
    - Refuse to accept it; or
    - Accept it without asking for a reduction in the price; or
    - Both parties may agree to reduce the original price.

4.4.2. Salient Features and Conditions

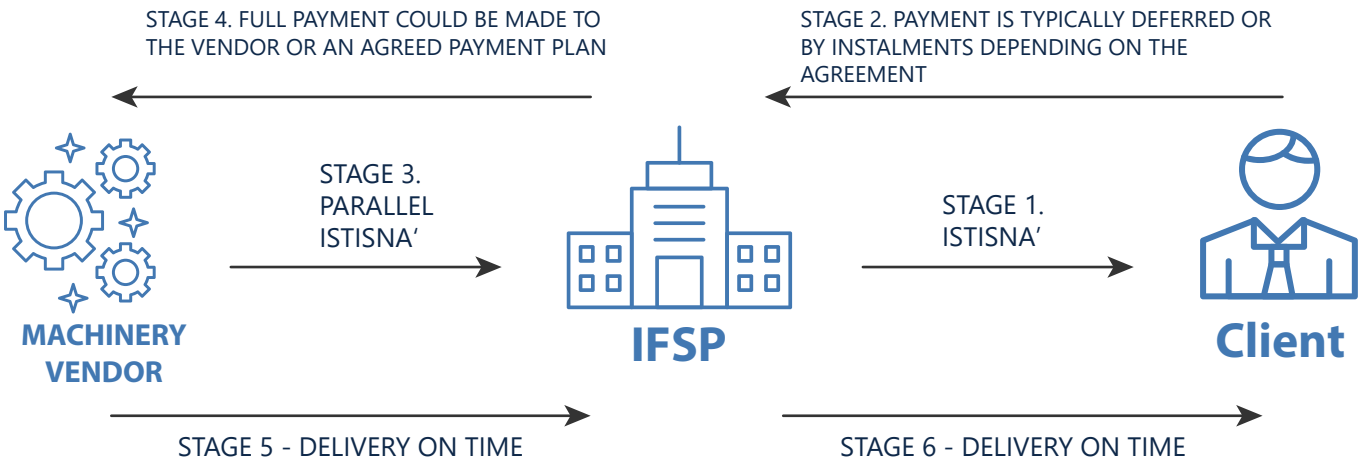
- Under an Istisna Machinery Finance Product, the IFSP, usually upon the client request, sells a certain machinery, to be manufactured and delivered on a specific future date/ timeframe, to the client against an agreed price to be typically paid in accordance with an agreed payment plan. In parallel, the IFSP would enter into another Istisna contract to purchase the requested machinery from the vendor[25].
- The difference between the sale price received from the client and the purchase price paid to the vendor will be the profit of the IFSP.

[25] The vendor is usually proposed/selected by the client

- The machinery to be manufactured in the future according to certain specifications.
- All features and specifications of the machinery should be clearly described and documented at the time of the contract.
- Delivery date/timeframe should be agreed in advance. Reasonable penalty for late delivery of the machinery could be charged to ensure a timely delivery and avoid any losses that could be incurred from late delivery[26]. However, such penalty shall not be applicable in cases of force majeure[27].
- Payment date(s) and method(s) are specified upon concluding the Istisna contract.
- The IFSP will typically sign a parallel Istisna contract with the machinery vendor to fulfil their commitment in the first Istisna contract signed with the client. However, both contracts shall not be interdependent on each other[28].
- While the Istisna contract signed with the client and the parallel Istisna contract signed with the vendor are independent from each other contractually, the IFSP should ensure having similar conditions, where applicable, in these two contracts in terms of machinery specifications, delivery date/time frame, late delivery penalty etc. to mitigate any risks related to issues in the agreed quality/timeframe. Moreover, selecting a vendor that is proposed/requested/approved by the client can assist in mitigating these issues.
- No direct ownership connection shall be present between the client in the first Istisna contract and the machinery vendor in the second Istisna contract.

4.4.3. Process Flow

Figure 8. Istisna Machinery Finance Process



[26] This is a penalty for late delivery of the machine and not a prohibited late payment charge
[27] Key cases of force majeure can be listed and agreed in the contract
[28] E.g., IFSP bears all the responsibilities of the first Istisna contract as if the parallel Istisna contract did not exist

4.5. Agricultural Finance

4.5.1. Definition

- Agricultural Finance is a finance facility that can help clients to get the needed liquidity to support their business activities until their produce are ready for harvesting and sale.
- This section explains how an Agricultural Finance product can be structured based on Salam.
- Salam is a sale contract whereby the buyer should make a full spot payment of the sale price for a certain quantity/quality of a produce to be delivered by the seller at an agreed future date/timeframe.

4.5.2. Salient Features and Conditions

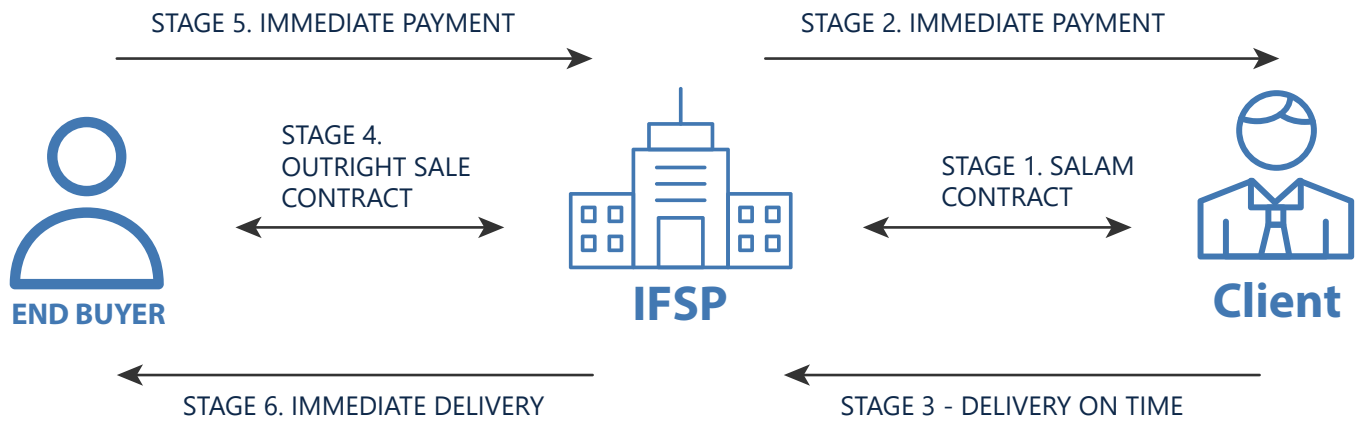
- Under a Salam Agricultural Finance Product, the client forward sells a certain quantity/ quality of agricultural crops to be produced and delivered on a specific future date/ timeframe to the IFSP against a full spot payment of the agreed sale price. Upon the successful delivery of the crops by the client in accordance with the agreed quantity/ quality, the IFSP would sell the crops to an end buyer for a higher spot price[29].
- The difference between the sale price received from the end buyer and the purchase price paid to the client will be the profit of the IFSP[30].
- Sale price should be clearly specified and agreed at the outset of the Salam contract. It should also be paid in full at the time of signing the Salam contract to the client.
- The produce to be delivered by the client must be:
  - Non-existing at the time of contracting (only crops to be produced in the future according to specific description).
  - Measurable (can be weighed, measured, or counted to avoid any ambiguities in relation to quantity).
  - Described thoroughly leaving no place for errors or disputes in terms of the expected quality.
  - General and replaceable (sold in units that are fungible[31]).

[29] The end buyer is usually proposed by the client (typically a customer of the client that wants the produce)
[30] To be determined in line with the IFSP's pricing and business requirements, among other parameters
[31] E.g., selling produce from a specified/designated tree in a certain location is not allowed under a Salam contract

- If the client is unable to deliver the produce in accordance with the agreed quantity/ quality, then they should source the same from the market.
- If all or part of the produce is not available in the market on the delivery date, then the IFSP has the option to:
  - Terminate the Salam contract and get their funds.
  - Wait until the produce is available in the market.
  - Ask the client to replace the produce with another one with a market value not more than the value of the original produce upon delivery[32].
- It is not permissible to stipulate late delivery penalties under a Salam arrangement.
- The IFSP may ask the client to get a suitable insurance policy[33] to cover certain risks related to the produce, subject to the SSB approval.
- As the IFSP do not want to end up owning the produce, the IFSP will secure an exit strategy at the outset (typically through a Promise to Purchase Form[34] provided/signed by an independent end buyer to purchase the produce from the IFSP).
- Upon the successful delivery of the produce, the IFSP would enter into separate/ independent outright sale contract with an end buyer in order to sell the produce for a higher spot price. However, the Salam contract and this outright sale contract shall not be interdependent on each other[35].
- While the Salam contract signed with the client and the outright sale contract signed with the end buyer are independent from each other contractually, the IFSP should ensure having similar conditions, where applicable, in these two contracts in terms of produce quantity, quality, delivery date/time frame, etc. to mitigate any risks related to these issues. Moreover, selecting a trusted end buyer that is proposed by the client and/ or an existing customer of the latter can assist in mitigating these issues[36].
- No direct ownership connection shall be present between the client in the Salam contract and the end buyer in the outright sale contract.

4.5.3. Process Flow

Figure 9. Salam Agricultural Finance Process



[32] Subject to having a clear exist strategy with a potential end buyer
[33] Islamic insurance if available
[34] This should be a legally binding unilateral promise from the end buyer
[35] E.g., IFSP bears all the responsibilities of the Salam contract as if the other contract did not exist
[36] Alternatively, the IFSP may sign a Wakala contract with the client to appoint the latter as their agent with a mandate of selling the produce to a third party at a certain price, subject to a number of conditions (this is typically not a preferred approach by Shariah scholars due to concerns of issues related to segregation of ownerships/ rights/risks etc.)

4.6. Working Capital Finance

4.6.1. Definition

- Working capital finance is a finance facility that can help clients getting the liquidity they need for their day-to-day operations and other business activities[37].
- This section explains how a Working Capital Finance product can be designed based on Investment Wakala.
- The definition and basic Shariah characteristics of Wakala have been explained in section 3.3.1 of the Guidelines.

4.6.2. Salient Features and Conditions

- Under a Wakala Working Capital Finance Product, the client acts as an investment agent of the IFSP to invest the latter's funds (Wakala Funds) in their Shariah compliant business activities[38] (Wakala Activities) with the aim of generating profit.

[37] Excluding purchasing fixed assets including property, equipment etc. or for business investments
[38] It could be all the business activities of the client or certain projects/transactions

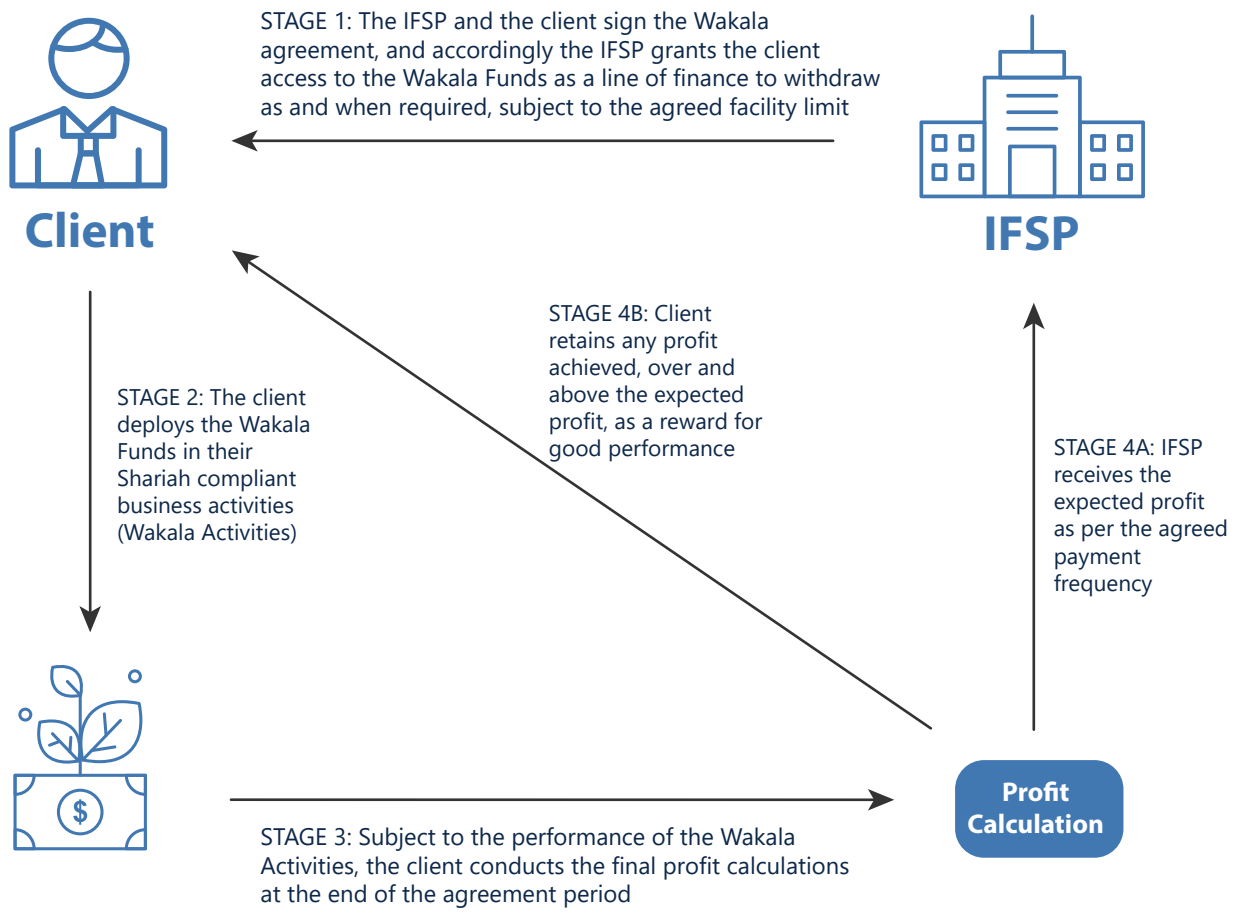
- The agency arrangement between the IFSP and the client will be for an agreed period (e.g., 1 year), renewable subject to consent of contracting parties.
- The client has the right to charge a Wakala fee upon executing the agency agreement and that fee is guaranteed to the client and does not depend on the investment performance. Such Wakala fee is typically symbolic (e.g., $1) so the client/IFSP may agree to drop it.
- The IFSP will provide the Wakala Funds to the client in the form of a line of finance[39] so the latter can withdraw funds as and when required to be deployed in their Shariah compliant business activities (only for working capital purposes).
- The IFSP will allow the client to mix the Wakala Funds with the client's own funds.
- The profit payable[40] to the IFSP will be capped at an agreed EPR[41] and based on the actual performance of the underlying Wakala Activities.
- The client has a fiduciary responsibility so they should duly perform their obligations under the Wakala agreement and look after the interests of the IFSP (i.e., acting as a trustee in investing the Wakala Funds). Therefore, neither the Wakala Funds nor profit are contractually guaranteed for the IFSP.
- The IFSP bears the risk of loss of the Wakala Funds. However, the client should bear any losses in cases of their gross negligence, wilful default, fraud, misconduct, or breach of the agreed Wakala terms and conditions.
- The IFSP should contractually request the client to NOT enter into any transaction that, in the reasonable judgment of the client, might return a lower profit than the agreed EPR (specific approvals from the IFSP could be requested in exceptional circumstances).
- The client shall calculate the actual profit rate achieved periodically[42] and:
  - If the actual profit rate generated by the Wakala Activities is more than the EPR, the IFSP will only receive the expected profit and the client shall hold on trust, for the benefit of the IFSP, any amount that is in excess of the expected profit (the Profit Reserve Amount (PRA)). The PRA will be used to stabilise profit payments during the agreement period and to offset any potential losses[43].
  - If the actual profit rate is less than EPR, the IFSP will only receive the actual profit[44].

[39] Subject to an agreed facility limit
[40] The IFSP may opt for receiving monthly advance profit payments based on the client's usage of the line of finance (amount and duration), but this would remain subject to realising the profit during the agreement period
[41] EPR is an annual percentage rate that represents the return rate that the IFSP is expecting to receive on their funds
[42] In most cases, monthly or quarterly
[43] The client may utilise the PRA for their business activities at their own risk, but it shall return the PRA to the IFSP on demand under certain circumstances (i.e., shortfall of EPR or in case of losses)
[44] The client may elect to top up the profit payment from their own funds to compensate for profit shortfall providing there is no pre-agreed contractual written obligation or pressure applied by the IFSP to do such compensation (this could be done to ensure the client maintains a good credit record)

- The client shall be contractually obliged to monitor the performance and the profitability of the Wakala Activities at all times. The client shall immediately inform the IFSP if the EPR might no longer be achievable.
- The client shall send a notice to the IFSP (1-month notice could suffice), proposing a revised EPR. The IFSP has the option of either accepting the new EPR or terminating the finance facility.
- If the IFSP terminates, the client shall return the Wakala Funds plus any accrued but unpaid profit up to the termination date. At the end of the agreement period, any sums held as PRA will be kept by the client as a reward for achieving the EPR.
- The IFSP may request the client to submit periodic financial performance reports[45] and written undertakings to confirm that the EPR, to the best of the client's knowledge, remains achievable for the coming reporting period (e.g., quarterly reports).
- The aforementioned contractual responsibilities of the client including active monitoring of the performance of the Wakala Activities, periodic performance reporting, and keeping the IFSP informed at all times are Shariah compliant capital-protection arrangements. Hence, any failure in these duties will be construed as negligence from the client which in turn would potentially make the latter as a guarantor for any subsequent losses.

4.6.3. Process Flow

Figure 10. Wakala Working Capital Finance Process



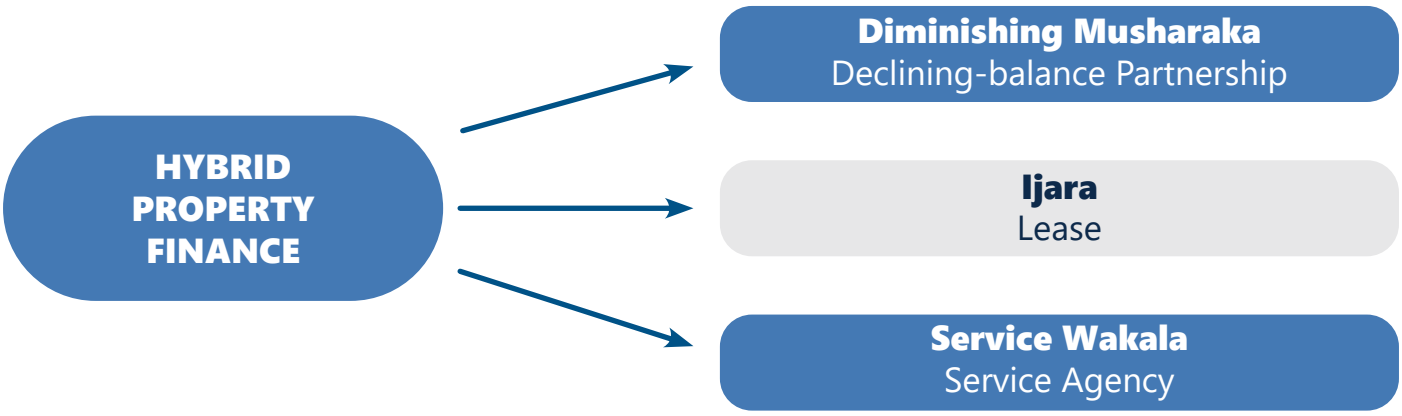
[45] To enable the IFSP to closely monitor the client's business activities

4.7. Property Finance

4.7.1. Definition

- Property finance is a finance facility that can help clients in acquiring properties to be used for residential and/or commercial purposes.
- This section explains how a Property Finance product can be designed using a hybrid and innovative Islamic solution developed in line with the industry's best practices using a unique combination of the following contracts:

Figure 11. Hybrid Property Finance Model



4.7.2. Salient Features and Conditions – Diminishing Musharaka

Diminishing Musharaka is a declining-balance partnership arrangement whereby the IFSP and the client become partners and accordingly co-own a specified property on the basis of profit and loss sharing. Such partnership is established on the premise that the client will gradually purchase the IFSP's shares in the property until the client becomes the sole owner thereof.

Property Price

- Each partner (client and IFSP) shall pay their share of the purchase price of the property according to the agreed split (e.g., 20/80)[46].
- The IFSP and the client will assume all ownership risks for their respective shares.
- The IFSP and the client should ideally have joint legal ownership of the property. However, it could be accepted to vest the legal title in the IFSP or the client for the duration of the partnership while the beneficial interest[47] is jointly shared according to each partner's share in the property (subject to relevant legal requirements and the SSB approval).

Client's Promise

- At the outset, the client will promise the IFSP to make periodic acquisition payments gradually until all shares in the property are completely transferred to the client. Accordingly, the share of each partner should be adjusted periodically.
- This promise should be irrevocable, unilateral and binding on the client

Guaranteeing the Value of Shares

- IFSP and the client are trustees on the shares in the property. Hence, they do not guarantee the shares to each other unless there was negligence, misconduct, wilful default or non-compliance with the terms and conditions of the signed Diminishing Musharaka Agreement. The IFSP and the client may obtain an insurance policy[48] to protect the property from certain risks, subject to the SSB approval.
- IFSP may ask for security against misconduct or negligence of the client.

Sale of the Musharaka Shares to the Client

- The partnership term is divided into equal periods (typically 3 or 6 month periods).
- A mutually agreed formula will be documented in the Diminishing Musharaka Agreement to calculate the acquisition payments to be made by the client periodically. While it is advised from a Shariah perspective to consider market prices of properties for determining the acquisition payments, it could be acceptable for the IFSP/client to agree on fixing the acquisition payments as per the purchase price to keep the product competitive, subject to the SSB approval[49].
- The client may make additional acquisition payments during the partnership term. Moreover, the client can even purchase all IFSP's shares in the property without incurring any additional early settlement charges or penalties (actual administration costs to close the finance facility early could be charged by the IFSP, subject to the SSB approval).

[46] The client share will be technically the deposit paid towards the purchase price of the property

[47] A beneficial interest in a property (or land) gives each partner a financial share in the property, even if they are not a legal owner. This means that they would have the right to get a share in any sale proceeds, or rental income (subject to the provisions/conditions of contracts signed between the IFSP and the client)

[48] Islamic if available

[49] E.g., if the property was purchased for $50,000 the IFSP will sell it for periodic acquisition payments the total of which would eventually be $50,000 (i.e., no profit is made by the IFSP from selling shares in the property). Otherwise, if market prices were used, the product will be highly likely more expensive for clients as property prices tend to increase over the years

Profit and Loss Sharing

- Any profit/loss generated from the property (mainly due to appreciation/ depreciation of the property value) shall be shared between IFSP and the client as per their shares in the property:
  - In terms of profit, IFSP would not make any profit from the sale of their shares to the client. IFSP would further forgo its share in any profit that could be generated from the sale price of the property to a third party to keep the product competitive.
  - In case of loss, the loss shall be distributed among the partners in proportion to their shares in the property. However, such loss won't materialise unless:
    - IFSP has to sell the property at a low price due to the client's default; or
    - There is a total loss in the property and the insurance proceeds (Islamic if available) were not sufficient to cover the dues.
  - Otherwise, other types of loss risks are mitigated through implementing the client's binding promise to purchase IFSP's shares in the property.

End of Partnership

- Diminishing Musharaka could be dissolved in the following cases:
  - At any time during the term of the agreement upon the request of any of the partners and subject to the agreed terms and conditions for termination; or
  - At the end of the partnership term; or
  - If the property is destroyed (insurance will typically cover such loss).
- In all cases, IFSP calculates the sale price of their shares in the property and advises the client to pay accordingly.
- Subject to the SSB approval, sale price of the IFSP shares is typically the outstanding finance amount at the time of ending the partnership to keep the product competitive and comply with business and legal requirements, where applicable.

4.7.3. Salient Features and Conditions – Ijara

- Ijara is a lease arrangement where the IFSP (Lessor) leases their shares in the property to the client (Lessee).
- Ijara is considered a sale of the usufruct of the property by the IFSP against the payment of rent by the client.
- Ijara is a binding arrangement executed through a Master Lease Agreement to determine the general framework of contracting.
- The Master Lease Agreement is executed after entering into the Diminishing Musharaka Agreement.

Property

- The property must be used in a Shariah compliant manner while being preserved and kept in good condition by the client[50].
- The Ijara term typically matches the partnership term.
- The client may sublet the property only after having the IFSP's consent (not to be unreasonably withheld, subject to legal, Shariah, and business requirements).

Ijara Term

- The Ijara term must be clearly specified in the Master Lease Agreement (e.g., 15 years).
- Like the partnership term, the Ijara term is divided into equal periods (typically 3 or 6 month periods).
- The IFSP may revise and amend (increase or decrease) the rent prior to commencement of each rent period.

Insurance, Maintenance and Repairs of the Property

- The IFSP, as a lessor, is responsible for completing the following in relation to their shares in the property:
  - Obtaining and maintaining a proper Islamic insurance (if available, otherwise, conventional insurance could be exceptionally accepted, subject to the SSB approval).
  - Carrying out structural maintenance (the repair work without which the property could not be used reasonably and properly by a lessee) and making any other payments that shall be paid by a lessor (e.g., taxes, service charges, superior landlord's charge etc.).
- The client (as a lessee) or the client's lessee (in case of subletting) shall perform the ordinary maintenance and repair required in respect of the property on a regular basis and at their own cost and expense (e.g., replacing bulbs).
- If the property is destroyed (or the usufruct thereof is impaired) wholly or partially as a result of the client's misconduct or non-compliance with the terms of the Master Lease Agreement, the client will be obliged to restore the property to its original condition and to pay the rent to IFSP for the time during which the property is being fixed.

[50] Properties used for residential purposes are generally considered Shariah compliant. However, properties used for commercial purposes are not always Shariah compliant, depending on the main business activity of the tenant (e.g., renting a shop that is mainly selling alcoholic beverages is not Shariah compliant)

Rent and Pricing

- On the commencement date of the Ijara term, the client becomes obliged to pay rent to the IFSP on the agreed payment dates.
- Prior to the commencement of each rent period (e.g., every 6 months of the Ijara term), the IFSP calculates the relevant rent payments (as per a formula that is agreed in advance to prevent dispute) and sends a notice to the client.
- The formula used to calculate the monthly rent is typically as follows:
  [Applicable Rate x IFSP's share in the property x N / 365] + Supplemental Rent
- The applicable rate is usually the cost of finance rate used by the IFSP to achieve their target return on their shares in the property[51]. The IFSP may refer to rates published by the regulator(s) to assist them in pricing their financial products and remain competitive.
- IFSP's share in the property is the outstanding finance amount.
- 'N' is the number of days in the relevant month.
- Supplemental rent is an additional rent amount that could be charged by the IFSP to cover additional costs related to the property maintenance[52].

Guarantees and Treatment of Rent Receivables

- Shariah compliant security (e.g., legal charge or guarantee) may be taken to:
  - Secure payment of rent; and/or
  - Compensation against misuse of the property
- If the client delays making any rent payment when due, without providing a valid reason that is acceptable to the IFSP, the client shall pay on demand a late payment charge calculated in accordance with an agreed formula. Such late payment charge is not considered as income to the IFSP and shall be donated to charity.
- The IFSP cannot increase overdue rent for previous periods as the latter become debt.
- Notwithstanding the foregoing, the IFSP is advised to reasonably assist clients that are going through financial distress as far as it is practically possible.
- The IFSP may stipulate that in case of default, the client should immediately pay all overdue rent from previous periods in addition to the remaining acquisition payments.

End of Ijara

- The Master Lease Agreement could end in the following cases:
  - At any time during the Ijara term upon the request of any of the parties and subject to the agreed terms and conditions for termination.
  - At the end of the Ijara term.
  - If the property is destroyed or in case of structural damage/loss that impairs the reasonable and proper use of the property (though insurance will typically cover such lost).
  - If the client does not pay the overdue rent payments and the IFSP has already stipulated that the agreement shall be terminated in such case.

[51] The applicable rate is typically fixed at the beginning of each rent period (e.g., every 6 months or 1 year) and reviewed periodically. However, the IFSP may reserve the right to increase or decrease the applicable rate during the Ijara term (Shariah Standards of AAOIFI recommends agreeing on a fixed cap for the applicable rate during the Ijara term)

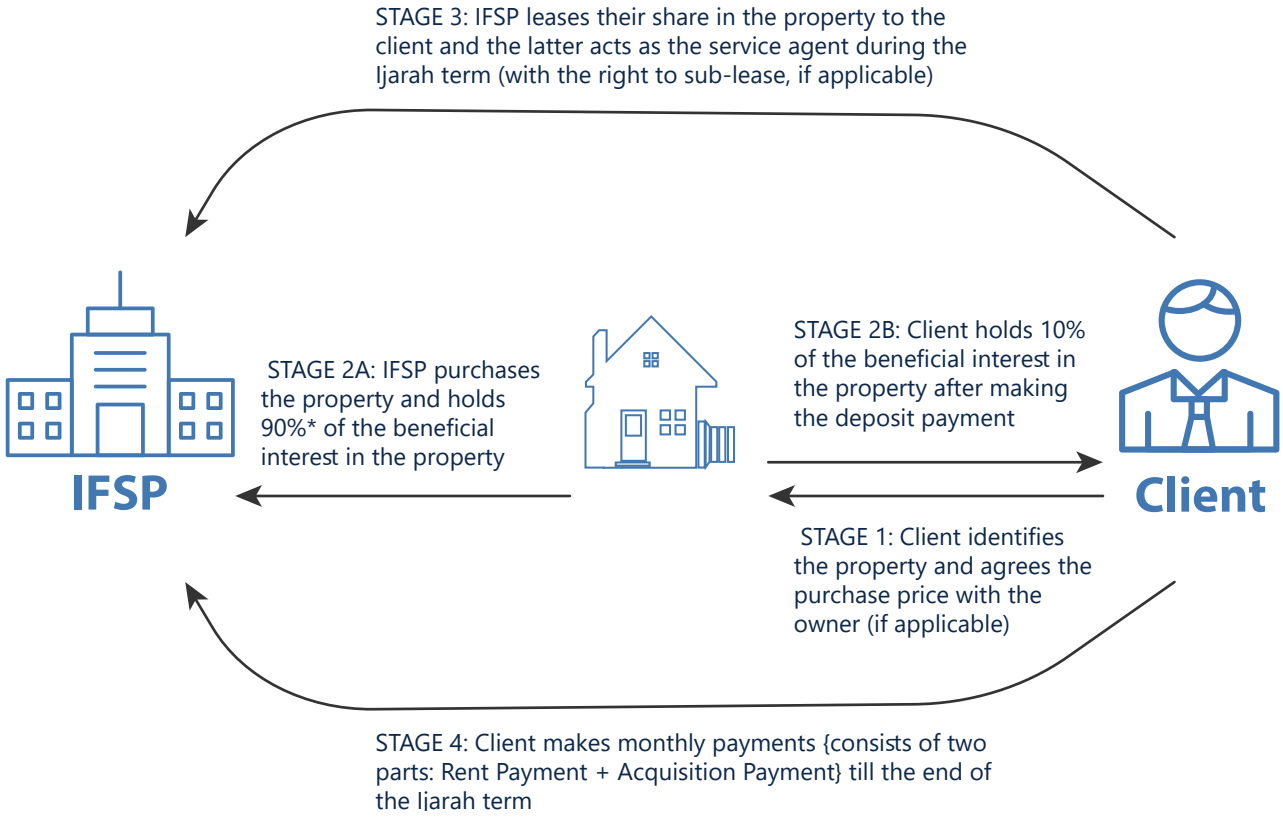
[52] Further details will be provided under the following Service Wakala sub-section

4.7.4. Salient Features and Conditions – Service Wakala

- Service Wakala is an agency arrangement whereby the IFSP (Principal) appoints the client (Service Agent) to insure, maintain (i.e., pay taxes, superior landlord's charges/rent etc.) and make structural repairs to the property on behalf of the IFSP.
- A Service Agency Agreement is typically executed after entering into the Diminishing Musharaka Agreement and the Master Lease Agreement.
- The client, acting as a service agent, has a fiduciary responsibility and hence acts as a trustee in conducting the delegated actions/services on behalf of the IFSP.
- The client may receive a nominal Wakala fee (e.g., $1) as remuneration for exercising their service agency duties on behalf of the IFSP.
- The client shall not appoint a sub-agent except with the permission of the IFSP.
- All costs and expenses incurred by the client in fulfilling their service agency mandate shall be reimbursed by the IFSP subject to receiving evidence of payments (e.g. invoices, receipts etc.).
- Notwithstanding the foregoing and subject to the SSB approval, the IFSP and the client may agree that the IFSP's obligation to pay any costs and expenses incurred by the client in fulfilling their agency mandate shall be offset against the client's obligation to pay the supplemental rent.

4.7.5. Process Flow

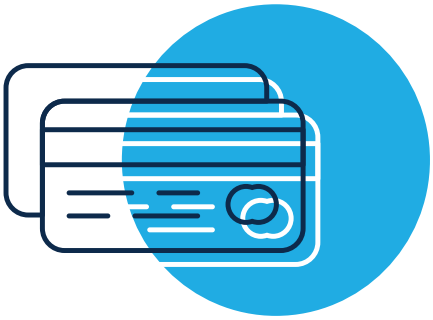
Figure 12. Hybrid Property Finance Process



4.8. Trade Finance

4.8.1. Definition

- This section explains how a Trade Finance product (Letter of Credit) can be designed based on Murabaha.
- The definition and basic Shariah characteristics of Murabaha have been explained in section 3.5.1 of the Guidelines.
- A Letter of Credit (LC) is a documentary credit confirming that an IFSP undertakes to pay the purchase price to an exporter upon receipt of the goods' documents conforming to a set of agreed specifications between the importer (client of the IFSP) and the exporter.
- The LC has two main types as follows:
  - Covered/Partially Covered: where the client (importer) deposits part of, or the entire purchase price of the goods with the IFSP for payment to the exporter upon receipt of the documents in the right order.
  - Financed: where the IFSP finances the entire amount for the purchase of the goods (trade finance).

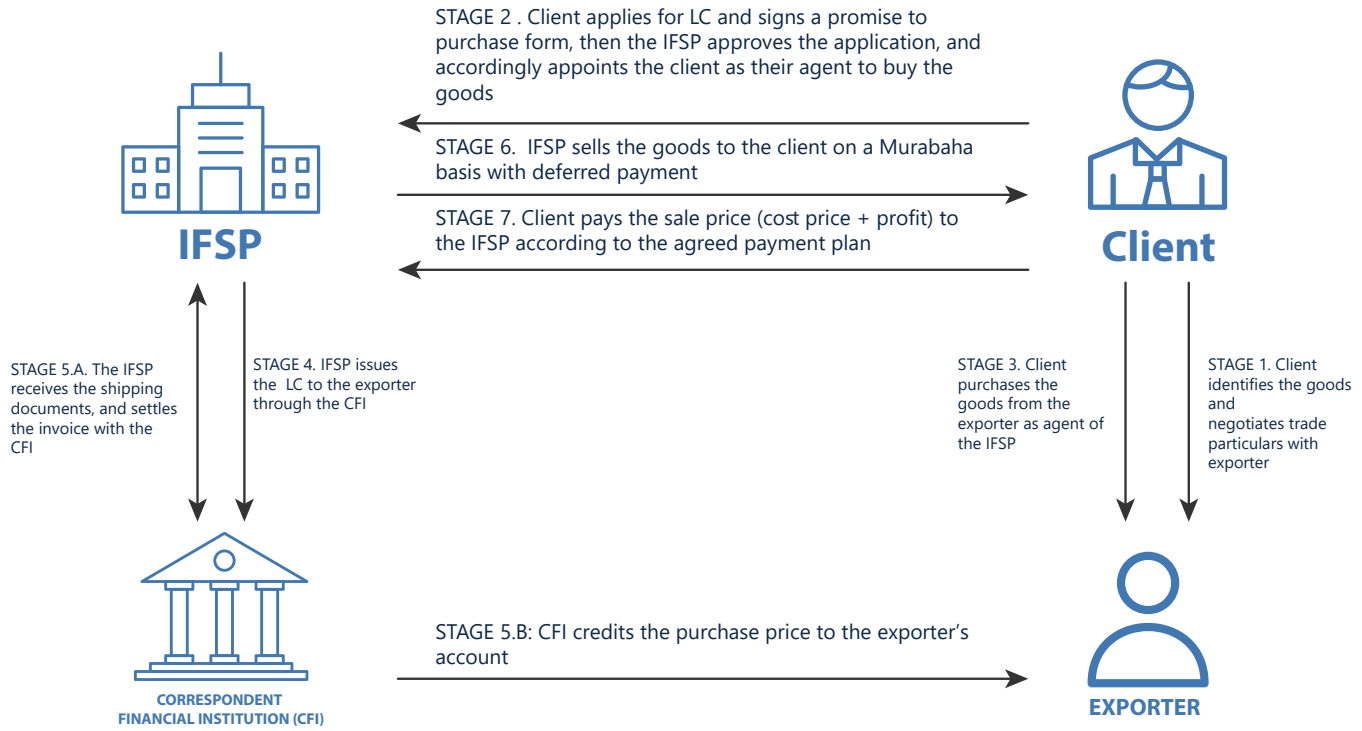


4.8.2. Salient Features and Conditions

- Under a Murabaha Trade Finance Product (LC), the IFSP, usually upon the client request/ promise, purchases certain goods from an exporter (issues the LC to the exporter through a correspondent financial institution) and on sell the same to the client with an agreed/disclosed profit with deferred payment basis (the client typically pays periodic instalments to the IFSP e.g., monthly, quarterly, etc.).
- The key Shariah requirements and conditions of Murabaha that have been explained in section 4.2.2 of the Guidelines are applicable to this product.
- The IFSP can charge the client for the actual expenses incurred in issuing the LC in addition to the profit of the Murabaha sale.
- It is permissible to secure international trade transactions using LCs provided that they comply with Shariah requirements.
- The IFSP should ensure conducting their financial transactions with conventional financial institutions (correspondent) on the basis of non-payment of interest.
- Where an LC involves payments in different currencies, Shariah requirements related to currency exchange must be observed.
- The shipping documents established in the IFSP's name suffice as the evidence of constructive possession and ownership of the goods and the IFSP can endorse the documents in the client's name before or upon their arrival at the relevant port.

4.8.3. Process Flow

Figure 13. Trade Finance Process

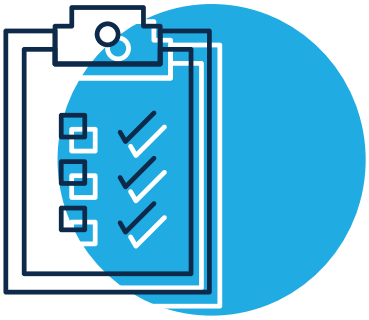


4.9. Key Considerations

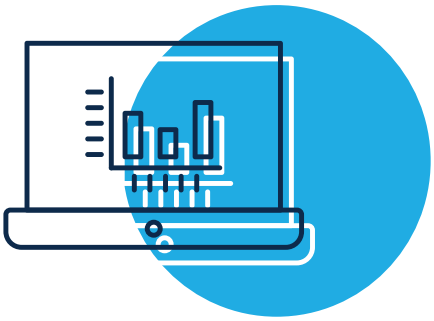
- Depending on the underlying structure, legal documentation for the aforementioned products may include the followings:

PRODUCT	LEGAL DOCUMENTATION
Auto Finance (Murabaha)	o Facility Letter. o Promise to Purchase Form. o Purchase Contract. o Murabaha Contract. o Security Document(s).
Personal Finance (Commodity Murabaha)	o Facility Letter. o Master Commodity Murabaha Agreement. o Security Document(s).
Machinery Finance (Istisna)	o Facility Letter. o Istisna Contract. o Parallel Istisna Contract. o Security Document(s).
Agricultural Finance (Salam)	o Facility Letter. o Promise to Purchase Form. o Salam Contract. o Outright Sale Contract. o Security Document(s).
Working Capital Finance (Wakala)	o Facility Letter. o Investment Wakala Contract. o Security Document(s).
Property Finance (Hybrid[53])	o Facility Letter. o Promise to Purchase Form. o Diminishing Musharaka Agreement. o Master Ijarah Agreement. o Service Agency Agreement. o Security Document(s).
Trade Finance (Murabaha)	o Promise to Purchase Form. o Agency Contract. o Purchase Contract. o LC Documents. o Murabaha Contract. o Security Document(s).

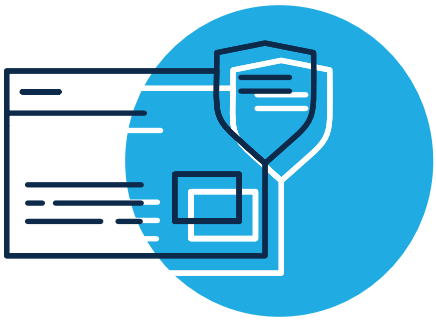
[53] An innovative solution based on a combination of Diminishing Musharaka, Ijara, and Service Wakala



- Operational documentation includes product manuals, processes and procedures, etc.
- All legal and operational documentation for the abovementioned Islamic assets and finance products must be reviewed and approved by the IFSP's SSB.
- The IFSP can set the profit rates of their asset and finance products in line with their business requirements taking into account any relevant regulations and the Shariah characteristics of the underlying contract/ arrangement.
- All fees/charges for any Islamic finance facility should be approved by the SSB.
- Treatment of Islamic asset and finance products in terms of capital adequacy, accounting, taxation, and other areas are defined in the relevant rules and regulations.
- A number of technology software and applications have been developed and used in the Islamic finance industry to streamline the implementation process of the aforementioned products.



5. CUSTODIAN OF THE GUIDELINES



5.1. Ownership and Custody

The Guidelines shall remain in the custody of the AIFC which is the owner, responsible for maintaining, updating, revising, and editing the Guidelines.

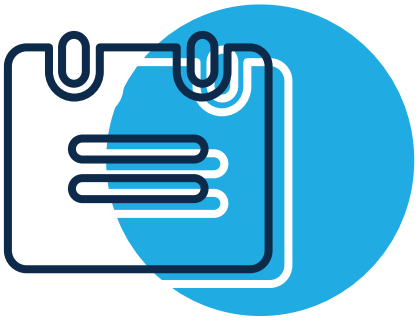
5.2. Revision and Updates

The Guidelines shall stay in effect until replaced by any revised version.

The Guidelines shall be reviewed at least once every 3 years by the AIFC to ensure they remain properly updated.

5.3. Effective Date

The Guidelines shall become effective from DD/MM/YYYY.

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