ISLAMIC FINANCIAL SERVICES BOARD

DISCLOSURES TO PROMOTE TRANSPARENCY AND MARKET DISCIPLINE FOR INSTITUTIONS OFFERING ISLAMIC FINANCIAL SERVICES (EXCLUDING ISLAMIC INSURANCE (*TAKĀFUL*) INSTITUTIONS AND ISLAMIC MUTUAL FUNDS)

December 2007

ABOUT THE ISLAMIC FINANCIAL SERVICES BOARD (IFSB)

The IFSB is an international standard-setting organisation that promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors. The standards prepared by the IFSB follow a lengthy due process as outlined in its Guidelines and Procedures for the Preparation of Standards/Guidelines, which involves, among others, the issuance of exposure drafts, holding of workshops and where necessary, public hearings. The IFSB also conducts research and coordinates initiatives on industry related issues, as well as organises roundtables, seminars and conferences for regulators and industry stakeholders. Towards this end, the IFSB works closely with relevant international, regional and national organisations, research/educational institutions and market players.

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ACRONYMS

CIS	Collective investment schemes
DCR	Displaced commercial risk
ECAI	External credit assessment institutions
FAS	Financial Accounting Standard
IAH	Investment account holders
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
IFSB	Islamic Financial Services Board
IIFS	Institutions offering Islamic financial services (excluding Islamic insurance (*takāful*) institutions and Islamic mutual funds)
IMF	International Monetary Fund
IOSCO	International Organisation of Securities Commissions
IRR	Investment risk reserve
PER	Profit equalisation reserve
PSIA	Profit-sharing investment accounts
RWA	Risk-weighted assets

Bismillahirrahmanirrahim
Allahumma salli wasallim 'ala Sayyidina Muhammad wa'ala ālihi wasahbihi

SECTION 1: GENERAL CONSIDERATIONS

1. Purpose and Objectives

1. The purpose of this Standard is to specify a set of key principles and practices to be followed by institutions offering Islamic financial services[1] (**IIFS**) in making disclosures, with a view to achieving transparency and promoting market discipline in regard to these institutions. This Standard is addressed to IIFS and to their supervisory authorities and other relevant policy-makers. For this purpose, recommendations have been developed for a set of disclosures that are differentiated by the type of stakeholders and that focus on the risk profile and financial soundness of the IIFS. For the disclosures to be effective in promoting market discipline, they would need to be complemented by the observance of international standards for good corporate governance of IIFS, and by the availability of a set of other infrastructure components for well-functioning financial markets that serve as the necessary conditions for an effective disclosure regime. These infrastructure components are broadly outlined as necessary conditions in Appendix A of this Standard.

2. The need for transparency is, above all, an important *Sharī`ah* consideration. Any form of concealment, fraud or attempt at misrepresentation violates the principles of justice and fairness in *Sharī`ah* as mentioned in the *Qur'an* in, among others, *Sūrah An-Nisa'* verse 135 and *Sūrah Al-Mutaffifin* verses 1 to 3.

3. The objectives of this Standard are: (a) to enable market participants to complement and support, through their actions in the market, the implementation of the Islamic Financial Services Board's (**IFSB**) capital adequacy, risk management, supervisory review and corporate governance standards; and (b) to facilitate access to relevant, reliable and timely information by market participants generally, and by investment account holders (**IAH**) in particular, thereby enhancing their monitoring capacity.

4. These disclosure principles and practices are designed to enable market participants generally, and IAH in particular, to assess key information on: 1) the type of IIFS and, where applicable, the scope of the consolidation method used by members of an Islamic financial group; 2) capital structure and overview of capital adequacy;3) the treatment of investment accounts, including their risks and returns; 4) the risk management process; 5) risk exposures by types of risk, and indicators of risk-sharing with IAH; 6) key aspects of general governance and *Sharī`ah* governance; 7) the scope of consumer-friendly disclosures concerning such risks and returns, *Sharī`ah* compliance and investment account products; and 8) the role of Islamic windows[2]. Such disclosures, when combined with adequate market and legal infrastructures, can enable market forces to enhance the stability and soundness of Islamic finance and reinforce other IFSB standards.

[1] Excluding Islamic insurance (*Takāful*) institutions and Islamic mutual funds.
[2] See the definition of Islamic window in paragraph 72

2. Scope of Application

5. This Standard is intended to be applied to IIFS, and shall include Islamic funds[3] managed by IIFS in the form of restricted investment accounts and Islamic window operations of conventional banks (with both asset and funding facilities).

6. The Standard is applied on a fully consolidated basis at the holding company level within a group or sub-group of the IIFS, or as appropriate on an individual basis subject to the discretion of the supervisory authorities. However, the Standard is not intended to be applied at the consolidated level to a group or sub-group that consists of entities other than IIFS.

7. The Standard builds on the existing guidelines and principles relating to bank transparency and bank governance issued by the Basel Committee on Banking Supervision, and the disclosure standards (Pillar 3) contained in the new Basel Capital Accord,[4] by elaborating on the specific features of IIFS that are typically not well-captured in the existing guidelines and standards on transparency and disclosure for conventional banks. It also draws on standards for collective investment schemes (**CIS**)[5] and on international accounting and auditing standards.

3. Achieving Appropriate Disclosure Levels

8. While the powers of, and means available to, supervisors to achieve the desired level of disclosure may vary among countries, a majority of banking supervisory authorities generally impose specific disclosure requirements on IIFS, which are in addition to those that may be imposed by other regulators or required by accounting standards and rules.[6] Although the practices of supervisors on requiring disclosures may vary, this Standard proposes that specific disclosures with regard to the treatment of the risk-weighted assets (**RWA**) attributable to the IAH in computing the IIFS's capital requirements, and the related disclosures on displaced commercial risk (**DCR**)[7], shall be made the qualifying criteria for the exercise of supervisory discretion in the treatment of

[3] The scope of this Standard does not include Islamic investment funds that offer units or shares of equal value, which represent ownership claims to the assets of the funds with an entitlement to the profits and an obligation to bear losses. Such investment funds fall within the scope of an IFSB Standard on the Governance of Islamic Investment Funds, and there are other applicable international financial reporting standards. However, a number of the disclosure requirements of this Standard are also applicable to Islamic investment funds that offer units or shares of equal value, when such funds are not vested in and managed by a separate legal entity but are managed by an IIFS under a *Muḍārabah* or *Wakālah* contract, as indicated in the IFSB Standard on the Governance of Islamic Investment Funds,

[4] Bank for International Settlements, *Basel Committee on Banking Supervision: International Convergence of Capital Measurement and Capital Standards: A Revised Framework 2005* (hereafter referred to as "Basel II").

[5] International Organisation of Securities Commissions (**IOSCO**) documents covering CIS, particularly Public Documents 59, 13, 154 and 155.

[6] Based on the findings of the Transparency and Market Discipline Survey carried out in September 2005, 94% of the IIFS surveyed responded that a disclosure framework specified by the banking authority was in place, in addition to the regulatory requirements imposed by the securities and exchange regulators, and the national accounting and legal frameworks.

[7] DCR is the additional credit and market risk borne by shareholders for the purpose of smoothing and maintaining the returns payable to IAH (as explained in Appendix A of the IFSB's Capital Adequacy Standard for IIFS).

these assets in the capital adequacy calculation.[8]

9. This Standard, together with other relevant international accounting standards and rules, would enable professional, international and national accounting bodies and other related institutions or agencies, including auditors, to facilitate appropriate disclosures.

4. Key Considerations for an Effective Disclosure Regime

10. The disclosure framework for IIFS under this Standard takes into consideration, and does not conflict with, international accounting standards and relevant national standards, which are broader in scope.

11. The information required under this Standard shall be made publicly and readily available and easily accessible, and could be provided either as part of the disclosure requirements associated with periodic financial reporting, or through product-oriented or investor-oriented disclosures (taking into account the needs of retail investors, who require consumer friendly and plain language disclosures) such as prospectuses or information memoranda. The appropriate medium and location of the disclosure shall be a matter for management discretion.

4.1 Interaction with Accounting Disclosures

12. This Standard shall complement the requirements of relevant international accounting standards as well as the Pillar 3 disclosure framework. It reflects the specific information needs of IAH and shareholders arising from the unique risk characteristics and features of IIFS, which may not be adequately addressed in existing international accounting standards.

13. Non-mandatory or non-statutory disclosures in the audited financial statements or regulatory reports may be disclosed through other public channels such as printed brochures, websites or other consumer-friendly media. Such disclosures shall be subjected to proper verification as regards their consistency with audited financial statements or regulatory reports.

14. Disclosures required by this Standard are not *per se* required to be audited, although they may fall within the audit scope by virtue of being covered by national or international financial reporting standards or listing requirements. In any event, the adequacy and reliability of information disclosed are the responsibility of the management.

4.2 Materiality

15. IIFS (and also Islamic Windows as mentioned in paragraph 5 of this Standard) shall disclose information that is *material* in the sense that its omission or misstatement could influence a user relying on that information for the purpose of making economic and legitimate assessments or decisions in accordance with *Sharī`ah* requirements. A qualitative judgement (use test) based on user information needs and *Sharī`ah* requirements will be an appropriate benchmark of materiality.

[8] Reference is made to the Supervisory Discretion formula in the IFSB's *Capital Adequacy Standard for Institutions (other than Insurance Institutions) Offering only Islamic Financial Services*, December 2005.

4.3 Frequency and Timeliness

16. Disclosures of a periodic nature set out in this Standard shall be made on a semi-annual basis (consistent with Pillar 3), subject to the following exceptions. Qualitative disclosures that provide a summary of risk management objectives, principles and policies adopted by an IIFS shall be published on an annual basis. Risk-sensitive information on IIFS, such as Tier 1 capital, total capital, and capital adequacy ratios and their components,[9] shall be disclosed on a quarterly basis. Product- or retail investor-oriented disclosures not periodic in nature but linked to the introduction of new products or modifications to existing products shall be published on a timely basis.

17. In all cases, material information shall be published as soon as practicable while meeting the deadlines set by the disclosure requirements of the supervisory authorities.

4.4 Proprietary and Confidential Information

18. Proprietary information encompasses information that is competition sensitive and, if shared, would jeopardise an IIFS's competitive position. This has an impact on the level of disclosure of an IIFS's customer base, details of internal arrangements or methodologies adopted by the IIFS. This Standard adopts the view that an appropriate balance needs to be achieved between the desirability of meaningful disclosure and the protection of proprietary and confidential information.

19. In circumstances where a particular detailed disclosure might significantly jeopardise the position of the IIFS, a more general but adequately informative disclosure would be appropriate, subject to supervisory discretion. For example, in a case where proprietary rights or interests are not adequately protected by available laws, levels of disclosure of information pertaining to such rights or interests may have to be limited. This limitation is not intended to conflict with the disclosure requirements under the relevant international accounting standards or relevant national requirements.

[9] Components of Tier 1 and total capital ratios are noted in Table 2, on capital structure disclosures, presented in Section 2.3.

SECTION 2: FINANCIAL AND RISK DISCLOSURE PRINCIPLES

1. General Disclosure Principles

20. IIFS shall have a formal disclosure policy, which is approved by their board of directors. The disclosure policy will address the IIFS's approach for determining what disclosures it will make and the internal controls over the disclosure process. In addition, IIFS shall implement a process for assessing the appropriateness of their disclosures, including validation and frequency.

21. The establishment of a Governance Committee,[10] as a body with the responsibility to oversee governance issues relating to IAH, can help to enhance the transparency of returns and risks and of the underlying factors that affect them.

22. The scope of disclosure shall be commensurate and consistent with the risk assessment and risk management objectives, policies and practices of the IIFS.[11]

23. In a manner consistent with, and complementary to, other IFSB standards (such as those on corporate governance and risk management[12]), this standard shall focus on financial, risk and governance disclosures to enable market participants to assess the different categories and the overall level of risk in IIFS, the extent of risk-sharing and DCR borne by shareholders, the practice of smoothing of returns on profit-sharing investment accounts (**PSIA**) and the resultant risk-return mix for IAH.

24. Such disclosures can address one of the fundamental issues in risk management in Islamic finance, which is the recognition and measurement of risks associated with PSIA, where IIFS commingle the funds of unrestricted IAH with their own (shareholders') funds. This Standard places particular emphasis on retail investor-oriented disclosures of risks, as well as returns to IAH.

25. IFSB also recognises the differences that exist within the disclosure framework among countries, and the varying levels of compliance among the IIFS under their jurisdictions. Notwithstanding the obligation of IIFS to comply with their national regulatory framework, this Standard is intended to enhance the level of transparency through disclosures based on international accounting and auditing standards, thus narrowing the gap in disclosure practices. In cases of differences or conflicts between the national regulatory framework and the IFSB standards, the supervisory authorities need to find ways of harmonising such differences or resolving the conflicts.

26. Recommended disclosures are presented below for the scope of inclusion in the disclosures for an individual IIFS, its capital structure, capital adequacy, investment accounts (including specific disclosures on unrestricted investment accounts and restricted investment accounts), risk management, categories of risk, general and *Sharī`ah* governance arrangements, consumer-friendly disclosures for retail IAH and the treatment of Islamic windows. For each category listed above, tables are presented showing both qualitative and quantitative disclosures, and highlighting key elements that shall be disclosed. A definition of Islamic windows for the purpose of these principles is

[10] The establishment of a Governance Committee is recommended in the IFSB's *Guiding Principles on Corporate Governance for Institutions Offering only Islamic Financial Services (excluding Islamic Insurance (Takāful) and Islamic Mutual Funds).*
[11] The risk assessment practices of an IIFS would reflect its size and nature of operations.
[12] IFSB, *Guiding Principles of Risk Management for Institutions (other than Insurance Institutions) Offering only Islamic Financial Services*, December 2005.

given in Section 7, together with a general statement as to how their disclosures shall be treated within the scope of these principles.

27. Given the differences in the practices of IIFS across jurisdictions (such as the availability of investment account products, prevalence of Islamic windows, etc), some of the contents presented below may not necessarily apply to all institutions. The recommended tables shall be followed as and when applicable, with appropriate adaptations by the supervisory authorities. Also, in view of the differences among countries and IIFS on the availability of historical data on key items in balance sheets and income statements, some of the requested disclosures of past data would have to be phased in during a transitional period until a track record of key data is built up.

28. In line with the above, the disclosure requirements in the following tables are intended to be applied on a "comply or explain" basis. In other words, instances of non-observance of any of the components of these disclosure requirements (for example, where observance is not feasible because the component is not applicable to the IIFS or because the necessary data are not available) shall be clearly and adequately explained.

2. Scope of Inclusion: Corporate Information

29. A summary of corporate information on the institutions included in the disclosure, and the differences, if any, in the bases of consolidation for financial reporting and for regulatory purposes, shall be disclosed**.** The recommended disclosures are set out in Table 1.

Table 1: Scope of Inclusion: Corporate Information

Qualitative Disclosures	1.	The name of the ultimate holding corporate entity (or parent entity) in the group to which this disclosure framework is applied, with an indication of whether it is an IIFS or a conventional financial institution with an Islamic window operation to which the framework is applicable.
	2.	An outline of differences in the bases of consolidation for financial reporting and for regulatory purposes, with a brief description of the entities within the group (a) that are fully consolidated; (b) that are pro-rata consolidated; (c) that are given a deduction treatment; and (d) from which surplus capital is recognised; plus (e) that are neither consolidated nor deducted (for example, where the investment is risk weighted). This specifically applies to fully-fledged IIFS bank subsidiaries. In the case of Islamic window operations, a separate set of financial statements is to be disclosed in the notes.
	3.	Any restrictions, or other impediments, on the transfer of funds or regulatory capital within the group.

Quantitative Disclosures	4.	The aggregate amount of surplus equity (in excess of the minimum regulatory requirements) of any unconsolidated *Takaful* (Islamic insurance) subsidiaries..[13]
	5.	The aggregate amount of capital deficiencies (in relation to the regulatory capital) in all subsidiaries not included in the consolidation,[14] and the name(s) of such subsidiaries.
	6.	The aggregate current book value of the firm's total interests in insurance entities, whether consolidated or not.

3. Capital Structure, including Equity of Unrestricted IAH

30. Disclosures of total and Tier 1 capital by the top consolidated entity, equity of unrestricted IAH[15] and the related prudential reserves of the IAH shall be disclosed. These disclosures are recommended in view of the potential of IAH to share in losses and thereby serve as a form of equity. Both qualitative and quantitative disclosures are set out in Table 2. More detailed disclosures on IAH are presented in Section 3.

Table 2: Capital Structure

Qualitative Disclosures	1.	Summary descriptive information on the types, forms, terms and conditions of the main features of all capital- and equity-related capital instruments and unrestricted investment accounts.

[13] Non-IIFS subsidiary and insurance entities within a group or sub-group of the IIFS are excluded from this consolidation. However, any equity interests in these subsidiaries must be disclosed. Any surpluses arising from the *Sharī`ah*-compliant activities of these subsidiaries must also be clearly distinguished and reported.

[14] The amount of such deficiencies should be deducted in calculating the group regulatory capital.

[15] The term "equity of unrestricted investment account holders" does not imply that such amounts are part of the bank's own (shareholders') capital. In principle, by virtue of the *Muḍārabah* contract, IAH share profits earned on assets financed by their funds with the bank as *Muḍārib*, and are exposed as *Rabb al-Māl* to losses on assets financed by their funds. Thus, they are in principle a type of residual claimant or equity investor, rather than a creditor. However, certain supervisors require IIFS to treat unrestricted IAH similarly to conventional depositors, in the sense that the IIFS shall not require unrestricted IAH to bear losses and shall pay them a smoothed return that reflects current market conditions.

Quantitative Disclosures	2.	The amount of Tier 1 capital, with separate disclosure of: • issued and paid-up share capital of IIFS, and any changes since the last reporting financial year; • reserves;[16] • minority interests in the equity of subsidiaries; • any capital- and equity-related capital instruments that are eligible for inclusion in Tier 1 capital; • surplus capital from insurance companies;[17] and • other reserves.[18] • Shareholdings equal to or exceeding 5% of the total paid-up capital.
	3.	The total amount of Tier 2 and Tier 3 capital.
	4.	Total eligible capital.
	5.	The amount of unrestricted IAH funds.
	6.	Profit equalisation reserve (**PER**) (shareholders' and IAH components)[19] and investment risk reserve (**IRR**).[20]

4. Capital Adequacy

31. Capital adequacy determination for IIFS differs from that for conventional financial institutions in that: (a) its financing arrangements are either asset-based or profit- and loss-sharing (*Mushārakah*), or profit-sharing and loss-bearing (*Muḍārabah*); and (b) much of the funding is raised through unrestricted investment accounts that are, in principle, a form of equity. As such, the underlying assets involved under the *Sharī`ah* -compliant financing contracts may be exposed to market (price) risk, as well as to credit risk in respect of the amount due from the counterparty. Risk-weighted assets financed by PSIA shall, in principle, be excluded in the calculation of the denominator of the capital ratio, insofar as the commercial risk of these assets does not affect the IIFS's owner's capital. In practice, however, a proportion of these RWA, or even the full amount, may be

[16] Reserves included in Tier 1 capital are disclosed reserves created or increased by appropriations of retained earnings, or other surplus (such as general reserves and legal reserves, freely and immediately available to meet claims against the bank). General loan loss reserves, asset revaluation reserves and other undisclosed reserves (all within legal and regulatory limits) are part of Tier 2 capital.

[17] The capital invested in a majority-owned or controlled insurance entity may exceed the amount of regulatory capital required for such an entity (surplus capital). Supervisors may permit the recognition of such surplus capital in calculating a bank's capital adequacy, under limited circumstances. Banks recognising surplus capital in insurance subsidiaries will publicly disclose the amount of such surplus capital recognised in their capital. Where a bank does not have a full ownership interest in an insurance entity (for example, 50% or more but less than 100% interest), surplus capital recognised should be proportionate to the percentage of interest held. Surplus capital in significant minority-owned insurance entities will not be recognised, as the bank would not be in a position to direct the transfer of the capital in an entity that it does not control (Basel II, 2005).

[18] Reserves available to the IIFS from the surplus capital of non-banking subsidiaries that are not consolidated. Such a reserve is often used to indicate financial strength.

[19] PER comprises amounts appropriated out of the gross income from the *Muḍārabah* to be available for smoothing returns paid to the IAH and the shareholders, and consists of a PSIA portion and a shareholder's portion. See IFSB, *Capital Adequacy Standard for Institutions (other than Insurance Institutions) Offering only Islamic Financial Services*, December 2005.

[20] IRR comprises amounts appropriated out of the income of IAH, after deduction of the *Muḍārib* share of income, to meet any future losses on the investments financed by the PSIA. See IFSB, *Capital Adequacy Standard for Institutions (other than Insurance Institutions) Offering only Islamic Financial Services,* December 2005.

subject to a capital requirement, depending upon the extent of risk-sharing between shareholders and unrestricted IAH.

32. Disclosures in relation to an IIFS's capital adequacy requirements for different risk categories according to types of assets (which are created from various *Sharī`ah*-compliant financing contracts), assigning risk weights to such assets, and the adjustment undertaken to the capital requirements for the risks shared with unrestricted IAH, shall be disclosed. The recommended disclosures are set out in Table 3.

Table 3: Capital Adequacy

Qualitative Disclosures	1.	A summary discussion of IIFS's approach to assessing the adequacy of its capital to support current and future activities.
	2.	A description of policy on identifying RWA funded by unrestricted investment accounts (if any).
Quantitative Disclosures	3.	Capital requirements[21] for: a) credit risk; b) market risk; and c) operational risk.
	4.	Capital adequacy ratio (**CAR**) (Standard formula or Supervisory Discretion formula).[22]
	5.	Ratio of total and Tier 1 capital to total RWA.
	6.	Ratio of total capital to total assets.
	7.	Disclosure of capital requirements according to different risk categories (credit risk and market risk) for each category of *Sharī`ah* -compliant financing contract.
	8.	Disclosure of DCR, when the supervisory discretion formula is used (see paras. 8 and 62).

[21] Capital requirements for credit, market and operational risk are covered in more detail in Tables 8, 11 and 12, respectively.
[22] As set out in IFSB, *Capital Adequacy Standard for Institutions (other than Insurance Institutions) Offering only Islamic Financial Services*, December 2005.

SECTION 3: DISCLOSURES FOR IAH

33. IAH engage in funding of IIFS's activities on a profit-sharing and loss-bearing basis as *Rabb al-Māl* under a *Muḍārabah* contract. The underlying *Muḍārabah* contract that governs the relationship between the account holders and IIFS would require specific disclosures pertaining to their rights to profits and associated risks. Disclosure of information on policies, procedures, product design/type, profit allocation basis and differences between restricted and unrestricted IAH are pertinent to provide clarity and transparency regarding the rates of return and associated risks that are applicable to PSIA. Furthermore, industry- or IIFS-specific policies on maintaining appropriate reserves to manage IAH returns also affect the risk-return mix facing IAH.

34. Since the majority of IAH are likely to be unsophisticated retail investors seeking a *Sharī`ah*-compliant alternative to conventional deposits, IIFS shall be encouraged to provide simplified disclosures, using simple language, and easy-to-understand measures of risk and risk-sharing, and complement it with participation in industry- or supervisor-led investor (and consumer) education efforts.

35. Given the broad similarities between PSIA and CIS, the available international standards, guidelines and discussions on risk disclosures by CIS,[23] and on the role of investor education in the effective regulation of CIS and CIS operators,[24] can be pertinent to designing policies in this area for enhancing the effectiveness of IIFS disclosures. See Section 4 for further details.

36. This section on IAH draws substantially on several industry and international standards including the international standards and guidelines relating to the disclosure requirements for CIS, such as those issued or endorsed by the IOSCO.[25]

37. The fundamental similarities between management of IAH funds and the operation of CIS imply that the IOSCO principles applied to CIS disclosure requirements continue to be relevant in designing the relevant disclosures for IAH, particularly restricted IAH, and investment funds that operate in accordance with *Sharī`ah* rules and principles, including Islamic mutual funds managed by IIFS in the form of restricted investment accounts and stand-alone Islamic funds**.**[26]

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[23] IOSCO Public Document 59, *Disclosure of Risk – A Discussion Paper, Report of the Technical Committee*, September 1996.

[24] IOSCO Public Document 117, *Discussion Paper on the Role of Investor Education in the Effective Regulation of CIS and CIS Operators, Report of the Technical Committee*, March 2001.

[25] IOSCO, Public Document 158, *Collective Investment Schemes as Shareholders: Responsibilities and Disclosure: A Report of the Technical Committee of the IOSCO,* September 2003*;* IOSCO Public Document 130, *Performance Presentation Standards for Collective Investment Schemes*, July 2002; Principles for CIS in IOSCO Objectives and Principles for Securities Regulation, and the related Methodology Documents (IOSCO Public Documents 154 and 155, October 2003).

[26] IOSCO, *Objectives and Principles of Securities Regulation*, Principle 19 sets out the scope of disclosure for CIS to include authorised open-ended funds that will redeem their units or shares, whether on a continuous basis or periodically. It also includes closed-end funds whose shares or units are traded in the securities market. It further includes unit investment trusts, contractual models and the European UCITS (Undertakings for Collective Investment in Transferable Securities) model. Principle 19 states: "Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme."

38. IIFS shall make disclosures of the policies, procedures, product design, product type and profit allocation basis of investment accounts. Such disclosures shall address any differences between restricted and unrestricted IAH, and the role of various reserves and other policies that may be used to manage the rates of return and the risks associated with PSIA. These disclosures shall also be consistent with the applicable disclosures for the CIS that operate based on *Sharī`ah* rules and principles[27].

39. The disclosures indicated may be made as part of the **periodic external financial reporting process** (**marked "F"** in Tables 4, 5 and 6), or as part of **product information published** in connection with new products or changes in existing products – for example, prospectuses and offer documents (**marked "P"** in Tables 4, 5 and 6). Some disclosures may be made under both headings.

Table 4: Investment Accounts (both Unrestricted and Restricted IAH)

			F	P
General Qualitative Disclosures	1.	Written procedures and policies applicable to the investment accounts, including a synopsis of the following: • range of investment products available from the IIFS; • characteristics of investors for whom various investment accounts may be appropriate; • purchase, redemption and distribution procedures; • experience of portfolio managers, investment advisors and trustees; • governance arrangements for the IAH funds; and • procedures for trading and origination of assets.		√
	2.	Disclosure that IAH funds are invested and managed in accordance with *Sharī`ah* requirements.	√	√
	3.	Product information and the manner in which the products are made available to investors.		√
	4.	Bases of allocation of assets, expenses and profit in relation to IAH funds.	√	
	5.	Disclosure on the policies governing the management of both unrestricted and restricted IAH funds, which covers the approaches to the management of investment portfolio, establishment of prudential reserves, and the calculation, allocation and distribution of profits.	√	√
General Quantitative Disclosures	6.	PER-to-PSIA ratio – that is: Amount of total PER / Amount of PSIA by type of IAH.	√	
	7.	IRR-to-PSIA ratio – that is: Amount of total IRR / Amount of PSIA by type of IAH.	√	
	8.	Return on assets (**ROA**) – that is: Amount of total net income (before distribution of profit to unrestricted IAH) / Total amount of assets financed by shareholders' equity and minority interests, Unrestricted IAH, and current accounts and other liabilities.	√	
	9.	Return on equity (**ROE**) – that is, Amount of total net income (after distribution of profit to IAH) / Amount of shareholders' equity.	√	
	10.	Ratios of profit distributed to PSIA by type of IAH.	√	√
	11.	Ratios of financing to PSIA by type of IAH.	√	

[27] These disclosures shall also be consistent with the requirements of the IFSB Standard on *Governance of Islamic Investment Funds*

Table 5:Unrestricted Investment Accounts

			F	P
Additional Qualitative Disclosures	1.	General investment objectives and policies that are offered to the unrestricted IAH based on the general business strategy and risk-sharing policies of the IIFS (including commingling of funds).		√
	2.	Disclosure on the major changes in the investment strategies that affect the investment accounts (including commingling of funds).	√	√
	3.	Method for calculation and distribution of profits.		√
	4.	Rules governing the transfer of funds to or from PER and IRR.	√	√
	5.	Bases applied for charging expenses to unrestricted IAH.	√	√
	6.	Description of total administrative expenses charged to unrestricted IAH.		√
Additional Quantitative Disclosures	7.	Total amount of unrestricted IAH funds, and sub-totals by asset category.	√	
	8.	Share of profits earned by unrestricted IAH, before transfers to or from reserves (amount and as a percentage of funds invested).	√	
	9.	Share of profits paid out to unrestricted IAH, after transfers to or from reserves (amount and as a percentage of funds invested).	√	
	10.	Movements on PER during the year.	√	
	11.	Movements on IRR during the year.	√	
	12.	Disclosure of the utilisation of PER and/or IRR during the period.	√	
	13.	Profits earned and profits paid out over the past three to five years (amounts and as a percentage of funds invested).	√	
	14.	Amount of total administrative expenses charged to unrestricted IAH.	√	
	15.	Average declared rate of return or profit rate on unrestricted PSIA by maturity (3-month, 6-month, 12-month, 36-month).		√
	16.	Changes in asset allocation in the last six months.	√	
	17.	Off-balance sheet exposures arising from investment decisions, such as commitments and contingencies.	√	
	18.	Disclosure of limits imposed on the amount that can be invested in any one type of asset.	√	√

Table 6: Restricted Investment Accounts

			F	P
Additional Qualitative Disclosures	1.	Written policies on the IIFS's fiduciary duties in managing IAH funds.		√
	2.	Investment objectives and policies applicable to the restricted IAH based on their specific investment portfolio.	√	√
	3.	Disclosure of the duties and obligations of investment account managers in managing the IAH funds.		√
	4.	Written policies and procedures for monitoring fiduciary duties and regulatory obligations of the investment account managers.	√	√
	5.	Method for calculation and distribution of profits.	√	√
	6.	If applicable, rules for the transfer of amounts to and from PER and IRR, including contractual or regulatory limits on management's discretion in the matter.	√	√
Additional Quantitative Disclosures	7.	Amount of restricted IAH funds for each fund with sub-totals by asset category.	√	
	8.	Share of profits earned by restricted IAH, before transfers to or from reserves (amount and as a percentage of funds invested).	√	
	9.	Share of profits paid out to restricted IAH, after transfers to or from reserves (amount and as a percentage of funds invested).	√	
	10.	Movements of PER during the year, if applicable.	√	
	11.	Movements of IRR during the year, if applicable.	√	
	12.	Disclosure of the computation of PER and/or IRR, if applicable.	√	
	13.	Disclosure of the utilisation of PER and/or IRR, if applicable.	√	
	14.	Current period returns.	√	√
	15.	Historical returns over the past three to five years.[28]	√	√
	16.	Average declared rate of return or profit rate on restricted PSIA by maturity (3-month, 6-month, 12-month, 36-month).		√
	17.	Off-balance sheet exposures arising from investment decisions, such as commitments and contingencies.	√	√
	18.	Changes in asset allocation in the last six months.	√	
	19.	Disclosure of limits imposed on the amount that can be invested in any one type of asset.	√	√

[28] The unavailability of historical data on key items in balance sheets and income statements would mean that some of the requested disclosures of past data would have to be phased in during a transitional period (of, say, three years) until a track record of key data is built up. See paragraph 27.

SECTION 4: RETAIL INVESTOR-ORIENTED DISCLOSURES FOR IAH

40. Some financial institutions publish a version of their annual report that is specifically intended for retail investors, providing synopses of key performance information and making use of graphical presentations (such as pie charts) rather than large amounts of numerical financial data which may be difficult to comprehend for a retail investor. This Standard proposes that such practices be adopted by IIFS as set out below, drawing on the disclosures set out in Tables 4, 5, and 6 of this Standard.[29]

41. Supervisors shall encourage IIFS to provide simplified disclosures in plain language in the prospectus or stakeholder reports so that investors are provided with comprehensible and balanced information on which to base their investment decisions. Such retail investor-oriented disclosures shall be designed to be readily accessible and reasonably easy to understand by investors who are not financial professionals. This will enable them to monitor the IIFS's performance as well as that of the fund managers, thereby contributing to market discipline.

42. Some of these disclosures will be specifically concerned to explain comprehensively, but in non-technical language, the risk-return characteristics of products such as restricted and unrestricted PSIA, including:

1. for unrestricted PSIA, the extent to which the IIFS is committed by its policies[30] to maintaining the IAH's investors' capital intact and to paying a competitive rate of return by accepting DCR;
2. the management fee (*Muḍārib share)* as a percentage of the total investment profit, and the extent to which it is subject to partial or total waiver in order to pay a competitive rate of return to IAH;
3. IAH's rights to withdraw funds during the term of the *Muḍārabah* contract, and any penalties, if permissible, such as forfeited shares of profits, that will be incurred by so doing;
4. the extent of management's right to appropriate IAH's share of investment profits in order to build up PER and/or IRR, to use these reserves to smooth profit payouts to IAH, and the disposition of unused balances on these accounts at the end of the relevant *Muḍārabah* contract;
5. investment and asset allocation policies for IAH funds, including, with particular reference to unrestricted IAH, the commingling of their funds with other funds managed by the IIFS, the balance between shareholders' and IAH's interests in terms of allocating investment funds and the risk-return characteristics of investments;
6. for unrestricted IAH, the extent of any sharing of profits from the IIFS's provision of fee-based banking;
7. the availability of "personal banking" and investment advisory and financial planning services for the benefit of IAH, and the degree of independence of such advisors in recommending products offered by other IIFS; and
8. complaints procedures available to dissatisfied IAH.

43. Retail investor-oriented disclosures for IAH (IAH disclosures) shall contain true, factual and balanced statements, and not projections or estimates of future performance

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[29] Reference is also made to IOSCO, *Performance Presentation Standards for Collective Investment Schemes: Best Practices Standards, Report of the Technical Committee of the IOSCO*, May 2004.
[30] The commitment should not be construed as a contractual commitment, as this would not be *Sharī`ah* compliant.

of the funds. These disclosures shall include all explanations, qualifications, limitations and other statements that are necessary to prevent the performance information from misleading investors.

44. IAH disclosures shall contain information to reflect, at an appropriate level of detail, the direct and indirect fees, expenses, taxes deducted and the net amount receivable by the IAH based on the profit calculation and allocation methods adopted by the IIFS.

45. In addition to the current period's performance information, the disclosures shall contain information on historical returns for IAH and shareholders compared to general market and asset returns, and the underlying profit calculation and allocation method(s), which are consistent over a reasonable comparative period to enable IAH to make performance comparisons and to evaluate risks.

SECTION 5: RISK MANAGEMENT, RISK EXPOSURES AND RISK MITIGATION

1. General Disclosures: Risk Exposures and Assessment

46. The risks to which IIFS are exposed, and the techniques they use to identify, measure, monitor and control those risks, are important factors which market participants consider in their assessment of an IIFS.

47. In this section, several key financing risks are considered: credit risk, equity investment risk,[31] liquidity risk, rate of return risk, market risk and operational risk as specified in the IFSB's *Guiding Principles of Risk Management for IIFS*. In addition, some disclosures on credit risk mitigation, DCR and facility-specific risks are peculiar to IIFS.

48. For each separate risk area, an IIFS shall describe its risk management objectives, policies and practices, the structure and organisation of the relevant risk reporting and measurement systems, measures and indicators of risk exposures, policies for hedging and/or mitigating risk, and strategies and processes for monitoring the continuing effectiveness of risk management tools and techniques such as hedging and other risk mitigants.

[31] Risk arising from entering into a partnership for the purpose of undertaking or participating in a particular financing or general business activity as described in the contract, and in which the provider of finance shares in the business risk, as defined in the IFSB's *Guiding Principles of Risk Management*, December 2005.

Table 7: General Disclosures

General Qualitative Disclosures	1.	A description of the IIFS's risk management objectives, strategies, policies and procedures by risk category or in aggregate.
	2.	Structure and organisation supporting the relevant risk management framework and functions.
	3.	Scope and nature of the risk measurement and reporting system.
	4.	Policies and practices for mitigating risks, including monitoring the continuing effectiveness of risk mitigants.
General Quantitative Disclosures	5.	Disclosure of the range and measures of risks facing each restricted IAH fund, based on its specific investment policies.
	6.	Disclosure of the treatment of assets financed by restricted IAH in the calculation of RWA for capital adequacy purposes.[32]
	7.	Disclosure of the treatment of assets financed by unrestricted IAH in the calculation of RWA for capital adequacy purposes.[33]
	8.	Composition of financing by type of contract as a percentage of total financing.
	9.	Percentage of financing for each category of counterparty[34] to total financing – that is, amount of financing extended to a category of counterparties (outstanding) / amount of total financing (outstanding) x 100.
	10.	Disclosure of the carrying amount of any assets pledged as collateral (excluding amounts pledged to the central bank or monetary authority) and the terms and conditions relating to each pledge.
	11.	The amount of any guarantees or pledges given by the IIFS and the conditions attaching to those guarantees or pledges

1.1 Credit Risk

49. Credit risk is generally defined as the exposure to the likelihood that a counterparty will fail to meet its obligations in accordance with agreed terms. This definition is applicable to IIFS managing the financing exposures of receivables and leases (for example, *Murābahah, Diminishing Mushārakah and Ijārah*) and working capital financing transactions/projects (for example, *Salam, Istisnā` or Muḍārabah*).[35]

50. Credit risk is also associated with non-traded equity instruments, such as those based on *Muḍārabah* and *Mushārakah* contracts, which are held for investment purposes and not for trading. The capital invested through *Muḍārabah* and *Mushārakah* may be

[32] According to the two CAR formulas in Appendix A of the IFSB's *Capital Adequacy Standard*, only operational risk arising from the IIFS's management of restricted IAH funds is taken into account, credit and market risk being borne by the IAH. In the case of the Supervisory Discretion Formula, the assumption is that DCR does not arise in relation to restricted IAH. Where the facts in a given case differ from this assumption, the appropriate proportion of such assets shall be included, on a risk-weighted basis for credit and market risk, in the denominator of the IIFS's CAR.

[33] See footnote 32.

[34] Categories of counterparty may include the government, financial intermediaries, non-financial private corporate entities, non-financial public enterprises and households.

[35] As defined in the IFSB's *Guiding Principles of Risk Management*, December 2005.

used to purchase shares in a publicly traded company or privately held equity or investment in a specific project portfolio or through a pooled investment vehicle. In any case, both are profit-sharing financings, under which the capital invested by the provider of finance does not earn a fixed return, but is explicitly exposed to impairment of capital in the event of losses. The capital impairment risk on such equity holdings is treated as part of credit risk.

51. An IIFS shall make disclosures of information that reflect its overall credit exposure, the distribution or percentage of credit risk exposures by segments including contract, counterparty, geography, and industry, as well as the quality of its assets overall and by sectors.

Table 8: Credit Risk

Qualitative Disclosures	1.	A description of the IIFS's credit risk management policies and objectives.
	2.	Risk management structure.
	3.	Disclosure of the names of external credit assessment institutions (**ECAI**) used for the purpose of assigning risk weights to assets.
	4.	Disclosure of definitions of past due receivables and impaired financial assets, and policies and practices for making loss provisions on financial assets.
Quantitative Disclosures	5.	Total gross credit exposures[36] and average gross credit exposures[37] over the period in terms of geographical area, counterparty and industry, and residual contractual maturity[38] for each class of Islamic financing assets, giving the percentages funded by the IIFS's own capital and current accounts and by PSIA, respectively.
	6.	Total gross credit exposures and average gross credit exposures over the period by rating categories, where applicable.
	7.	Total gross exposure and average gross exposure to equity-based financing structures by type of financing contract.
	8.	Amount of past due and impaired financing assets, as well as specific and general loss provisions, classified by counterparty, industry and significant geographic areas, for each class of Islamic financing assets.
	9.	Disclosure of the amount and changes in loss provisions[39] during the financial year.
	10.	Disclosure of any penalty imposed on customers for default, and the disposition of any monies received as penalties.

[36] That is, after accounting offsets in accordance with the applicable accounting regime, and without taking into account the effects of credit risk mitigation techniques, such as collateral.

[37] Where the period end position is representative of the risk positions of the IIFS during the period, the average gross exposures need not be disclosed.

[38] This may already be covered by accounting standards, in which case IIFS may wish to use the same maturity groupings as used in accordance with those standards.

[39] Loss provisions could be specific or general, and are made in relation to receivables, financing and investment assets. The former (specific) could be identified as providing for expected impairment losses on specified assets, including doubtful receivables. The latter (general) are in fact part of prudential reserves in that they do not relate to any specified *expected* impairment losses but, rather, provide a cushion against *unexpected* losses.

1.2 Credit Risk Mitigation

52. IIFS shall make disclosures regarding credit risk mitigation techniques that have been recognised for the purposes of reducing capital requirements.

Table 9: Credit Risk Mitigation

<table>
<tr><td rowspan="4">Qualitative Disclosures</td><td>1.</td><td>Disclosure of use of collateral, and other Sharī`ah-compliant risk mitigation techniques together with related policies for assets leased under Ijārah Muntahiyah Bittamlīk.</td></tr>
<tr><td>2.</td><td>A description of the main types of collateral and other credit risk mitigants taken by the IIFS, such as Hamish Jiddiyyah,[40] Urbūn,[41] PSIA, pledged assets, Sukūk, and guarantees by third parties.</td></tr>
<tr><td>3.</td><td>Disclosure of the policies and processes for valuation of collateral and for ensuring its enforceability, together with related policies and processes for assets leased under Ijārah Muntahiyah Bittamlīk. When the assets are not readily convertible into cash by the IIFS, the policies for disposing of the assets, or for using them in the IIFS's operations, shall be disclosed.</td></tr>
<tr><td>4.</td><td>Where a third party guarantee is taken as a risk mitigant, the risk weight applicable to the guarantor shall be disclosed.</td></tr>
<tr><td rowspan="2">Quantitative Disclosures</td><td>5.</td><td>Disclosure of the total carrying amounts by type of collateral of any assets held as collateral by the IIFS (including any haircuts[42]) and the terms and conditions relating to the pledges.</td></tr>
<tr><td>6.</td><td>Disclosure of the carrying amount of assets owned and leased under Ijārah Muntahiyah Bittamlīk.</td></tr>
</table>

[40] A refundable security deposit held as collateral by the IIFS prior to establishing a contract and which carries a limited recourse. See IFSB's *Capital Adequacy Standard for Institutions (other than Insurance Institutions) Offering only Islamic Financial Services*, December 2005.

[41] Earnest money held as collateral (taken from a purchaser or lessee) to guarantee contract performance after a contract is established. See IFSB's *Capital Adequacy Standard for Institutions (other than Insurance Institutions) Offering only Islamic Financial Services*, December 2005.

[42] The term "haircut" refers to a discount on the full value of an asset as collateral, after taking into consideration some inherent risks that affect the volatility of the market price or value of the asset. It is commonly expressed in terms of a percentage by which an asset's value as collateral is reduced. See IFSB's *Capital Adequacy Standard for Institutions (other than Insurance Institutions) Offering only Islamic Financial Services*, December 2005.

1.3 Liquidity Risk

53. Liquidity risk is the potential loss to IIFS arising from their inability either to meet their obligations or to fund increases in assets as they fall due without incurring unacceptable costs or losses.[43]

54. An IIFS shall make disclosures regarding its liquidity management framework, on an overall basis, and separately, by categories of funding and financing. The recommended disclosures are set out in Table 10.

Table 10: Liquidity Risk

Qualitative Disclosures	1.	A summary of the liquidity risk management framework in addressing risk exposure for each category of funding as well as on an aggregate basis: • current accounts; • unrestricted investment accounts; and • restricted investment accounts.
	2.	General information on policies to address liquidity risk , taking into account the ease of access to *Sharī`ah*- compliant funds and diversity of funding sources.
Quantitative Disclosures	3.	Indicators of exposures to liquidity risk such as short-term assets to short-term liabilities, liquid asset ratios or funding volatility.[44]
	4.	Maturity analysis of financing and various categories of funding (current account, unrestricted investment account and restricted investment account) by different maturity buckets.

[43] As defined in the IFSB's *Guiding Principles of Risk Management*, December 2005.

[44] "Funding volatility" refers to sensitivity of depositors, investment account holders and creditors to events that may undermine confidence and result in rapid withdrawal of funds. Funding volatility can be measured by a variety of balance sheet indicators, such as liquid assets to overall funding, or volatile liabilities net of liquid assets to total illiquid assets, and by using cash flow estimates at various maturities, if such estimates were available.

1.4 Market Risk

55. Market risk is defined as the risk of losses in on- and off-balance sheet positions arising from movements in market prices – that is, fluctuations in values in tradable and marketable instruments (including *Sukūk*), in investments in lease assets and in off-balance sheet individual portfolios (for example, restricted investment accounts). The risks arise from the current and future volatility of market values of specific assets and of foreign exchange rates.[45]

56. An IIFS shall make disclosures regarding its framework for market risk management in respect of all assets held for sale, including those that do not have a ready market and/or are exposed to high price volatility.

Table 11: Market Risk

Qualitative Disclosures	1.	Disclosure of appropriate framework for market risk management, including reporting, in respect of all assets held for sale, including those that do not have a ready market and/or are exposed to high price volatility.
Quantitative Disclosures	2.	Indicators of exposures to market risk, such as: • breakdown of market RWA by: i) equity position risk in the trading book and market risk on trading positions in *Sukūk*; ii) foreign exchange risk; and iii) commodity risk; • foreign exchange net open positions to capital; • commodity net open positions to capital; or • equity net open positions to capital.
	3.	Total amounts of assets subject to market risk by type of assets.
	4.	Measures of value-at-risk or other sensitivity analyses for different types of market risk, such as; • foreign exchange risk; • commodity price risk; and • potential losses due to movements in market rate of return, benchmark rates or equity prices.

[45] As defined in IFSB's *Guiding Principles of Risk Management*, December 2005.

1.5 Operational Risk

57. IIFS are exposed to a range of operational risks that could materially affect their operations. Operational risk[46] is risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events, including losses resulting from *Sharī`ah* non-compliance[47] and the failure in fiduciary responsibilities[48] of the IIFS towards different fund providers. Failure of these controls may affect the soundness of the IIFS's operations and its reliability of reporting.

58. An IIFS shall make disclosures regarding its systems and controls, including those for *Sharī`ah* compliance, and the mechanisms it has in place to safeguard the interests of all fund providers. (See also Section 6 on *Sharī`ah* governance disclosures.)

Table 12: Operational Risk

Qualitative Disclosures	1.	Policies to incorporate operational risk measures into the management framework – for example, budgeting, target-setting, and performance review and compliance.
	2.	Policies on processes; (a) to help track loss events and potential exposures; (b) to report these losses, indicators and scenarios on a regular basis; (c) to review the reports jointly by risk and line managers; and (d) to ensure *Sharī`ah* compliance (see Table 17).
	3.	Policies on the loss mitigation process via contingency planning, business continuity planning, staff training and enhancement of internal controls, as well as business processes and infrastructures.
Quantitative Disclosures	4.	Disclosure of the RWA equivalent for operational risk.
	5.	Indicators of operational risk exposures, such as: • gross income[49]; and • amount of *Sharī`ah non*-compliant income (see also Table 17).

[46] As defined in the IFSB's *Guiding Principles of Risk Management*, December 2005.
[47] *Sharī`ah* non-compliance risk is the risk that arises from an IIFS's failure to comply with the *Sharī`ah* rules and principles determined by the *Sharī`ah* Board of the IIFS or the relevant body in the jurisdiction in which the IIFS operate.
[48] Fiduciary risk is the risk that arises from an IIFS's failure to perform in accordance with explicit and implicit standards applicable to its fiduciary responsibilities. As a result of losses in investments, an IIFS may become insolvent and therefore unable to: (a) meet the demands of current account holders for repayment of their funds; and (b) safeguard the interests of its IAH.
[49] Gross income is defined as in the IFSB's *Capital Adequacy Standard*, namely: (a) net income from financing activities which is gross of any provisions and operating expenses and depreciation of *Ijārah* assets; (b) net income from investment activities; and (c) fee income (commission and agency fees), less investment account holders' share of income.

1.6 Rate of Return Risk

59. "Rate of return risk" refers to the possible impact on the net income of the IIFS arising from the impact of changes in the market rates and relevant benchmark rates on the return on assets and on the returns payable on funding.[50] This impact arises from the unrestricted IAH funds being invested in fixed-return assets such as *Murābahah*, when the IAH expect a return reflecting current market conditions. An increase in benchmark rates (or market rates) may result in IAH having expectations of a higher rate of return, while the returns on assets may be adjusting more slowly due to longer maturities, thereby affecting net income to IIFS during any reference period. Rate of return risk differs from interest rate risk in that IIFS are concerned with the returns on their investment activities at the end of the investment-holding period and with the impact on net income after the sharing of returns with IAH. In contrast, in measuring interest rate risk, the cost of funding is contractually independent of the return on assets.

60. Insofar as IAH share in the profits and bear the losses on investments and related operations of IIFS, any impact on the return on assets will be offset, at least in part, by the corresponding adjustments in the return payable on IAH funds. The extent to which IAH share the risks will depend on the IIFS's policies to absorb part of the risks that would otherwise be borne by IAH under a *Muḍārabah* contract. Thus the greater the absorption of risks by IIFS (known as DCR), the greater the likely magnitude of the rate of return risk.

61. An IIFS shall make disclosures, both qualitative and quantitative, of factors that cause rate of return risk and some indicators of this risk, including data on maturity gaps, and on the sensitivity to changes in market rates of the returns on various *Sharī`ah*-compliant financing contracts and of the returns payable to the various sources of funding. Disclosures of risks and returns for investment accounts, and the related disclosures on DCR below (see paragraph 62), are also relevant in assessing the rate of return risk.

Table 13: Rate of Return Risk

Qualitative Disclosures	1.	Discussion of factors affecting rates of return and benchmark rates, and the effects thereof on the pricing of contracts.
	2.	Processes and systems to monitor and measure the factors that give rise to rate of return risk.
Quantitative Disclosures	3.	Indicators of exposures to rate of return risk – for example, data on expected payments/receipts on financing and funding and the cost of funding at different maturity buckets according to time of maturity or time of repricing for floating rate assets or funding.
	4.	Sensitivity analysis of IIFS's profits and the rate of returns to price or profit rate movements in the market.

2. Displaced Commercial Risk

62. "Displaced commercial risk" refers to the magnitude of risks that are transferred to shareholders in order to cushion the IAH from bearing some or all of the risks to which

[50] As defined in the IFSB's *Guiding Principles of Risk Management*, December 2005.

they are contractually exposed in *Muḍārabah* funding contracts. Under a *Muḍārabah* (profit-sharing and loss-bearing) contract, in principle, unrestricted IAH are exposed to the aggregate impact of risks arising from the assets in which their funds are invested, but they benefit from the DCR assumed by the IIFS. This risk-sharing is achieved by constituting and using various reserves such as PER, and by adjusting the *Muḍārib's* profit share in order to smooth the returns payable to the IAH from exposure to the volatility of the aggregate returns arising from banking risks, and thereby to enable payment of returns that are competitive in the marketplace. Such transfer of risks (and returns) from IAH to shareholders requires inclusion of a proportion of the RWA funded by IAH in the denominator of the CAR.[51]

63. "PER" refers to reserves set aside from *Muḍārabah* profits before applying the profit-sharing distribution; hence, part of the PER is a component of shareholders' equity and the remainder is a component of the equity of IAH. The use of PER may help to smooth the rates of return paid to IAH and (as dividends) to shareholders. In particular, the use of the PER may be combined with the IIFS giving up a part or all of its *Muḍārib* share of profits, in order to smooth the profit payout to IAH so as to match current market returns (IAH's opportunity cost). Such a profit payout to IAH shall be distinguished from the unadjusted *Muḍārabah* outcome, with the profits being shared according to the agreed contractual ratios, and with no smoothing of the returns paid to unrestricted IAH.

64. IRR is a reserve set aside from the part of profits allocated to IAH based on the applicable profit share. Such a reserve belongs to IAH and may be used only to absorb losses (other than those due to misconduct or negligence) during a financial period. In any case, information on variability of aggregate *Muḍārabah* profits, the size and use of PER and IRR and of profits distributed after the utilisation of these reserves, is of prime importance in determining the risk-return mix facing the IAH and the size of DCR assumed by IIFS.

65. An IIFS shall disclose the framework, policy and practices for managing the risk-return mix of the IAH and the resulting DCR, and provide indicators that enable the stakeholders to assess the aggregate risks facing the IAH and the extent of risks transferred to IIFS.

[51] As specified in the IFSB's *Capital Adequacy Standard for Institutions (other than Insurance Institutions) Offering only Islamic Financial Services, December 2005*.

Table 14: Displaced Commercial Risk

Displaced Commercial Risk (also see Section 3: Disclosures for IAH)	1.	Disclosure of the IIFS's policy on DCR, including the framework for managing the expectations of its shareholders and unrestricted IAH, the sharing of risks among the various stakeholders, and the range and measures of risks facing unrestricted IAH based on the IIFS's general business strategies and investment policies.
	2.	Disclosure of historical data over the past five years: • total *Muḍārabah* profits available for sharing between unrestricted IAH and shareholders (as *Muḍārib*) as a percentage of *Muḍārabah* assets); • *Muḍārabah* profits *earned* for unrestricted IAH (as a percentage of assets) before any smoothing; • *Muḍārabah* profits *paid out* to unrestricted IAH (as a percentage of assets) after any smoothing; • balances of PER and IRR, and movements on these in determining unrestricted IAH payout; • variations in *Muḍārib's* agreed profit-sharing ratio from the contractually agreed ratio; and • market benchmark rates.
	3.	Five-year comparison of historical rate of return of unrestricted IAH in relation to the market benchmark rate.[52]
	4.	Five-year comparison between the percentage rate of returns to IAH and the percentage returns to shareholders from *Muḍārabah* profits.
	5.	Amount and percentage of profits appropriated to PER and IRR.
	6.	Analysis of the difference between aggregate *Muḍārabah*-earned profits and profits distributed (paid out) to IAH as a function of movements in PER, IRR and the *Muḍārib's* share.
	7.	Analysis of the proportion of the RWA funded by IAH that should be considered in arriving at the total RWA (α, as specified in Appendix A of the IFSB's *Capital Adequacy Standard*), as approved by the supervisors, together with an explanation of the underlying rationale.

[52] CIS operators are required to present five-year standardised performance information, as stipulated in IOSCO Public Document 169, *Performance Presentation Standards for Collective Investment Schemes: Best Practices Standards,* May 2004.

3. Contract-specific Risks

66. Each type of Islamic financing asset is exposed to a varying mix of credit and market risks. This mix can also vary according to the stage of the contract. Accordingly, it is appropriate to monitor the total risk exposure in each type of financing asset and the corresponding capital charge for each type.

Table 15: Contract-specific Risks

Qualitative Disclosures	1.	Policy on relative shares of various *Sharī`ah*-compliant financing contracts and capital allocation for various types of *Sharī`ah*-compliant financing contracts (see also Table 3, no. 7).
Quantitative Disclosures	2.	Total RWA classified by type of *Sharī`ah*-compliant financing contract.

SECTION 6: GENERAL GOVERNANCE AND *SHARĪ`AH* GOVERNANCE DISCLOSURES

67. Disclosures of general and *Sharī`ah* governance are designed to provide information on the structure, processes and functioning of such governance in an IIFS. An important objective of these disclosures is to ensure transparency regarding *Sharī`ah* compliance by IIFS.

68. International standards, codes and best practices of corporate governance, such as *Principles of Corporate Governance* issued by the OECD, and *Enhancing Corporate Governance for Banking Organisations* issued by the Basel Committee on Banking Supervision, and other relevant governance standards, are congruent with these aims and, where relevant, are complementary in terms of guidance for appropriate disclosures.

69. The IFSB's *Corporate Governance Standard* deals with four areas: general governance approach; rights of IAH; compliance with *Sharī`ah* rules and principles; and transparency of financial reporting in respect of investment accounts.

70. Various corporate and *Sharī`ah* governance practices are adopted by different IIFS in different countries. In particular, some countries have a national *Sharī`ah* authority that issues or approves the applicable *Fatāwa*, while in other countries, each IIFS has a *Sharī`ah* board which issues the applicable *Fatāwa* for that IIFS.

71. An IIFS shall make disclosures of the structure, processes and functioning of its general and *Sharī`ah* governance. Such disclosures shall include the rights of IAH, compliance with *Sharī`ah* rules and principles, and transparency of financial reporting in respect of investment accounts.[53]

[53] Arrangements for monitoring *Sharī`ah* compliance by an IIFS also differ. With specific reference to *Sharī`ah* compliance, the tables in this Standard, taken together with other relevant governance standards include disclosure requirements that are designed to allow stakeholders to judge whether the corporate governance arrangements of the IIFS are such as reasonably to ensure *Sharī`ah* compliance.

Table 16: General Governance Disclosures

Qualitative Disclosures	1.	Disclosure and explanation of any departure from complying with the applicable financial reporting standards.[54]
	2.	Disclosure of the IIFS's corporate governance arrangements and practices, including whether the IIFS complies in full with the IFSB's *Corporate Governance Standard*, and if it does not so comply, an explanation of any non-compliance.
	3.	Disclosure of any related party transactions[55] and treatment of material events by the IIFS.
	4.	Disclosure of any investor/consumer education programmes for information on new products and services.
	5.	Information on mediation and advice bureaus for investors and customers set up by the IIFS, including clearly written procedures for lodging of complaints.
	6.	Disclosure of social functions and charitable contributions of the IIFS, such as *Sadaqah*, *Qarḍ,* etc.

Table 17: *Sharī`ah* Governance Disclosures

Qualitative Disclosures	1.	A statement on the governance arrangements, systems and controls employed by the IIFS to ensure *Sharī`ah* compliance and on how these meet applicable national or international standards, and if there is less than full compliance with desirable standards, an explanation of the reasons for non-compliance. In countries where national guidelines on *Sharī`ah* governance in IIFS exist, and the related governance requirements of the IFSB's *Corporate Governance Standard* are followed, a statement of compliance with these standards (and reasons for any non-compliance) shall be provided.
	2.	Disclosure of how *Sharī`ah non*-compliant earnings and expenditure occur and the manner in which they are disposed of.
	3.	Disclosure of whether compliance with *Sharī`ah* rulings is mandatory or not.
Quantitative Disclosures	4.	Disclosure of the nature, size and number of violations of *Sharī`ah* compliance during the year.
	5.	Disclosure of annual *Zakāt* contributions of the IIFS, where relevant, according to constitution, general assembly or national requirements.
	6.	Remuneration of *Sharī`ah* board members.

[54] Reference is made to the IFSB's *Guiding Principles on Corporate Governance for Institutions Offering only Islamic Financial Services (excluding Islamic Insurance (Takāful) and Islamic Mutual Funds)*

[55] Reference is made to IAS 24, *Related Party Disclosures.*

SECTION 7: TREATMENT OF ISLAMIC WINDOWS

72. For the purposes of this Standard, an Islamic window operation is defined as part of a conventional financial institution (which may be a branch or dedicated unit of that institution) that provides both fund management (investment accounts) and financing and investment that are *Sharī`ah* compliant. In principle, these windows are potentially self-contained in terms of *Sharī`ah*-compliant financial intermediation, as the funds managed will be invested in *Sharī`ah*-compliant assets. The term "window" is not employed in all jurisdictions, while in others it may be applied to operations that do not meet the definition given above but which are described, together with the applicable disclosure requirements, in paragraph 76 of this Standard.

73. As an identifiable unit within a conventional financial institution that provides a complete intermediation process, from sourcing funds to providing finance, the Islamic window is deemed to be responsible to its fund providers (current account holders and IAH) in the same way as a fully-fledged IIFS. Disclosure requirements as per this Standard shall therefore apply to an Islamic window, as defined in this Standard.

74. Subject to the materiality criteria as indicated in paragraph 15 of this Standard, a complete set of financial statements with notes for an Islamic window shall be provided as part of the notes to the financial statements of the conventional financial institution of which the window is a part. This Standard requires that this, or an equivalent, practice be followed by all institutions having Islamic window operations as defined for the purpose of this Standard.

75. This Standard makes it a requirement that an Islamic window as defined here be accounted for as a virtual branch of the institution of which it is a part. If this institution's accounting system is not designed to produce this information, any requisite changes to the institution's accounting system will need to be made[56].

76. The term "window" is used in some jurisdictions to refer to operations whereby a financial institution invests funds in *Sharī`ah*-compliant assets, including *Sukūk*, without such funds being mobilised as investment accounts or other deposits specifically for *Sharī`ah*-compliant investment purposes. These operations may be carried out either through branches offering current account facilities or other units of the institution. Such operations do not meet the definition of an Islamic window given in paragraph 72 above. Nevertheless, where such asset holdings are material, the institution shall comply with those disclosure requirements that relate to the risk management of the *Sharī`ah*-compliant assets and the appropriate risk weightings of those assets for capital adequacy purposes. Such disclosure requirements also apply to holdings of S*ukūk* by a financial institution.[57] Such financial institutions are not IIFS, but their activities form part of the Islamic financial services industry.

77. In addition, information on the appropriate mechanism established to provide *Sharī`ah* oversight of the activities of an Islamic window, as recommended in the IFSB's *Guiding Principles of Corporate Governance for IIFS*, shall be disclosed.

[56] The financial statements of a window operation should appear as part of the notes to the financial statements of the entity of which the window is a part. If this entity does not publish separate financial statements, the financial statements of the window operation should be included in the notes to the consolidated financial statements of the institution's parent entity.

[57] In principle, such disclosure requirements would be required by IFRS 7. However, IFRS 7 makes no mention of *Sukūk or other Sharī`ah*-compliant assets.

Appendix A

1. Necessary Conditions for an Effective Transparency and Disclosure Regime for IIFS

78. The concept of transparency is wide-ranging and covers the notions of accountability as well as the legal and accounting infrastructure for economic decisions. However, from an operational perspective of a central bank or supervisory authority, "transparency of an IIFS" refers to an environment where material and reliable information about the IIFS is made available in a timely and accessible manner to the market at large and to all stakeholders. Such transparency can reduce asymmetric information and uncertainty in financial markets.

79. "Market discipline" refers to those environmental features, which, in response to the disclosure of material information, elicit prompt adjustments in either prices or quantities of financial positions in the IIFS, and thereby provide incentives for IIFS to limit excessive risk-taking and to pursue good governance. Market discipline, in this sense, requires a set of mechanisms through which markets can penalise excessive risk-taking or inadequate transparency.

80. The transmission mechanism by which information disclosure can act as a trigger for improved risk management and better governance by IIFS depends, however, on the availability of certain infrastructure components that can facilitate adequacy and reliability of information, and that can affect the incentives and capacity of various stakeholders to process and act on the information. These infrastructure components include:

- the accounting and auditing standards and the environment that govern the reliability of information disclosed;
- the availability of markets in which IIFS issue instruments;
- an effective market microstructure that determines price discovery and the efficiency with which available information is translated into asset prices;
- a corporate governance framework for IIFS that provides incentives for both the stakeholders and management to act on the information;
- the availability of external credit assessment institutions (ECAI) or rating agencies and other information service firms that help to process and analyze available information;
- investor education programmes to facilitate proper investment decisions, and to serve as an additional tool for investor protection; and
- legal and institutional arrangements for investor rights and investor protection, and the transparency of these arrangements.[58]

81. Several of these infrastructure components also serve as necessary conditions for effective supervision generally, and not just for strengthening market discipline, and hence have close links to Pillar 2 of Basel II and the related IFSB document.[59] The infrastructure elements are further explained below.

[58] Good practices in financial policy transparency are presented in the International Monetary Fund's (**IMF**) *Code of Good Practices in Monetary and Financial Policy Transparency*, September 1999. Such transparency can affect the incentives to monitor, and the capacity to influence, IIFS, thereby supporting good corporate governance.
[59] IFSB *Guidance* on *Key Elements in the Supervisory Review Process for Institutions Offering Islamic Financial Services*, December 2007.

1.1 Internationally recognised accounting and auditing standards and effective institutional arrangements to enforce good audit and accounting frameworks will contribute to ensuring the accuracy, reliability, timeliness and comparability of the information disclosed across firms.

82. In practice, IIFS in most countries adopt national accounting standards, supplemented with the international accounting and other applicable standards. Recent advances in risk measurement and approaches to risk mitigation have, however, led to significant revisions in international accounting standards.[60] Many national standards are still in the process of being adapted, to reflect the risk disclosures that are needed to capture more comprehensive risk measurement and risk mitigation practices. Such revisions are meant to enhance disclosures of entities' (including IIFS's) exposures to risks and how these are managed. Such information will be useful for users' assessment in order to make informed judgements on risk and return. The extent of such disclosure depends on the extent of an IIFS's use of financial instruments and its exposure to risk.

83. Development of additional guidance on the prudentially-oriented disclosures, including risk disclosures, implied by this Standard would need to be closely coordinated and aligned with the ongoing developments in the general accounting and financial reporting standards, in order to avoid conflicts and to enhance risk disclosures.

1.2 An effective regulatory and operational environment for capital and money markets, and an effective microstructure for the functioning of these markets, are needed to encourage IIFS to issue tradable instruments in the markets, and to ensure that sufficient price signals are available and that market prices promptly incorporate the information disclosed.

84. The development and strengthening of capital markets with an emphasis on Islamic asset securitisation will facilitate issuance by IIFS of tradable instruments to raise equity capital, obtain funding, and manage liquidity and risks. However, well-functioning capital markets require an effective market microstructure. "Market microstructure" refers to the types of trading systems used to match orders to buy and sell (for example, auction markets, dealer markets, etc), rules for execution of trades (including transparency of pre-trade and post-trade information), and the roles of various market intermediaries involved in the mechanics and functioning of the markets. These institutional components play a key role in determining the liquidity of the market (whether trades can be executed rapidly at minimal cost and with minimum impact on prices) and the efficiency of price discovery (whether prices adjust to market-clearing levels in an orderly way).

85. In addition to the mechanics of trading, the quality of markets and market intermediaries will also affect price discovery and liquidity. Specifically, the quality of the research function performed by financial analysts, the robustness of the payment settlement system, and the effectiveness of regulation of the market intermediaries, all affect the confidence level and liquidity of markets.

[60] For example, IFRS 7, *Financial Instruments: Disclosures* (2005), which has particular relevance to banks and financial institutions, in that it requires entities to provide disclosures of financial instruments in their financial statements to enable users to evaluate the significance of financial instruments for the entity's financial position and performance, and the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the reporting date, and how the entity manages those risks. In this regard, IFRS 7 complements the disclosure requirements of Pillar 3.

86. When information on the soundness of an IIFS and its counterparties is promptly reflected in the prices of the IIFS's securities that are traded (for example, an IIFS's issued equity or *Sukūk*), or in the prices of claims on major IIFS counterparties, such price information can provide signals that permit the holders of such instruments to intervene and demand management changes. An aspect of this form of market discipline is the existence of a well-functioning market for corporate control, which can facilitate takeovers of financial firms for the purposes of restructuring. Forward-looking market price signals can also complement the information on an IIFS's risk profile and soundness relied upon by supervisors that will trigger timely action to reduce risks or raise capital. Thus, market price developments can both complement and facilitate effective supervision.

87. Even if markets provide good signals, their effect on IIFS's behaviour depends upon the incentive structures and governance mechanisms that enable stakeholders to exert pressure on the Board, in turn resulting in actions by management to behave prudently. Thus, well-designed corporate governance mechanisms for IIFS serve as key factors in making market discipline effective.

1.3 Availability of external credit assessment institutions and other information service firms (investment advisors, investment research firms, credit bureaus, etc) can facilitate effective disclosures and enhance market discipline.

88. Such institutions can help to assimilate and synthesise available disclosures in order to provide ratings of obligors and instruments, indicate changes in ratings due to new information, and summarise and assess risk-return information for the benefit of investors. The availability of ECAIs that can consider the specific operational features of Islamic finance instruments is also an important requirement for the application of the Standardised Approach to capital adequacy under the IFSB's *Capital Adequacy Standard for IIFS*.

89. Appropriate measurement and disclosure of credit and equity risks in various Islamic finance facilities can be achieved from institutional arrangements for systematic data collection, including establishing credit (and equity) registries. Such registries for Islamic finance facilities can be developed by including *Sharī`ah*-compliant financing contracts in existing credit registries or by developing registries specifically for *Sharī`ah*-compliant contracts. Appropriate adaptations of credit registries can help in strengthening credit risk measurement, which is needed in order to adopt the advanced capital measurement approaches and associated disclosures envisaged in the new Basel Capital Accord.

1.4 A programme of investor and stakeholder education, and more broadly, consumer education, contributes to investor protection and stakeholder awareness, and enhances market discipline through better-informed investment and financing decisions.

90. Investor (and consumer) education can be seen as a tool to enable investors to understand better both the returns and the risks from various financial products, and to help make investment and financing decisions that best suit their circumstances and the needs of the IIFS's counterparties. Investor education is not a substitute for effective supervision, or for properly tailoring the disclosures to the type of counterparty.

1.5 Robust legal and institutional arrangements for insolvency, investor rights and protection (rights of shareholders and IAH), creditor rights and depositor protection, and the transparency of such policies, are essential to enhance market discipline.

91. Properly designed legal and institutional arrangements for insolvency, creditor, shareholder and IAH rights, including arbitration mechanisms, can empower these stakeholders to act on available information, and thus to exercise market discipline. Markets and market discipline require that there be legal mechanisms to foreclose on non-performing assets and, if necessary, to force obligors into bankruptcy or reorganisation where value available for depositors and investors may be maximised. That is, market discipline requires that the *Sharī`ah*-compliant financing contract be enforceable in the relevant legal jurisdiction. This consideration would require that sound principles and good practices for insolvency and a creditor rights regime[61] be adopted, with appropriate adjustments to accommodate the specifics of *Sharī`ah*-compliant financing contracts (under which investors do not normally have the status of creditors).

92. In practice, the legal and institutional arrangements for investor and depositor rights in conventional financial institutions may not be adequate to deal with the special role of IAH, who typically lack the safeguards necessary to protect their interests. Such safeguards may exist both at the macro level in terms of the legal regime for insolvency and investor protection, and at the micro level in terms of the IIFS's statutes and corporate governance arrangements. This latter issue is being addressed in the IFSB's *Guiding Principles of Corporate Governance for IIFS*, which proposes the establishment of a Governance Committee that (among other things) is expected to represent the IAH interests.

93. The Governance Committee could play a role in enhancing investor awareness and fostering consumer-friendly disclosures, while also serving as a channel for IAH to act on the information disclosed. However, significant further work will be needed on the development of an appropriate legal infrastructure for investor rights in IIFS.

94. However, the incentives to act towards market discipline will be influenced by the availability of implicit or explicit guarantees for depositors and IAH protection, as further discussed in paragraph 96 below.

95. Adequate transparency of the policy and institutional framework for insolvency, investor rights and investor protection, including the ranking of IAH claims in the event of IIFS insolvency, can influence the strength of market discipline.[62]

2. Potential Limitations of a Public Disclosure Regime

96. Several factors may weaken the effectiveness of public disclosures by IIFS in influencing market discipline. First, the incentives to act in response to market signals will be influenced by the availability of implicit or explicit guarantee schemes (such as deposit protection) for current account holders and IAH, and the treatment of IAH that may be a feature of such schemes. For example, the perception of guarantees of capital and return on IAH funds, by forming and using various reserves such as profit equalisation reserve and investment risk reserve, may reduce the incentives of IAH to monitor the performance of IIFS. Thus, arrangements that significantly limit stakeholders' exposure to risk, such as deposit insurance or lender of last resort arrangements, will reduce the

[61] The World Bank and United Nations Commission on International Trade Law (UNCITRAL), *Creditor Rights and Insolvency Standard*, December 2005.
[62] IMF, *Code of Good Practices on Transparency of Monetary and Financial Policies,* September 1999.

effectiveness of market discipline.

97. Second, when the market becomes aware that an IIFS is in a weakened position, it may overreact – that is, react more harshly than is desirable, thereby triggering insolvency. This could also set in motion a broader reaction through interbank linkages and contagion. Such effects can be minimised through the availability of safety nets and liquidity facilities, and of a generally transparent environment of ongoing disclosure where well-managed IIFS can be better distinguished from weaker IIFS, and where problems can be corrected at an early stage.

98. Third, the cost involved in public disclosure – that is, the incremental cost of developing, implementing and maintaining a system to generate required disclosures and their publication – can be relatively high for some IIFS that have not adequately developed such a system. However, these costs are not borne by, and cannot be passed on to, the market participants (other than investors) who benefit from the disclosures. Nevertheless, it is clearly in the interest of such IIFS to incur the costs of developing effective risk management systems. For those IIFS that already have well-developed risk management systems, the relevant information shall already be available internally and be used by management to operate the business, in which case the incremental cost of public disclosure should be low. These cost implications for some IIFS would need to be managed by allowing sufficient time to implement strengthened risk management systems in IIFS, so that the incremental cost of developing the systems required for internal purposes and for making additional public disclosures could be spread over a reasonable period of time for some firms.

99. Fourth, in situations of generalised over-extensions of risk due to system-wide factors affecting all IIFS as well as conventional banks, the market discipline will not work, as the price signals identify only the relative performance of a bank, not system-wide effects. This issue requires a broader policy response going beyond prudential controls on individual IIFS.

DEFINITIONS

The following definitions are intended to give a general understanding of the Arabic terms used in this document. The list is by no means exhaustive.

Diminishing *Mushārakah*	Diminishing *Mushārakah* is a form of partnership in which one of the partner promises to buy the equity share of the other partner gradually until the title to the equity is completely transferred to the buying partner. The transaction starts with the formation of a partnership, after which buying and selling of the other partner's equity take place at market value or the price agreed upon at the time of entering into the contract. The "buying and selling" is independent of the partnership contract and should not be stipulated in the partnership contract since the buying partner is only allowed to give only a promise to buy. It is also not permitted that one contract be entered into as a condition for concluding the other.
Hamish Jiddiyyah	*Hamish Jiddiyyah* is a refundable security deposit held as collateral by the IIFS prior to establishing a contract and which carries a limited recourse.
Ijārah	An *Ijārah* contract refers to an agreement made by IIFS to lease to a customer an asset specified by the customer for an agreed period against specified instalments of lease rental. An *Ijārah* contract commences with a promise to lease that is binding on the part of the potential lessee prior to entering the *Ijārah* contract.
Ijārah Muntahiyah Bittamlīk	An *Ijārah Muntahiyah Bittamlīk* (or *Ijārah wa Iqtina*) is a form of lease contract that offers the lessee an option to own the asset at the end of the lease period either by purchase of the asset through a token consideration or payment of the market value, or by means of a gift contract.
Investment Risk Reserve	Investment risk reserve is the amount appropriated by the IIFS out of the income of IAH, after allocating the *Muḍārib*'s share, in order to cushion against future investment losses for IAH.
Istisnā`	An *Istisnā`* contract refers to an agreement to sell to a customer a non-existent asset, which is to be manufactured or built according to the buyer's specifications and is to be delivered on a specified future date at a predetermined selling price.
Muḍārabah	A *Muḍārabah* is a contract between the capital provider and a skilled entrepreneur whereby the capital provider would contribute capital to an enterprise or activity, which is to be managed, by the entrepreneur as the *Muḍārib* (or labour provider). Profits generated by that enterprise or activity are shared in accordance with the terms of the *Muḍārabah* agreement whilst losses are to borne solely by the capital provider unless the losses are due to the *Muḍārib*'s misconduct, negligence or breach of contracted terms.
Murābahah	A *Murābahah* contract refers to a sale contract whereby the IIFS sell to a customer at an agreed profit margin plus cost (selling price), a specified kind of asset that is already in their possession.
Mushārakah	A *Mushārakah* is a contract between the IIFS and a customer to contribute capital to an enterprise, whether existing or new, or to ownership of a real estate or moveable asset, either on a temporary or permanent basis. Profits generated by that enterprise or real estate/asset are shared in accordance with the terms of *Mushārakah* agreement whilst losses are shared in proportion to each partner's share of capital.

Profit Equalisation Reserve	Profit equalisation reserve (PER) is the amount appropriated by the IIFS out of the *Muḍārabah* income, before allocating the *Muḍārib*'s share, in order to maintain a certain level of return on investment for IAH and to increase owners' equity.
Qarḍ	A non-interest bearing loan intended to allow the borrower to use the loaned funds for a period with the understanding that the same amount of the loaned funds would be repaid at the end of the period.
Restricted Investment Accounts	The account holders authorise the IIFS to invest their funds based on *Muḍārabah* or agency contracts with certain restrictions as to where, how and for what purpose these funds are to be invested.
Salam	A *Salam* contract refers to an agreement to purchase, at a predetermined price, a specified kind of commodity not available with the seller, which is to be delivered on a specified future date in a specified quantity and quality. The IIFS as the buyers make full payment of the purchase price upon execution of a *Salam* contract. The commodity may or may not be traded over the counter or on an exchange.
Sukūk	*Sukūk* (certificates) represents the holder's proportionate ownership in an undivided part of an underlying asset where the holder assumes all rights and obligations to such asset.
Unrestricted Investment Accounts	The account holders authorise the IIFS to invest their funds based on *Muḍārabah* or *Wakālah* (agency) contracts without laying any restriction. The IIFS can commingle these funds with their own funds and invest them in a pooled portfolio.
Urbūn	*Urbūn* is earnest money held as collateral (taken from a purchaser or lessee) to guarantee contract performance after a contract is established.