



MONETARY AUTHORITY OF SINGAPORE

**GUIDELINES ON THE APPLICATION
OF BANKING REGULATIONS
TO ISLAMIC BANKING**

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1 INTRODUCTION

1.1 These guidelines aim to provide banks with guidance on the regulation of Islamic banking in Singapore. They cover MAS' general approach to the regulation of Islamic banking, providing guidance on the admission framework for financial institutions intending to offer Islamic financial services and the regulatory treatment for Islamic banking products, including the capital treatment of such products. These guidelines only cover the application of the Banking Act (Cap 19), Banking Regulations and written directions issued pursuant to the Banking Act, and do not cover the application of other legislation, such as the Directives to the Merchant Banks, the Securities and Futures Act and Financial Advisers Act.

1.2 MAS' Banking Regulations clarifying the treatment of Islamic banking products are set out in regulations 4A, 22, 23, 23A, 23B, 23C, 23D and 23E. These regulations are applicable to a bank licensed under the Banking Act. MAS Notice 637 sets out the minimum capital adequacy ratios for all banks incorporated in Singapore, and the rules that they are required to apply in calculating those ratios. The capital requirements in MAS Notice 637 will apply to Islamic financial products on the same basis as conventional banking products.

1.3 These guidelines seek to clarify MAS' policy on Islamic banking by explaining the regulatory treatment of specific Islamic structures. Nothing in these guidelines modify or detract from the requirements set out in the Banking Act, Banking Regulations, and written directions issued pursuant to the Banking Act. The types and descriptions of Islamic financial structures set out in these guidelines are not intended to be exhaustive, nor do they prescribe a uniform structure for all products named in the guidelines. We have set out descriptions in these guidelines to explain more precisely how the Banking Regulations would apply to specific structures. However financial institutions should seek their own legal advice when structuring the transactions and applying the Banking Regulations.

1.4 MAS will continue to refine the regulatory framework as new Islamic structures evolve, and these guidelines will be reviewed on a periodic basis to ensure their relevance. Please contact MAS if you have any questions on the regulation of Islamic banking which are not covered by these guidelines. Please send your queries to:

Prudential Policy Department
Monetary Authority of Singapore
10 Shenton Way, MAS Building
Singapore 079117
Fax: 62203973
Email: policy@mas.gov.sg

2 MAS' APPROACH TO ISLAMIC BANKING

2.1 MAS' regulatory approach is focused on addressing the risks to the soundness of a financial institution. While Islamic finance has specific features, such as the varying degrees of retention of asset and business risks in Islamic transactions, an Islamic bank is generally exposed to the same types of risks as a conventional bank. Such risks include credit risk, liquidity risk and operational risk, among others. These risks are not dissimilar to those faced by a conventional bank, and many of the prudential and supervisory issues are similar to those for a conventional bank. Thus, MAS has adopted the same regulatory approach towards Islamic and conventional banks.

I ADMISSION OF ISLAMIC BANKS

2.2 MAS applies the same set of admission criteria when considering an application by a conventional bank and an Islamic bank to operate in Singapore. MAS' primary concern, when admitting new players, is the safety and soundness of the new institution. While the unique features of Islamic banking may alter the source and extent of risks¹, MAS does not expect the risk profile of an Islamic bank to be fundamentally different from its conventional banking counterparts. Fundamentally, MAS expects all banks, Islamic or conventional, to remain focused on their core banking business. A sound Islamic bank shares the same hallmarks of a sound conventional bank, all of which are evaluated under the admission criteria publicly available on the MAS website.

2.3 A conventional bank with existing operations in Singapore which wishes to conduct Islamic banking business in Singapore should keep MAS duly informed if any such plans are being made and notify MAS before commencing Islamic banking activities. Every bank should also ensure that they are well-managed and possess the necessary risk management capabilities to offer Islamic banking services.

¹ For example, while the need to comply with *Shariah* laws introduces an additional dimension to an Islamic bank's reputational risk exposure, the nature of the risk is not different from a conventional bank's need to protect its reputation by ensuring that its performance matches up to its representations to its customers.

II SINGLE REGULATORY FRAMEWORK

2.4 MAS' regulatory framework for banks applies to both conventional and Islamic banking, including conventional banks offering Islamic banking services and products. The regulatory framework addresses risks to a bank's soundness – e.g. risk to solvency, liquidity risk, credit risk and market risk – which both Islamic and conventional banks are exposed to.

2.5 As part of the single regulatory framework, a bank carrying out Islamic banking activities will be required to comply with the same set of rules and regulations as any other bank in Singapore, namely the Banking Act, Banking Regulations, Notices and Directives. These rules will include the need to maintain eligible assets (MAS Notice 640), maintain sufficient liquidity buffers (MAS Notice 613), keep ample provisions (MAS Notice 612), observe large exposure limits (Banking Act, section 29), limit property-related exposures (Banking Act section 33), put in place strict anti-money laundering controls (MAS Notice 626) and comply with minimum regulatory capital requirements (MAS Notice 637). Every bank should also observe any general principles laid out in guidelines closely (e.g. Guidelines on Risk Management Practices)

2.6 MAS' approach is to look through the form of the Islamic products to assess the economic substance and risks involved, and use that assessment as the basis for regulation. Where Islamic products are similar to conventional products in economic substance and risks, we accord both the same regulatory treatment. More detailed explanation of the application of these regulations will be set out in Section 3: Regulatory Treatment of Islamic Banking.

2.7 The main risk that Islamic banks face which is unique to them is *Shariah* compliance risk. In addition to managing the risks faced by conventional banks, such as credit, market, operational risks, an Islamic bank also has to ensure that it is in compliance with *Shariah* rulings as this carries significant reputational risk to the bank. As a prudential regulator, MAS does not prescribe what constitutes *Shariah* compliance nor endorse specific *Shariah* rulings. Nevertheless, MAS expects Islamic banks to take into account *Shariah* compliance matters and to manage this compliance risk as part of their overall risk management process². Nothing in these guidelines should be construed as expressing an opinion on *Shariah* acceptability.

² This could include putting in place policies on *Shariah* compliance, resolution processes for disputes relating to rulings, internal *Shariah* review processes, etc. For further examples of some of these practices, banks may wish to refer to IFSB's "Guiding Principles on Corporate Governance For Institutions Offering Only Islamic Financial Services (Excluding Islamic Insurance (*Takaful*) Institutions and Islamic Mutual Funds)".

III SINGLE CAPITAL FRAMEWORK

2.8 MAS Notice 637 sets out the minimum capital adequacy ratios for all banks incorporated in Singapore, and the rules that they are required to apply in calculating those ratios. The capital requirements in MAS Notice 637 will apply to Islamic financial products on the same basis as they apply to other banking products. The examples used in these guidelines are for illustrative purposes only and are not intended to be definitive or exhaustive. The actual application of the requirements in MAS Notice 637 will vary depending on the circumstances of each case. A bank incorporated in Singapore is responsible for making its own assessment of the risks associated with each product and the capital rules that are applicable.

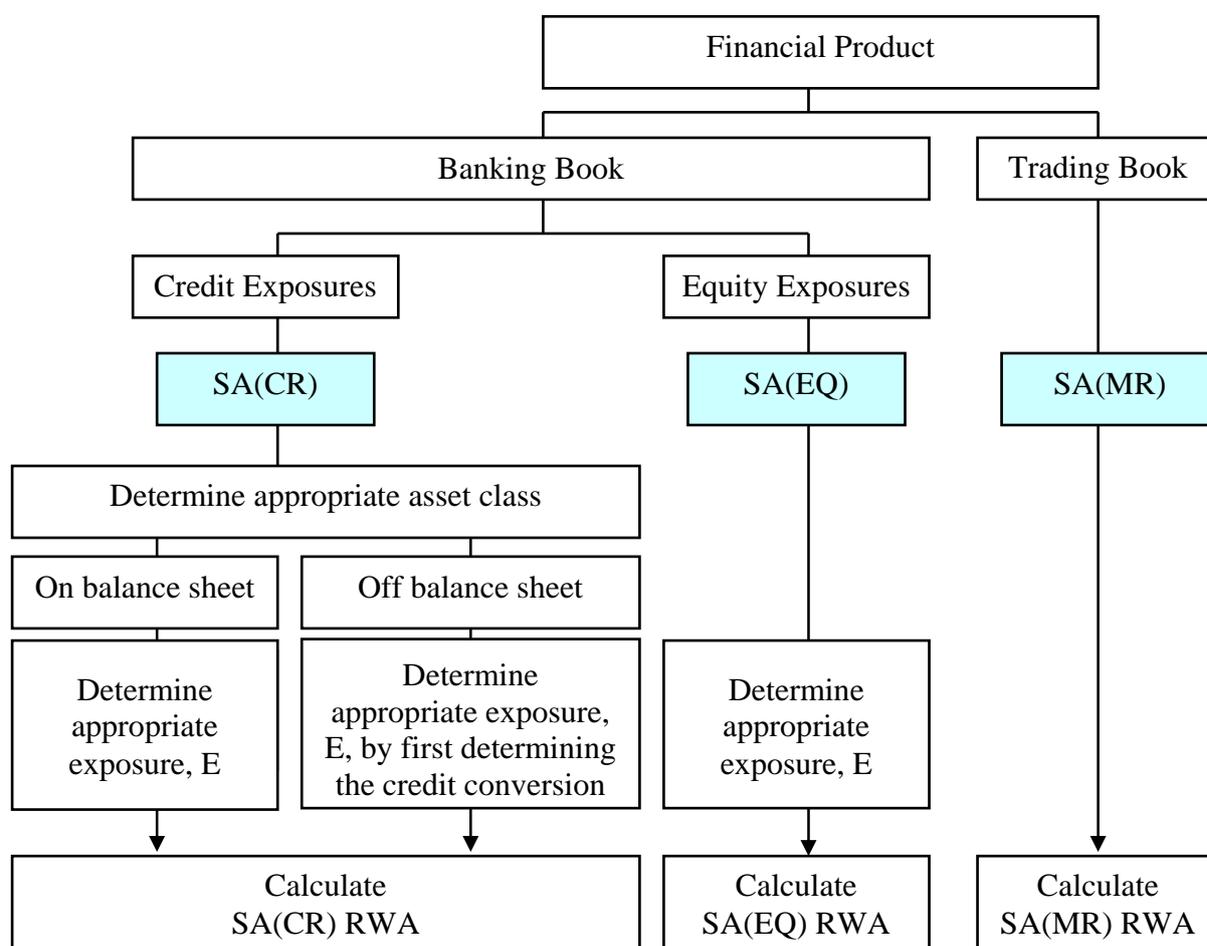
2.9 The decision tree below (Figure A) provides a stylised illustration of the analysis that may be carried out to determine which of the rules in MAS Notice 637 should apply to an Islamic financial product³. As a starting point, a bank incorporated in Singapore has to assess whether the exposure on its books arising from the financial product is to be allocated to its trading book or banking book⁴. This will determine whether Part VII (Credit risk) or Part VIII (Market risk) of MAS Notice 637 is applicable to the financial product⁵.

³ These Guidelines assume the use of the standardised approaches in respect of Islamic financial products currently.

⁴ This assessment should be made in accordance with the definitions of the banking book and trading book in MAS Notice 637 (see Part II and Subdivision 3 of Division 1 of Part VIII).

⁵ For pre-settlement counterparty exposures arising from OTC derivative transactions and SFTs, provisions in both Parts VII and VIII may be applicable (see footnote 103 of MAS Notice 637).

Figure A: Stylised Decision Tree for Determining Capital Requirements



2.10 For exposures where Part VII is applicable, a bank incorporated in Singapore has to determine whether the standardised approach to credit risk (SA(CR)) in Division 3 or the standardised approach to equity exposures (SA(EQ)) in Division 5 should be applied⁶. In making this assessment, the bank should look at the economic substance of the risks to determine if the product has the economic effect of a credit exposure or an equity exposure as defined in paragraph 7.5.1 of MAS Notice 637.

2.11 In a structure where the amount and date of the full principal repayment is contractually agreed upon and determined at the outset, a bank incorporated in Singapore is primarily exposed to the risk that the

⁶ For securitisation exposures, securitised exposures and PE/VC investments, Division 6 and Subdivision 5 of Division 5 of Part VII will apply, as the case may be. These Guidelines assume that the exposures in the illustrations that follow do not fall within the definition of a securitisation exposure, securitised exposure or PE/VC investment.

counterparty will not be able to honour its contractual obligation to repay on the agreed future date (i.e. it is a credit exposure). The bank should, in general, apply the SA(CR) under Division 3 of Part VII of MAS Notice 637 to such an exposure. The bank should use the risk weight that is associated with the relevant asset class listed in paragraph 7.3.1 of MAS Notice 637. For on-balance sheet exposures, the bank should determine the appropriate exposure, E, or where applicable, E*, in accordance with Accounting Standards⁷. For off-balance sheet exposures, the bank should determine the appropriate exposure, E, by multiplying the notional amount of each exposure with the appropriate credit conversion factor, or CCF⁸.

2.12 For exposures that pose risks similar to those arising from equity exposures as defined in paragraph 7.5.1 of Part VII, a bank incorporated in Singapore should apply the SA(EQ) under Division 5 of Part VII of MAS Notice 637.

2.13 Further guidance on the capital treatment of common Islamic products will be provided in Section 3: Regulatory Treatment of Islamic Banking.

⁷ See paragraph 7.2.4 of MAS Notice 637.

⁸ See paragraph 7.2.6 of MAS Notice 637.

3 REGULATORY TREATMENT OF ISLAMIC BANKING

I FUNDING STRUCTURES

4.1 Islamic banks commonly fund their activities through the acceptance of non-interest bearing deposits, such as *wadiah* and *qard hassan* deposits. Banks in Singapore are allowed to offer such non-interest bearing deposits as these deposits satisfy the legal definition of a “deposit” set out in the Banking Act.

4.2 In addition to collecting non-interest bearing deposits, Islamic banks also make use of the *mudaraba* (profit-sharing) structure to collect funds in the form of Profit Sharing Investment Accounts (“PSIAs”). There is an element of risk-sharing in PSIAs, and account-holders contractually agree to bear the losses on the assets which they fund. As the principal sums placed by account-holders with the bank in these PSIAs are not guaranteed at maturity, we do not consider these accounts to be “deposits”. Banks are allowed to offer such products as investment products, and should not be marketing them as “deposits”.

4.3 A third common structure for deposits is the *murabaha* deposit. MAS issued regulations 23 and 4A of the Banking Regulations to allow banks to offer such deposits.

Murabaha Deposit

Regulation 23 and Regulation 4A of the Banking Regulations (“regulation 23 and regulation 4A” respectively)

4.4 In a typical *murabaha* deposit transaction (Figure B⁹), the customer pays a bank a sum of money, and appoints the bank as an agent to purchase assets with the paid sum of money. The customer then sells the assets back to the bank at a price which is higher than the bank’s original purchase price, and receives the bank’s payment on a deferred basis. The mark-up in price is the profit made by the customer. The bank, after purchasing the assets from the customer, sells the assets to an external party.

4.5 In such transactions, as a result of the mark-up sale, the customer has a contractual claim on the bank for the amount of money he earlier paid to the bank plus the mark-up. The payoffs and risks in making a *murabaha* deposit are similar to that of a deposit placed in the conventional banking system. In recognition of the similarity in economic substance and risks between a *murabaha* deposit and a conventional deposit, banks are allowed to collect

⁹ All diagrams in these guidelines are for illustrative purposes only.

murabaha deposits under regulation 23, and regulation 4A was issued to augment the definition of deposits in the Banking Act to include monies paid in the form of *murabaha* deposits.

4.6 For regulation 23 and regulation 4A to apply, the bank has to ensure that (1) the customer undertakes to sell the assets which the bank has purchased on his behalf, and the bank then on-sells the assets; (2) both parties do not derive gains or suffer losses from fluctuations in the price of the assets; (3) the mark-up charged by the customer does not depend on the market value of the asset; and (4) the payment by the bank to the customer is on a deferred basis. The bank is to notify MAS whenever it intends to accept *murabaha* deposits. Throughout the transaction, the bank is expected to minimise the holding period of the assets so as to avoid being exposed to the price movements of the assets. Incidental risks arising from operational and legal arrangements are acceptable, insofar as such arrangements are made with best effort to minimise risks in the first place.

REGULATION 23

Prescribed purchase and sale business

23.—(1) For the purposes of section 30(1)(d) of the Act, and subject to paragraph (2), the business of purchasing and selling assets is prescribed as a business that any bank in Singapore may carry on, or enter into any partnership, joint venture or other arrangement with any person to carry on, if such business is carried on under the following arrangement:

- (a) for the purpose of making funds of a customer available to a bank, the customer appoints the bank or any other person as agent, to purchase on his behalf, an asset, in circumstances where the asset is existing at the time of the purchase;
- (b) an amount of money (the original price) is paid by the customer to the bank or such other person referred to in sub-paragraph (a), as the case may be, for the purchase of the asset;
- (c) the bank purchases the asset from the customer at a price (the marked-up price) that is greater than the original price, and sells the asset;
- (d) the bank and customer, respectively, do not derive any gain or suffer any loss from any movement in the market value of the asset other than the difference between the marked-up price and the original price (which represents the profit or return to the customer for making funds available to the bank); and
- (e) the marked-up price or any part thereof is not required to be paid by the bank to the customer until after the date of sale of the asset by the bank.

(2) The bank shall notify the Authority of its —

- (a) intention to commence the business referred to in paragraph (1); or

(b) commencement of such business within 14 days after the commencement of such business.

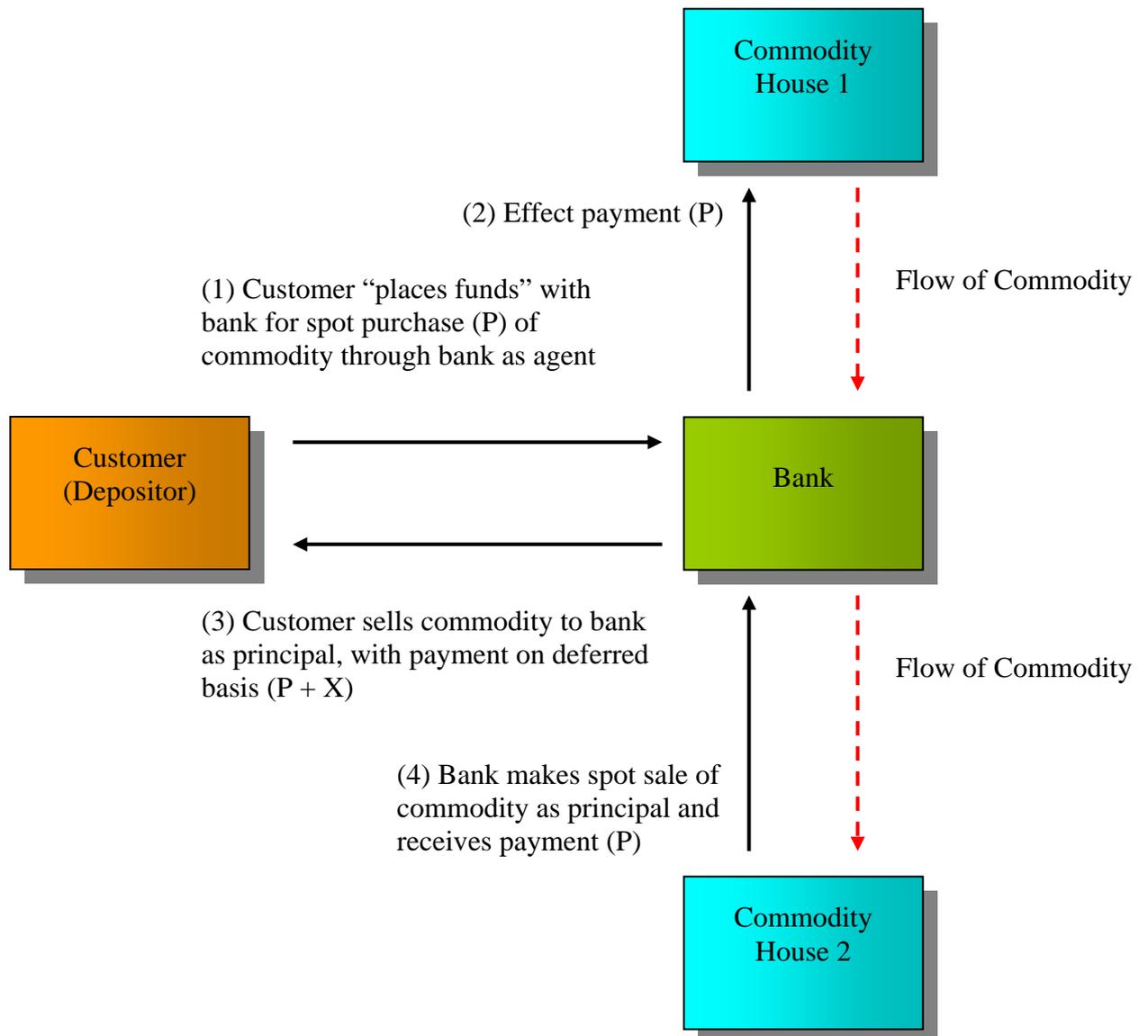
REGULATION 4A

Prescribed deposit

4A. For the purposes of section 4B(4)(b) of the Act, a sum of money paid by a person (*A*) to another person (*B*) or any other person as an agent of *A* is prescribed as a deposit made by *A* with *B*, if it is paid for the purpose of making funds of *A* available to *B* and under the following arrangement:

- (a) the payment is made to enable *B* or the agent to purchase an asset on behalf of *A*, being an asset that exists at the time of the purchase;
- (b) *B* purchases the asset from *A* at a price (the marked-up price) that is greater than the sum of money paid by *A*, and sells the asset;
- (c) *A* and *B*, respectively, do not derive any gain or suffer any loss from any movement in the market value of the asset other than the difference between the marked-up price and the sum of money paid by *A* (which represents the return to *A* for making funds available to *B*); and
- (d) no part of the marked-up price is required to be paid by *B* to *A* until after the date of sale of the asset by *B*.

Figure B: Structure of a *murabaha* deposit



II FINANCING STRUCTURES AND INVESTMENTS

4.7 On the asset side, an Islamic bank invests in *sukuk* and equity-based investments. There are also a number of common Islamic structures which banks use to provide financing. These typically involve a bank trading in and holding tangible assets, such as commodities and immovable property, or sharing risks with their customers through the use of partnerships or equity participation. There is generally extensive use of risk mitigation which lower or limit the risks of asset ownership to the bank and have the effect of leaving the Islamic bank primarily exposed to the credit risk of the customer being financed. We have issued regulations on commonly used Islamic financing structures to provide greater clarity on the regulatory treatment of such structures. The capital requirements in MAS Notice 637 will also apply to Islamic financial assets held by a bank incorporated in Singapore on the same basis as they apply to other banking products.

Murabaha Financing

Regulation 22 of the Banking Regulations (“regulation 22”)

4.8 Regulation 22 allows banks to enter into *murabaha*-based (mark-up) financing arrangements (Figure C). In such a transaction, a bank generally purchases the asset to be financed, and then sells it to the customer at a mark-up, to be paid on a deferred basis.

4.9 For a *murabaha* financing transaction to fall within regulation 22, the mark-up must represent the profit to the bank for providing financing, and the bank’s profit should not be dependent on the market value of the asset. We also expect the bank to ensure that it takes on little additional risk from its ownership of the asset, such as by minimising the time between the purchase and sale of the asset, and ensuring that the customer is under a legal obligation to take delivery of the asset. The main risk the bank should be exposed to is the credit risk of the customer, although it may also be exposed to some legal and operational risks. The payment by the customer can be either in a lump sum, or in instalments. The bank can also choose to take security over the underlying asset in a *murabaha* to enforce the repayment of the amount owed.

Capital Treatment

4.10 Where a structure falls within the definition of a *murabaha* financing structure as stipulated above, the bank should treat the amount $\$(P+X)$ as a credit exposure and apply the SA(CR) under Division 3 of Part VII of MAS Notice 637 (refer to Figure C).

REGULATION 22

Prescribed alternative financing business

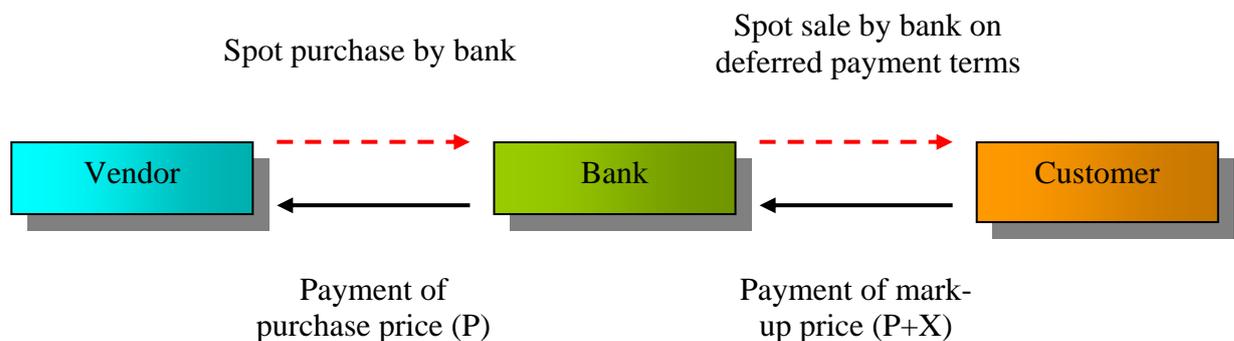
22.—(1) For the purposes of section 30 (1) (d) of the Act, and subject to paragraph (2), the Authority hereby prescribes the business of purchasing and selling assets as a business that any bank in Singapore may carry on, or enter into any partnership, joint venture or other arrangement with any person to carry on, if such business is carried on under the following arrangement:

- (a) the bank, at the request of and for the purpose of financing the purchase of each of those assets by a customer, purchases the asset from the seller in circumstances where the asset is existing at the time of the purchase;
- (b) the bank sells the asset to the customer;
- (c) the customer is under a legal obligation to the bank to take delivery of the asset;
- (d) the amount payable by the customer for the asset (the marked-up price) is greater than the amount paid by the bank for the asset (the original price), and the difference between the marked-up price and original price is the profit or return to the bank for providing such financing to the customer;
- (e) the bank does not derive any gain or suffer any loss from any movement in the market value of the asset other than as part of the profit or return referred to in sub-paragraph (d); and
- (f) the marked-up price or any part thereof is not required to be paid until after the date of the sale.

(2) The bank shall notify the Authority of its —

- (a) intention to commence the business referred to in paragraph (1); or
- (b) commencement of such business within 14 days after the commencement of such business.

Figure C: Structure of a *murabaha* financing contract



Murabaha Interbank Placements

Regulation 23A of the Banking Regulations (“regulation 23A”)

4.11 Regulation 23A expands the scope for *murabaha* transactions by allowing *murabaha* interbank placements, which are important liquidity instruments for Islamic banks. (Figure D)

4.12 A *murabaha* interbank placement closely follows the structure of *murabaha* deposit permitted under regulation 23. The key difference lies in the parties involved – instead of a non-bank customer, a bank is the party placing the funds. Bank A appoints Bank B as an agent to purchase assets on its behalf, and places a sum of money with Bank B to fund the purchase. Upon receiving the assets, Bank A sells the assets to Bank B at a marked-up price – original purchase price plus a margin. Bank B buys the assets, pays Bank A on a deferred basis, and sells the assets to an external party. This structure allows Bank A to place a sum of money with Bank B, similar to the *murabaha* deposit.

4.13 The qualifying conditions for regulation 23A are: (1) both banks are obliged to complete their respective purchase or sale transactions; (2) both banks do not derive any gains or suffer any losses from changes in price of the assets; and (3) the mark-up charged by Bank A is set independently from the price of the asset and represents its only gain in the transaction. Banks can be in the role of either Bank A or Bank B, and should inform MAS whenever they decide to conduct such transactions.

4.14 There are other possible variations to this structure. For example, Bank B, after being appointed as an agent for Bank A, could appoint its own agent to buy and sell the assets. Another possibility is for Bank B to deal with a single external party when purchasing and selling assets. In general, these variations do not alter the underlying economic substance of the transaction and are thus accepted within regulation 23A.

Capital Treatment

4.15 Where a structure falls within the definition of a *murabaha* interbank financing structure as stipulated above, the bank should treat the amount $\$(P+X)$ as a credit exposure and apply the SA(CR) under Division 3 of Part VII of MAS Notice 637 (refer to Figure D).

REGULATION 23A

Prescribed inter-bank purchase and sale business

23A.—(1) For the purposes of section 30(1)(d) of the Act, and subject to paragraph (3), the business of purchasing and selling assets is prescribed as a business that any bank in Singapore may carry on, or enter into any partnership, joint venture or other arrangement with any person to carry on, if such business is carried on under the following arrangement:

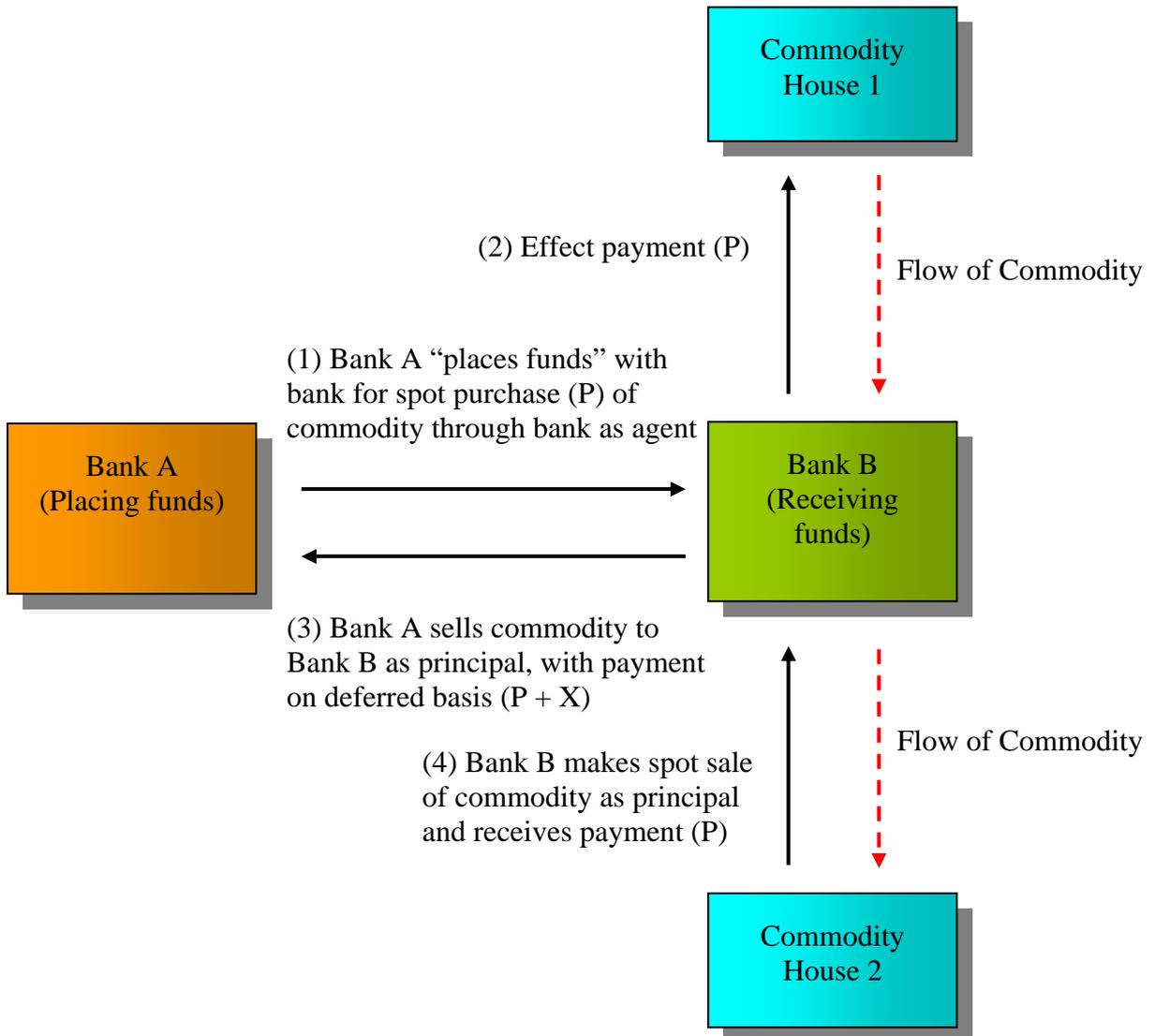
- (a) for the purpose of making funds of the bank (“A”) available to another bank or merchant bank (“B”), A purchases, or appoints B or any other person as an agent of A to purchase on its behalf, an asset for an amount of money (the original price), in circumstances where the asset is existing at the time of the purchase;
- (b) B purchases the asset from A at a price (the marked-up price) that is greater than the original price, and sells the asset, or appoints A, or any other person as an agent of B, to sell the asset on its behalf;
- (c) A and B, respectively, do not derive any gain or suffer any loss from any movement in the market value of the asset other than the difference between the marked-up price and the original price (which represents the profit or return to A for making funds available to B); and
- (d) the marked-up price or any part thereof is not required to be paid by B to A until after the date of sale of the asset by B.

(2) For the purposes of section 30(1)(d) of the Act, and subject to paragraph (3), the arrangement set out in paragraph (1), in circumstances where the roles of A and B are reversed, is prescribed as a business that any bank in Singapore may carry on or enter into any partnership, joint venture or other arrangement with any person to carry on.

(3) The bank shall notify the Authority of its —

- (a) intention to commence the business referred to in paragraph (1); or
- (b) commencement of such business within 14 days after the commencement of such business.

Figure D: Structure of a *murabaha* interbank placement



Ijara wa iqtina

Regulation 23B of the Banking Regulations (“regulation 23B”)

4.16 Regulation 23B clarifies the regulatory treatment of *ijara wa iqtina* transactions (Figure E). An *ijara wa iqtina* financing typically involves a bank purchasing an asset at the request of the customer, and then leasing the asset to the customer. The lease will generally end either by the bank transferring the ownership of the asset to the customer at the end of the lease term, or by the customer terminating the lease early and purchasing the asset from the bank at a price agreed upfront.

4.17 For an *ijara wa iqtina* financing to fall within regulation 23B, while the bank has ownership of the asset for the duration of the lease, the customer or a third party must be appointed as a service agent to take on the obligations in connection with the use of the asset, including but not restricted to the maintenance and insurance of the asset. The bank has to pass on the ownership of the asset by the end of the lease. We also expect banks to ensure that they are protected against losses from movements in the market value in the asset, including the total loss of the asset, such as through ensuring that there is adequate insurance. The profits that the banks make should be a return for providing financing, and be independent of the market value of the asset. Such financing structures are similar to finance leases in terms of risks.

4.18 Regulation 23B also allows for variations on the typical *ijara wa iqtina* financing structure, such as when a third party purchases the asset from the bank instead of the customer, or a third party is appointed as the service agent to take on the obligations in connection with the use of the asset.

Capital Treatment

4.19 Where a structure falls within the definition of an *ijara wa iqtina* financing structure as stipulated above, the bank should calculate an exposure to the customer equivalent to the discounted stream of lease payments by applying the SA(CR) under Division 3 of MAS Notice 637.

REGULATION 23B

Prescribed leasing business

23B.—(1) For the purposes of section 30(1)(d) of the Act, and subject to paragraph (2), the business of leasing assets (whether in the form of movable or immovable property) is prescribed as a business that any bank in Singapore may carry on, or enter into any partnership, joint venture or other arrangement with any person to carry on, if such business is carried on under the following arrangement:

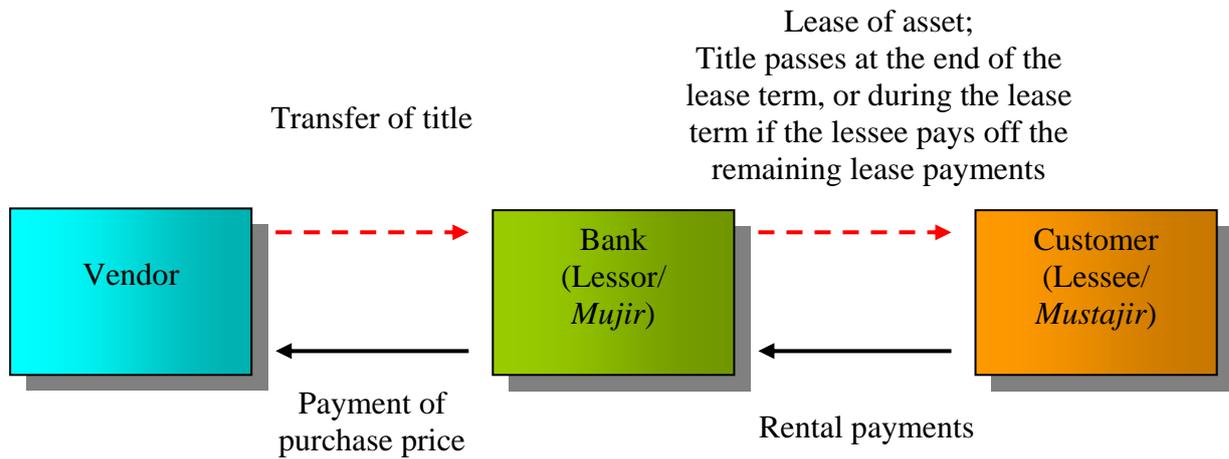
- (a) the bank, or the bank's agent, purchases an asset at the request of a customer for an amount of money (the original price) for the purposes of financing the use or purchase, or both, of the asset by the customer;
- (b) the bank, or the bank's agent, leases the asset to the customer;
- (c) in a case where the asset is not in existence at the time the bank, or the bank's agent, leases the asset to the customer, an amount of money (the advance payment) may be paid by the customer to the bank, or the bank's agent, for the subsequent use of the asset;
- (d) an amount of money (the rental) is paid by the customer to the bank, or the bank's agent, for the lease of the asset;
- (e) the bank, or the bank's agent, appoints the customer, or a third party, to take on the obligations in connection with the use of the asset, including its maintenance and insurance;
- (f) in the event of an early termination of the lease, the customer, or a third party, shall purchase the asset from the bank, or the bank's agent, at a price determined at the start of the lease (the early termination price);
- (g) upon expiry of the lease —
 - (i) where the aggregate of all rental and advance payments made under the lease is greater than the original price, the bank, or the bank's agent, shall, whether with or without consideration, transfer the ownership of the asset to the customer or a third party;
 - (ii) where the aggregate of all rental and advance payments made under the lease is equal to or less than the original price, the customer or a third party shall purchase the asset from the bank, or the bank's agent, at a sale price determined at the start of the lease (the sale price), which amount shall be consideration for the transfer of the asset;
- (h) the total amount payable by the customer and such third party referred to in either sub-paragraph (f) or (g), if any, for the asset comprising —
 - (i) the advance payment;
 - (ii) the rental; and
 - (iii) the sale price or early termination price,
 is greater than the original price, and the difference between the total amount payable and original price is the profit or return to the bank for providing such financing to the customer;
- (i) the bank, or the bank's agent, does not derive any gain or suffer any loss from any movement in the market value of the asset, including total loss of the asset, other than as part of the profit or return referred to in sub-paragraph (h).

(2) The bank shall notify the Authority of its —

- (a) intention to commence the business referred to in paragraph (1); or

(b) commencement of such business within 14 days after the commencement of such business.

Figure E: Structure of a typical *ijara wa igtina* contract



Diminishing Musharaka

Regulation 23C of the Banking Regulations (“regulation 23C”)

4.20 A diminishing *musharaka* transaction (“DM”) is a joint ownership arrangement where a bank gradually sells its portion of the jointly owned asset to the customer, allowing its share of the asset to “diminish” over time. (Figure F) DM transactions are commonly combined with leasing arrangements, where the bank leases its share of the asset to the customer, thus allowing the customer to use the asset entirely while redeeming ownership. The asset can be in the form of property, vehicles, machinery or commodities.

4.21 Regulation 23C permits the conduct of DM transactions, provided certain conditions are met. The sum of payments (i.e. rent and instalment) made by the customer to the bank must exceed the bank’s original contribution, with the excess representing a return to the bank for providing financing. This return must be agreed to by the bank and the customer at the start of the transaction. The bank is also required to appoint the customer or a third party as service agent to take on the obligations in connection with the use of the asset, including but not restricted to the maintenance and insurance of the asset. The bank should not be exposed to fluctuations in the market value of the asset, except in the event of a default by the customer. In such a case, the bank may structure the loan as a non-recourse mortgage and suffer a loss if in the sale of the asset as collateral, the proceeds are insufficient to cover the amount due from the customer. Finally, the co-owned asset must ultimately be wholly owned by the customer.

Capital Treatment

4.22 Where a structure falls within the definition of a diminishing *musharaka* financing structure as stipulated above, the bank should apply the SA(CR) under Division 3 of Part VII of MAS Notice 637. For example, in the case of a diminishing *musharaka* where the asset is a residential property, the bank should apply the risk weights under the residential mortgage asset class¹⁰ of SA(CR). For other types of tangible assets, the bank should apply a 100% risk weight under the other exposures asset class¹¹ of SA(CR). The amount that should be risk-weighted, E¹², will be the outstanding redemption amount due to the bank at the relevant time.

¹⁰ See paragraph 7.3.1(h) of MAS Notice 637 for criteria applicable to the residential mortgage asset class.

¹¹ See paragraph 7.3.1(i) of MAS Notice 637 for the scope of the other exposures asset class.

¹² See Division 2 of Part VII of MAS Notice 637 for the rules relating to the calculation of E.

REGULATION 23C

Prescribed joint purchase and periodic sale business

23C.—(1) For the purposes of section 30(1)(d) of the Act, and subject to paragraph (2), the business of jointly purchasing and selling (on a periodic basis) assets (whether in the form of movable or immovable property) is prescribed as a business that any bank in Singapore may carry on, or enter into any partnership, joint venture or other arrangement with any person, if such business is carried on under the following arrangement:

- (a) the bank, or the bank's agent, jointly purchases an asset with the customer at the request of the customer and contributes an amount of money towards the purchase price (the contribution) for the purposes of financing the use or purchase, or both, of the asset by the customer;
- (b) the bank, or the bank's agent —
 - (i) sells a portion of its share of the asset on a periodic basis to the customer for an amount of money determined at the start of the arrangement (the redemption); and
 - (ii) leases the unsold portion of its share of the asset to the customer for an amount of money determined at the start of the arrangement (the rental);
- (c) in a case where the asset is not in existence at the time of the joint purchase and the bank, or the bank's agent, leases the unsold portion of its share of the asset to the customer, an amount of money (the advance payment) may be paid by the customer to the bank, or the bank's agent, for the subsequent use of that portion of the asset;
- (d) the bank, or the bank's agent, appoints the customer, or a third party, to take on the obligations in connection with the use of the asset, including its maintenance and insurance;
- (e) in the event of an early termination of the arrangement, the customer shall purchase from the bank, or the bank's agent, the remainder of the unsold portion of the bank's, or the bank's agent's, share of the asset at a price determined at the start of the arrangement (the early termination price);
- (f) upon expiry of the arrangement, the customer shall have purchased from the bank, or the bank's agent, the whole of its share of the asset and obtained full ownership of the asset;
- (g) the total amount payable by the customer for the asset comprising —
 - (i) the advance payment;
 - (ii) the redemption;
 - (iii) the rental; and
 - (iv) the early termination price;

is greater than the contribution, and the difference between the total amount payable and the contribution is the profit or return to the bank for providing such financing to the customer;

(h) the bank, or the bank's agent, does not derive any gain or suffer any loss from any movement in the market value of the asset, including total loss of the asset, other than as part of the profit or return referred to in sub-paragraph (g), except in circumstances provided in sub-paragraph (i);

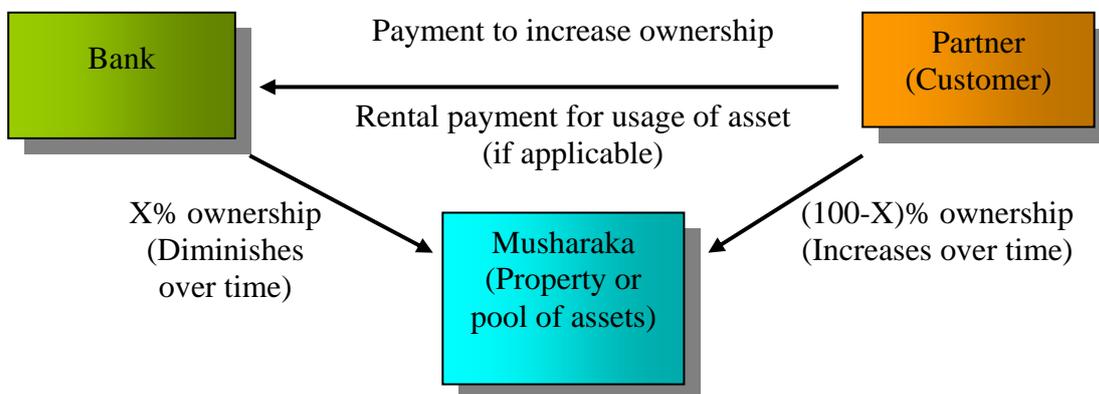
(i) in a case where the customer is unable to pay the bank, or the bank's agent, the early termination price, the bank, or the bank's agent may sell the asset to a third party at a price lower than the outstanding amount payable by the customer.

(2) The bank shall notify the Authority of its —

(a) intention to commence the arrangement referred to in paragraph (1); or

(b) commencement of such arrangement within 14 days after the commencement of such arrangement.

Figure F: Structure of a typical diminishing *musharaka* contract



Spot Murabaha

Regulation 23D of the Banking Regulations (“regulation 23D”)

4.23 Spot *murabaha* transactions involve the purchase of assets at a marked-up price, similar to the other forms of *murabaha* transactions set out above, with one key difference – the purchase price is paid immediately (hence “spot”) and not on a deferred basis. Spot *murabaha* transactions are used together with unilateral undertakings from either a bank or its counterparty, to effect immediate payments as part of financial transactions. (Figure G) These financial transactions include hedging instruments (e.g. profit rate swap) and investment-based transactions where the ultimate payout is linked to an external rate (e.g. performance of an index). The unilateral undertakings will be used to fix the formula for the ultimate payout, which are then executed through a spot *murabaha* transaction.

4.24 For a spot *murabaha* transaction to be permitted under regulation 23D, the payout to be effected must be pursuant to a financial transaction, as defined in the Banking Act. These are the activities set out in sections 30(1)(a),(b) and (c) of the Banking Act. A bank has to avoid taking on non-financial risks. This necessarily means that the bank is not allowed to take physical delivery of the underlying assets, and will not derive any gains or suffer losses other than the mark-up in the price of the asset, agreed between the bank and its customer at the start of the transaction, or calculated based on a pre-agreed formula. .

Capital Treatment

4.25 Where a structure falls within the definition of a spot *murabaha* financing structure as stipulated above, the bank should apply SA(CR) under Division 3 of Part VII of MAS Notice 637. The amount that should be risk-weighted, E, will be based on the relevant rules set out in Division 2 of Part VII of MAS Notice 637.

REGULATION 23D

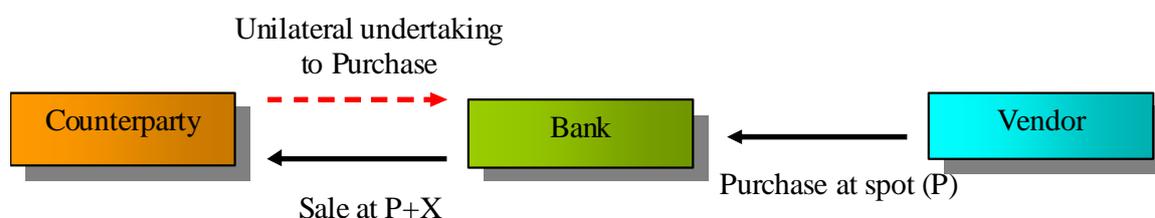
Prescribed purchase and sale business at spot price

23D.—(1) For the purposes of section 30(1)(d) of the Act, and subject to paragraph (2), the business of purchasing and selling assets at spot price is prescribed as a business that any bank in Singapore may carry on, or enter into any partnership, joint venture or other arrangement with any person to carry on, if such business is carried on under the following arrangement:

- (a) for the purpose of effecting payment resulting from the carrying on of any business by the bank under section 30(1)(a), (b) or (c) of the Act —
 - (i) the bank undertakes to purchase an asset from a customer (bank purchase undertaking);

- (ii) the customer undertakes to purchase an asset from the bank (customer purchase undertaking);
 - (iii) the bank undertakes to sell an asset to a customer (bank sale undertaking); or
 - (iv) the customer undertakes to sell an asset to the bank (customer sale undertaking),
- for an amount of money determined at the time of the giving of the undertaking by the bank or the customer, as the case may be (the agreed price);
- (b) where the bank purchase undertaking is exercised by the customer, or the customer sale undertaking is exercised by the bank, the bank purchases the asset from the customer at the agreed price, in circumstances where the asset is existing at the time of the purchase, and immediately sells the asset to a third party at spot price;
 - (c) where the customer purchase undertaking is exercised by the bank, or the bank sale undertaking is exercised by the customer, the bank will purchase the asset from a third party at spot price in circumstances where the asset is existing at the time of the purchase, and immediately sells the asset to the customer at the agreed price;
 - (d) the bank does not take physical delivery of the asset;
 - (e) the bank does not derive any gain or suffer any loss from any movement in the market value of the asset other than the difference between the spot price and the agreed price.
- (2) The bank shall notify the Authority of its —
- (a) intention to commence the business referred to in paragraph (1); or
 - (b) commencement of such business within 14 days after the commencement of such business.

Figure G: Structure of a spot *murabaha* transaction



Istisna

Regulation 23E of the Banking Regulations (“regulation 23E”)

4.26 An *istisna* contract is a sale contract of an asset which is to be manufactured or constructed according to the purchaser’s specification. The purchaser agrees to the terms of delivery and specifications, issues an order and makes progress payments for the construction of the asset. The manufacturer constructs the assets according to the specifications and delivers the completed asset within a certain timeframe. This is largely used for the financing of assets under construction, including project finance.

4.27 Regulation 23E sets out the conditions which must be met for a bank to enter into an *istisna* contract for the financing of assets under construction. To fall within regulation 23E, at the customer’s request, the bank will commission the customer to construct an asset. Concurrent with the commissioning of the construction of the asset, the bank must arrange for the transfer of the ownership of the asset, upon its completion, to the customer. Such an arrangement can either be in the form of an *ijara* contract or an undertaking provided by the customer to commit to the purchase of the asset from the bank. Where an *ijara* contract is used, the contract must meet the requirements set out in regulation 23B where the asset is not in existence at the time the asset is leased.

4.28 The customer will appoint a third party to construct the asset. Neither the bank nor the customer should be involved in the construction or manufacture of the asset. The bank will make progress payments to the customer for the construction of the asset, and the asset will be transferred on a mutually agreed date to the bank when the construction is completed. In the event that the completed asset is not transferred to the bank as agreed, the customer must either refund all progress payments made by the bank, or substitute a comparable asset, subject to the bank’s agreement. Where the customer refunds the progress payments made by the bank, the lease arrangement or purchase undertaking will be cancelled. Where a comparable asset is substituted, the comparable asset will replace the original asset in the lease arrangement or purchase undertaking from the customer. The bank should ensure that it is able to enforce the repayment of all progress payments from the customer in the event that no asset is transferred to the bank.

4.29 At the end of the arrangement, except where the customer has refunded all progress payments to the bank and no asset has been transferred to the bank, the ownership of the completed asset or comparable asset must be transferred to the customer. The amount which the customer pays the bank for the completed asset or comparable asset must be higher than the sum total of the progress payments made by the bank for the construction of the asset, with the excess representing a return to the bank for providing financing. This return must be independent of the market value of the asset.

Capital Treatment

4.30 Where a structure falls within the definition of an *istisna* financing structure as stipulated above, the bank should apply the SA(CR) under Division 3 of Part VII of MAS Notice 637. For example, in the case of a *istisna* where the bank's customer is a corporate, the bank should apply the relevant risk weights under the Corporate asset class¹³ of SA(CR). The amount that should be risk-weighted, E¹⁴, will be based on the relevant rules set out in Division 2 of Part VII of MAS Notice 637.

REGULATION 23E

Prescribed procurement business

23E.—(1) For the purposes of section 30(1)(d) of the Act, and subject to paragraph (2), the business of procuring and selling assets (whether in the form of movable or immovable property) is prescribed as a business that any bank in Singapore may carry on, or enter into any partnership, joint venture or other arrangement with any person to carry on, if such business is carried on under the following arrangement:

- (a) the bank, or the bank's agent, at the request of the customer and for the purposes of financing the procurement and the use or purchase, or both, of an asset by the customer, commissions the customer to construct the asset in accordance with the customer's specifications for an amount of money (the purchase price);
- (b) contemporaneously with the commissioning referred to in sub-paragraph (a) —
 - (i) the bank, or the bank's agent, and the customer enter into an arrangement prescribed under regulation 23B where the asset is not in existence at the time the asset is leased to the customer (the lease arrangement); or
 - (ii) the customer gives an undertaking to the bank, or the bank's agent, to purchase the asset from the bank, or the bank's agent, immediately after the transfer of the ownership of the asset to the bank, or the bank's agent, by the customer under sub-paragraph (e)(i) (the purchase undertaking);
- (c) the customer procures the construction of the asset by a third party;
- (d) the bank, or the bank's agent, makes payment of the purchase price to the customer on a periodic basis (the progress payment);
- (e) one of the following takes place:
 - (i) the customer transfers the ownership of the asset to the bank, or

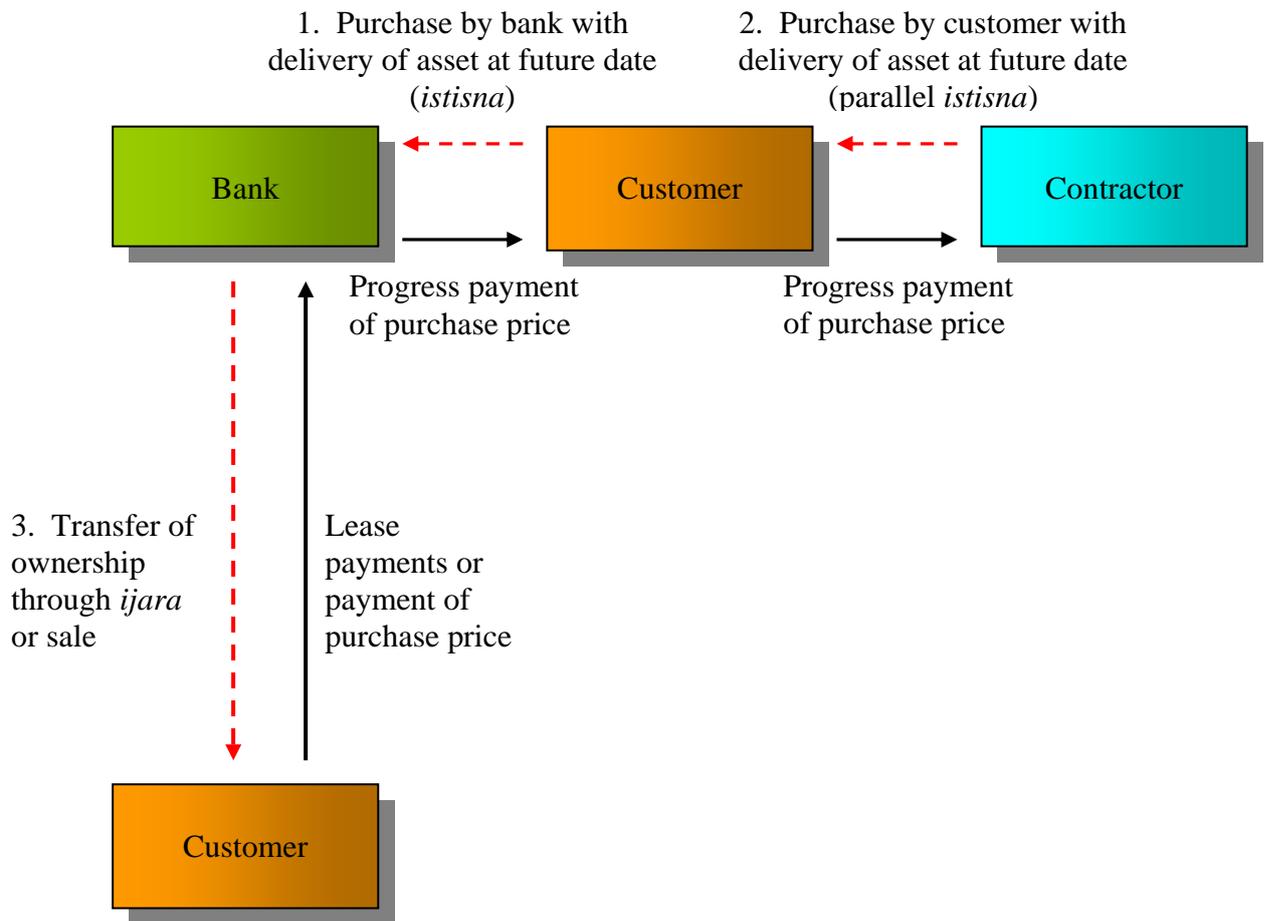
¹³ See paragraph 7.3.1(f) of MAS Notice 637 for criteria applicable to the corporate asset class.

¹⁴ See Division 2 of Part VII of MAS Notice 637 for the rules relating to the calculation of E.

the bank's agent, on a mutually agreed date on or after the completion of the construction of the asset by the third party;

- (ii) the customer refunds all progress payments to the bank, or the bank's agent, and the lease arrangement or the purchase undertaking, as the case may be, is cancelled; or
 - (iii) the bank, or the bank's agent, agrees to the substitution of the asset that is the subject of the lease arrangement or the purchase undertaking with a comparable asset, and the customer transfers the ownership of the comparable asset to the bank, or the bank's agent, on a mutually agreed date;
- (f) the bank, or the bank's agent, does not take physical delivery of the asset or the comparable asset;
 - (g) at the end of the arrangement, the bank, or the bank's agent, transfers ownership of the asset, or of the comparable asset, to the customer pursuant to the lease arrangement or the purchase undertaking, except in the circumstances referred to in sub-paragraph (e)(ii);
 - (h) the amount payable by the customer for the asset, or the comparable asset, is greater than the purchase price, and the difference between the total amount payable and the purchase price is the profit or return to the bank for providing such financing to the customer;
 - (i) the bank, or the bank's agent, does not derive any gain or suffer any loss from any movement in the market value of the asset, including from the total loss of the asset, other than the profit or return referred to in sub-paragraph (h).
- (2) The bank shall notify the Authority of its —
- (a) intention to commence the business referred to in paragraph (1); or
 - (b) commencement of such business within 14 days after the commencement of such business.

Figure H: Structure of an *istisna* transaction



Sukuk

4.31 A bank's investments in *sukuk* and equity-based investments are subject to the general exposure and investment limits set out in the Banking Act, Banking Regulations and written directions issued pursuant to the Banking Act. These include, among others, section 31 (Limit on equity investments) and section 32 (Investments in companies undertaking non-financial businesses) of the Banking Act.

Capital Treatment

4.32 *Sukuk* are arranged using a range of structures, but they generally fall into two broad categories –

- (1) Asset-based *sukuk*, where there is a purchase undertaking by the originator to repurchase the underlying assets; and
- (2) Asset-backed *sukuk* where the holders would bear any losses in case of the impairment of the assets.

Asset-based sukuk

4.33 The bank should maintain capital for *sukuk* by applying the SA(CR) under Division 3 or the SA(EQ) Division 5 of Part VII of MAS Notice 637, as the case may be.¹⁵

4.34 In determining whether to apply the SA(CR) or SA(EQ), the bank should assess the economic substance of the risks associated with the *sukuk*. If the tenor and full principal repayment to the *sukuk* holder are fixed at the time of the *sukuk* issuance, and the purchase undertaking is irrevocable and enforceable, the holder of the *sukuk* is primarily exposed to the risk that the counterparty issuing the purchase undertaking will not be able to honour its obligation to repay on the agreed future date. An example of this is an asset-based *sukuk* in which the full repayment of the principal rests upon an undertaking by the originator to purchase the assets upon maturity of the *sukuk*. A bank holding such a *sukuk* should apply the SA(CR) under Division 3 of Part VII of MAS Notice 637. The risk weights that should be applied under SA(CR) will depend on the asset class and credit quality grade of the entity that provides the purchase undertaking.¹⁶ MAS expects a bank that plans to apply this approach to satisfy itself that claims against the party providing the purchase undertaking are legally enforceable and that it will be able to obtain repayment of the principal from the proceeds of such claims.

¹⁵ The rules under SA(MR) in Part VIII of MAS Notice 637 should apply to *sukuk* that are held by a bank in its trading book. These Guidelines do not deal with the issue of whether the *sukuk* satisfy the *Shariah* criteria for being tradeable, as this is unrelated to the capital treatment.

¹⁶ For example, if the purchase undertaking was short-term in nature and issued by a corporate entity, and the short-term issue-specific rating falls within credit quality grade I, the bank should apply a risk weight of 20% (see paragraph 7.3.25 of MAS Notice 637).

4.35 In the case of *sukuk* in which the tenor and full repayment of the principal are not fixed at the time of issuance, or in which the purchase undertaking is not irrevocable and enforceable, the bank should treat its investment in the *sukuk* as an equity exposure under SA(EQ) in Division 5 of Part VII of MAS Notice 637. Likewise, the bank should treat equity-based *sukuk* where there is no purchase undertaking as an equity exposure under SA(EQ).

Asset-backed sukuk

4.36 The bank should maintain capital for asset-backed *sukuk* by applying the SA(CR) under Division 3 or the SA(EQ) Division 5 of Part VII of MAS Notice 637, as the case may be. In determining whether to apply the SA(CR) or SA(EQ), the bank should assess the economic substance of the risks associated with the underlying assets in the *sukuk*.