[Exposure Draft (AGEB 1/2023) of the]

AAOIFI Governance Standard (GS)__

Governance and Management of Investment Accounts

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[ED of] AAOIFI Governance Standard (GS) __ "Governance and Management of Investment Accounts" is set out in paragraphs 1-134.

Where the context so requires, the use of the masculine gender shall include the feminine gender and the singular shall include the plural, and vice versa, and the word "person" shall include any institution, corporation, firm, partnership, body corporate or other forms of association. The table of contents and headings do not form part of the text of the standard and are for the purpose of convenience and ease of understanding, and may, at times, help in the interpretation of text only.

This standard shall be read in conjunction with AAOIFI's relevant Shari'ah standards and financial accounting standards, as applicable.

Preface

PR1 Islamic finance has specific characteristics / products which distinguish it from the conventional finance. As an alternative to Riba-based conventional banking (interest-bearing) deposits, Islamic financial institutions (IFI / the institutions) offer to take the customer's funds on the basis of participatory investment instruments (most commonly, investment accounts).

PR2 Such customers, more commonly referred to as the investment accountholders (IAHs), normally authorise an institution to invest their funds in Shari'ah compliant underlying assets (in form of investments, financing and services under Shari'ah compliant modes). The most important feature of such investment accounts is that unlike the conventional banking deposits, the invested capital or a fixed profit thereon is not guaranteed, and in case of a loss in the underlying assets, these are susceptible to losses, as well.

PR3 This unique feature of Islamic finance imposes challenges on different fronts, especially on governance (most importantly, from Shari'ah compliance and the IFIs' fiduciary responsibility perspective). In a dual banking system, whereby the IFIs co-exist with the conventional banks, additional challenges are faced by IFIs. AAOIFI Governance and Ethics Board (AGEB) felt the need to develop a standard on this subject in order to safeguard the interest of the fund providers (investment accountholders), from both, the Shari'ah compliance and the IFIs' fiduciary responsibility perspective.

Introduction

Overview

IN1 This standard sets out a governance framework for the management of investment accounts (IAs) and other similar participatory investment instruments. This standard aims to complement AAOIFI existing Shari'ah, governance and financial accounting standards and eventually result in:

a. better implementation of Shari'ah principles and rules applicable to such structures;

b. safeguarding the interest of all stakeholders through fulfilment of fiduciary responsibilities of the Islamic financial institutions (IFI / the institutions);

c. ensuring adequate profit and loss computation and attribution to the respective parties, in line with the contractual arrangements and requirements of Shari'ah principles and rules;

d. ensuring appropriate level of transparency and disclosure; and

e. mitigating the reputation risk for the Islamic finance industry.

Rationale(s) of this standard

IN2 Generally, a significant portion of the risk bearing funds mobilised in an IFI is derived from investment accountholders (IAHs) and other participatory investment instruments holders. However, such investors do not have any representation in an institution at the level of those charged with governance (TCWG) / senior management to safeguard their interest similar to shareholders.

IN3 One of the critical issues in Shari'ah governance for IFIs is the fiduciary responsibility which is about safeguarding the interests of all types of fund providers and ensuring a fair and equitable treatment. However, there are challenges in the management of profit computation and attribution to IAHs' and other participatory investment instruments holders' funds. Those challenges are with respect to providing the best possible fair returns and at the same time adequately manging risk. Similarly, there are significant complexities involved in the overall lifecycle of such instruments, particularly with regard to the computation and attribution of profits. In addition, the fairness element requires appropriate accounting and financial reporting practices.

IN4 It is worth noting that certain regulatory and supervisory authorities (RSAs) have developed regulatory requirements related to governance and control mechanism for IAs and similar instruments. However, still the majority of RSAs have not addressed this issue in reasonable details.

IN5 In this regard, different aspects of management of IAs related to Shari'ah, governance, audit and accounting and ethics are covered in the relevant AAOIFI standards. However, no specific governance standard for the governance and management of IAs, similar accounts and instruments and their underlying assets had been issued by AAOIFI.

IN6 In view of the same, the AAOIFI Governance and Ethics Board (AGEB) felt the need to develop this standard to provide governance, management and control requirements, at one place, and harmonising Shari'ah compliant practices across jurisdictions and among the institutions within the same jurisdiction. This standard is expected to provide guiding principles to IFIs to better manage the profit-sharing mechanism's equitability to different fund providers, particularly IAHs, improving the level of Shari'ah compliance, mitigating the reputational risk and to increase stakeholders' confidence in the industry.

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Objectives of the standard

1. This standard aims to set out the principles for governance and management of investment accounts (IAs) held with, and other participatory investment instruments (PIIs), having a nature similar to IAs, issued by, the Islamic financial institutions (IFIs / the institutions).

2. It is expected that the implementation of good governance practices for IAs and other similar PIIs (collectively referred to as IAs in this standard, unless the context suggests otherwise) through the adoption of this standard, in turn, would help the Islamic finance industry achieve the following objectives:

   a. improve the overall level of Shari'ah compliance in respect of IAs;

   b. improve the overall risk management mechanism for IAs;

   c. enhance the confidence of current and potential investment accountholders (IAHs) and holders of other PIIs (collectively referred to as IAHs in this standard, unless the context suggests otherwise) and stakeholders in IFIs, and resultantly, their mutual sustainability and growth;

   d. safeguard the reputation of the Islamic finance industry by providing fair and equitable treatment to IAHs, protecting their respective rights in accordance with the best practices of business conduct in respect of consumer protection and enhancing transparency and disclosures;

   e. promote better governance structures and controls to safeguard the interest of IAHs, especially for the low-risk IAs (LRIAs); and

   f. promote the practices of having high-risk IAs (HRIAs) with appropriate governance structures and transparency, to promote the participatory investments on one hand, and to provide opportunities for high-risk, high-return investments to IAHs (as appropriate to their respective risk appetite), on the other hand.

Scope

3. The standard shall apply to all participatory investment instruments issued by an IFI, including:

   a. IAs based on Mudaraba or similar contracts (including without limitation, Musharaka) that represent quasi-equity, including both, the HRIAs and the LRIAs, as well as, investments placed by other financial institutions;

b. Al-Wakala Bi Al-Istithmar[1] arrangements comingled with unrestricted investment accounts (URIA) based on Mudaraba (or Musharaka);

c. a participant's investment instrument offered by a Takaful institution, if the same is subject to classification as quasi-equity[2]; and

d. off-balance-sheet[3] assets under management, e.g., restricted investment accounts[4] and Al-Wakala Bi Al-Istithmar arrangements.

4. This standard shall also be applicable, insofar as suitable, to the following:

a. a Sukuk or similar instrument based on a participatory structure, issued by an institution (whether, or not, being an IFI), in addition to the requirements of respective AAOIFI Governance Standard (GS)[5]; and

b. a participants' investment fund (PIF) managed by a Takaful institution, not qualifying for classification as quasi-equity[6], in addition to the requirements of any relevant AAOIFI GSs.

Definitions

5. For the purpose of clarity and interpretation of this standard, and in the specific context of this standard, the following short definitions are relevant:

a. Control[7] – An institution controls an asset or business, when it has substantially all risks and rewards incidental to ownership of such asset or business, duly meeting both of the following conditions:

i. it is directly exposed to, and has rights to, variable returns (negative and positive, respectively) from its involvement with such assets or business; and

ii. it has the ability to affect those returns through its power over the assets or business.

b. Demand IAs – are the IAs which are invested without any commitment by the IAH for maintaining the investment for a specific period of time, and with a commitment by the institution to immediately encash the investment amount (along with due profit or loss) when demanded;

[1] See paragraph 37 of AAOIFI FAS 31 "Investment Agency (Al-Wakala Bi Al-Istithmar)" and paragraphs 12/1 and 12/1/1 of AAOIFI Shari'ah Standard (SS) 46 "Al-Wakalah Bi Al-Istithmar (Investment Agency)"
[2] See paragraph 11(n) of "AAOIFI Conceptual Framework for Financial Reporting (Revised 2020)"
[3] See paragraph 50 of "AAOIFI Conceptual Framework for Financial Reporting (Revised 2020)"
[4] See paragraph 2/1/2 of AAOIFI SS 40 "Distribution of Profit in Mudaraba-Based Investment Accounts"
[5] AAOIFI GS 12 "Sukuk Governance"
[6] See paragraph 11(n) of "AAOIFI Conceptual Framework for Financial Reporting (Revised 2020)"
[7] See paragraph 5 of AAOIFI FAS 44 "Determining Control of Assets and Business"

c. Displaced commercial risk (DCR) – refers to the extent of additional risk borne by an institution's owners in comparison to the situation where the IAHs assume all commercial risks (including credit, market, equity-investment risks, as well as, rate of return risk) associated with the underlying assets of the respective investment pool, considering the need to match their respective rates of return with the rate of return prevalent in the respective market (including avoidance of losses to be passed on to them);

d. External Shari'ah audit (ESA) – is an independent assurance engagement to provide reasonable assurance that an IFI complies with the "Shari'ah principles and rules" applicable to its financial arrangements, contracts and transactions during a specific period based on a specific set of "Shari'ah principles and rules" contained in the criteria[8];

e. Fiduciary capacity[9] – is the capacity to act, in good faith, on behalf, and for the benefit, of another party with a duty to preserve trust;

f. Hiba – is the voluntary act of payment of money or transfer of an asset to another party without a consideration [Explanation: In the specific context of this standard, Hiba generally refers to any amount voluntarily paid / transferred by an institution (normally, out of its share of profit) to IAHs as a gift to meet the desired level of return on IAHs' funds];

g. High-risk investment accounts (HRIAs) – include such unrestricted investment accounts and most of the restricted investment accounts which do not meet the definition of low-risk investment accounts (LRIAs);

h. Internal Shari'ah audit[10] – is a function part of the governance organs of an IFI, being independent of management, with the primary objective to provide assurance to those charged with governance and the Shari'ah supervisory board (SSB) in relation to an institution's adherence to the Shari'ah principles and rules;

i. Investment account (IA) – is a participatory investment instrument (see paragraph 5(u)) commonly kept and operated as a banking account with an Islamic bank or similar financial institution;

j. Investment pool[11] – in the specific context of this standard, comprises distinct assets whose risks and rewards (wholly or proportionately) are attributable to the funding provided by respective investors within owners' equity, quasi-equity and off-balance-sheet assets under management of an institution. It is generally a virtual entity and, at times, a separate reporting entity;

[8] See paragraph 15 of AAOIFI SOAA 6 "External Shari'ah Audit"
[9] See paragraph 3(a) of AAOIFI FAS 46 "Off-Balance-Sheet Assets Under Management"
[10] See paragraph 4(c) of AAOIFI GS 11 "Internal Shari'ah Audit"
[11] See paragraph 4(a) of AAOIFI FAS 47 "Transfer of Assets Between Investment Pools"

k. Investment risk reserve (IRR)[12] – is the amount appropriated by an IFI out of the income arising from the assets pertaining to relevant profit and loss taking investors, in order to cushion against credit risk, market risk and equity investment risk mainly pertaining to residual future possible losses (after impairment and credit losses accounted for in line with the requirements of AAOIFI Financial Accounting Standard (FAS) 30 “Impairment, Credit Losses and Onerous Commitments”) for the respective stakeholders arising from the respective assets and investments;

l. Islamic financial institutions (IFIs / the institutions)[13] – are financial institutions that operate in line with Shari’ah principles and rules performing banking, insurance / Takaful, capital markets and similar activities and include the standalone branches, divisions and windows of conventional financial institutions that offer products and services in line with Shari’ah principles and rules;

m. Low-risk investment accounts (LRIAs) – are the investment accounts offered to the investors at large with lower risk appetite and a safe-keeping mindset [Explanation: LRIAs include the LRURIAs and similar instruments considered to be quasi-equity (having put option / fixed maturity) and stable and low return expectation, with minimal risk of losses. Their other characteristics include that these can be withdrawn on demand (immediately, or within a suitable notice and processing period), and are subject to high liquidity and withdrawal risk];

n. Management[14] – for the purpose of this standard, is an organ, or combination of organs, that manages an IFI’s operations and resources (including human resources). Management’s functions include, inter-alia, risk assessment, objective setting, planning, organising, staffing, leading or directing and controlling an IFI. Management includes such directors and employees who are involved in the above-mentioned functions, irrespective of their designations. It may also refer to specific departments and / or the whole organisational management collectively;

o. Monetary assets[15] – in the specific context of this standard, for the purpose of application of the tangibility requirements, in line with the Shari’ah principles and rules, are assets that are in the form of either:

   i. cash;

   ii. contractual right to receive cash or another monetary asset from another person, institution or entity; or

   iii. contractual right to exchange a monetary asset with another person, institution or entity;

[12] See paragraph 6(a) of AAOIFI FAS 35 “Risk Reserves”
[13] See paragraph 7(K) of AAOIFI GS 14 “Islamic Crowdfunding Governance”
[14] See paragraph 4(f) of AAOIFI GS 11 “Internal Shari’ah Audit”
[15] See paragraph 4(b) of AAOIFI FAS 47 “Transfer of Assets Between Investment Pools”

p. Mudaraba[16] – is a profit-oriented participation between capital and work. [Explanation: Generally, in the context of an institution, it is conducted between investment accountholders as owners of capital and the institution as a Mudarib. The institution announces its willingness to accept the funds of investment accountholders, the sharing of profits being as agreed upon between the two parties, and the losses being borne by the owner of funds except if they were due to misconduct, negligence or violation of the conditions agreed upon by the institution. In the latter cases such losses would be borne by the institution.];

q. Off-balance-sheet assets under management[17] – include assets held, managed, administered or otherwise dealt with in an arrangement that gives an institution a fiduciary responsibility but not control;

r. Off-balance-sheet participatory investment instruments (including investment accounts) [18] – are the participatory investment instruments (including investment accounts) whereby the underlying assets meet the definition of off-balance-sheet assets under management and hence, the institution does not control the same;

s. Off-balance sheet items[19] – include funds or assets held, managed, administered, or otherwise dealt with in an arrangement that gives an institution a fiduciary responsibility, as well as, commitments and contingent liabilities. Equity of investment accountholders, in respect of which an institution does not enjoy authority over decisions with regards to the use and deployment / investment of funds, is considered as an off-balance sheet item;

t. On-balance-sheet participatory investment instruments (including investment accounts) [20] – are the participatory investment instrument (including investment accounts) whereby an institution controls the underlying assets in line with the requirements of the relevant AAOIFI FASs, including in particular, unrestricted investment accounts;

u. Participatory investment instruments – in the specific context of this standard, include all instruments (particularly including investment accounts) whereby the investors are entitled to share / take the profit and bear the risk of loss and are entitled to a residual interest in the underlying assets or business (commonly referred to as an investment pool), in line with Shari'ah principles and rules. These are normally based on Mudaraba but also include structures based on Musharaka, Al-Wakala Bi Al-Istithmar and certain hybrid structures. Participatory investment instruments may be divided into two main categories. First, where the institution controls the underlying assets, which are classified as quasi-equity instruments.

[16] See paragraph 4(h) of AAOIFI FAS 45"Quasi-equity (including Investment Accounts)"
[17] See paragraph 3(b) of AAOIFI FAS 46 "Off-balance-sheet Assets Under Management"
[18] See paragraph 3(c) of AAOIFI FAS 46 "Off-balance-sheet Assets Under Management"
[19] See paragraph 50 of "AAOIFI Conceptual Framework for Financial Reporting (Revised 2020)"
[20] See paragraph 4(i) of AAOIFI FAS 45 "Quasi-equity (including Investment Accounts)"

Second, where the institution does not control the underlying assets, and manages the same only in a fiduciary capacity, which are classified as off-balance-sheet investment instruments;

v. Participatory stakeholders[21] – are such stakeholders who, under a contractual arrangement with an institution, are entitled to share / take the profit and bear the risk of loss and entitled to a residual interest in the net assets of the underlying assets or business;

w. Participatory structure[22] – is a type of contractual investment arrangement under which the investors are entitled to share / take the profit and bear the risk of loss and are entitled to a residual interest in the underlying assets or business;

x. Profit and loss computation (PLC) period – is the period at the end of which the respective profits and losses of the respective investment pool are calculated and the liquidation (normally being constructive liquidation) and attribution of profits and losses to respective stakeholders takes place [Explanation: normally a PLC period is shorter than a financial reporting period of the institution, and in practice is normally a month or a quarter. In case of short-duration investments e.g., a week, it may be limited to such period];

y. Profit equalisation reserve (PER) – is the amount appropriated by an IFI out of the income arising from the assets pertaining to profit and loss taking investors, in order to maintain a certain level of return on investment for such stakeholders (and the shareholders, as applicable) and hence is a tool for managing the rate of return risk (including the displaced commercial risk);

z. Profit sharing ratios (PSRs) – in the specific context of this standard, include the ratios applicable to the working partner (i.e., the Mudarib's share in case of a Mudaraba contract or the working partner's share in case of a Musharaka contract) and to different classes of IAs and, where applicable, to the other commingled funds (in line with the requirements of this standard) in a specific investment pool;

aa. Public interest institutions – are the institutions that are of significant public relevance because of the nature of their business, their size or the number of their stakeholders. In the specific context of this standard, public interest institutions shall include:

   i. all listed institutions or entities (i.e., their common shares are listed and publicly traded on a stock exchange);

   ii. all institutions or entities that have publicly traded securities other than common shares e.g., Sukuk; and

[21] Also see paragraph 11(l) of "AAOIFI Conceptual Framework for Financial Reporting (Revised 2020)"
[22] See paragraph 4(b) of AAOIFI FAS 44 "Determining Control of Assets and Business"

iii. all retail Islamic financial institutions (IFIs), that deal with a large number of common stakeholders e.g., investment accountholders, depositors, unitholders, participants and employees, etc. [Explanation: the number of investment accounts, unitholders or participants for the purpose of this standard shall be considered large if it is in excess of 10,000 unless differently defined by the respective regulator];

bb. Quasi-equity[23] – is an element of the financial statements that represents participatory contributions received by an institution on a profit sharing or participation basis. It has:

i. primary characteristics of equity, i.e., in case of loss (unless negligence / misconduct / breach of contractual terms is proved), the institution is not liable to return the lost funds to the fund providers and the fund providers share the residual interest in the underlying assets or business;

ii. certain characteristics of a liability, i.e., it has a maturity or put option of redemption / liquidiation; and

iii. certain specific features, i.e., the rights of the fund providers are limited only to the underlying assets or business and not on the whole of the institution, as well as, they don't have certain rights associated only with owners';

cc. Reserve[24]– is a component of equity (i.e., pertaining to shareholders, or non-controlling interests) or quasi-equity (i.e., pertaining to participating stakeholders such as unrestricted investment accountholders) set aside by way of appropriations from respective earnings or retained earnings, as well as, value adjustments for the benefit of such respective stakeholders by way of managing various risks posed to such equity or quasi-equity balances or off-balance sheet items;

dd. Restricted investment accounts (RIAs) – are the investment accounts where the investment accountholders (being fund providers) authorise the institution (as Mudarib) to invest the funds on the basis of Mudaraba in a specific underlying asset or a specific investment pool of underlying assets, whereby the discretion of investment (or financing) decisions of the institution is limited;

ee. Shari'ah principles and rules[25] – comprise the Shari'ah principles and rules defined by the following hierarchy, as appropriate:

i. the Shari'ah standards issued by Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI);

[23] See paragraph 4(l) of AAOIFI FAS 45 "Quasi-equity (Including Investment Accounts)"
[24] See paragraph 4(m) of AAOIFI FAS 45 "Quasi-equity (Including Investment Accounts)"
[25] See paragraph 7(x) of AAOIFI GS 14 "Islamic Crowdfunding Governance"

ii. the regulations issued by the respective jurisdiction's regulator insofar as these entail the regulatory Shari'ah requirements;

iii. the rulings of the central Shari'ah board of the respective jurisdiction [if there is one];

iv. the requirements of the applicable financial accounting standards (FASs) as issued by AAOIFI insofar as these entail Shari'ah-related requirements; and

v. the approvals and rulings given by the respective Shari'ah supervisory board;

ff. Senior management[26] – for the purpose of this standard, represents collectively the group of most senior members of the management who are responsible for the overall decision making for an institution, individually or collectively;

gg. Tangibility requirements[27] – in the specific context of this standard, are the requirements defined by an institution in line with Shari'ah principles and rules, acceptable for the purpose of transfer of an asset(s) (generally, not being or including debt) from an investment pool to another;

hh. Those charged with governance (TCWG) – in line with the International Ethics Standards Board for Accountants (IESBA) pronouncement, are "the person(s) or organisation(s) (for example, a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. For some entities in some jurisdictions, those charged with governance may include management personnel, for example, executive members of a governance board of a private or public sector entity, or an owner-manager"[28], of an institution, or otherwise, having the similar responsibilities with regard to the management of IAHs and other participatory investment instruments;

ii. Time-bound IAs – are the IAs which are invested with a commitment by the IAH for maintaining the investment for a specific period of time, with or without early encashment options subject to specific terms and conditions;

jj. Transfer of assets[29] – in the specific context of this standard, is the transfer of assets from one investment pool to another (whether on-balance-sheet or off-balance-sheet) by way of either sale, exchange, investment, clearing or others (e.g., Hiba) in line with a contractual arrangement, or through reconstitution of multiple investment pools immediately following their constructive liquidation, in line with the requirements of Shari'ah principles and rules;

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[26] See paragraph 4(g) of AAOIFI GS 11 "Internal Shari'ah Audit"
[27] See paragraph 4(e) of AAOIFI FAS 47 "Transfer of Assets Between Investment Pools"
[28] See IESBA pronouncement on the definition of those charged with governance
[29] See paragraph 4(f) of AAOIFI FAS 47 "Transfer of Assets Between Investment Pools"

kk. Unrestricted investment accounts (URIAs) – are the investment accounts that do not meet the definition of restricted investment accounts (RIAs). [Explanation: With this type of account, the investment accountholder authorises an institution to deploy / invest the accountholder's funds in a manner which an institution deems appropriate without laying down any restrictions as to where, how and for what purpose the funds should be invested. Under this arrangement an institution can commingle the investment accountholders' funds with its own funds or with other funds the Islamic bank has the right to use (e.g., current accounts). The investment accountholders and the institution generally share the returns on the invested funds; and

ll. Weightages – in the specific context of this standard, reflect the contractually agreed weights applied as per agreed profit and loss computation mechanism, to the average balances of different IAs or classes of IAs, within an investment pool, for the purpose of profit attribution and distribution for a specific PLC period, resulting in weight-affected returns allocated to such IAs. [Note: The term weightages as used in this standard shall not be confused with the term "weighted average balance", which is used as a common arithmetical term, and is a method of calculating average balances; as such weighted average balance reflects only a mathematical result without any subjective element, while applying weightages, on the other hand, is a systemic method of assigning returns attributable to different balances.]

Part A: Core principles of governance of IAs

Core principles of governance applicable to all IAs

6. Core principles of governance of IAs shall include the following:

   a. Shari'ah compliance – whereby a robust Shari'ah governance structure shall be in place to ensure Shari'ah compliance in respect of IAs, in both, the legal form and the substance, with regard to all IAs;

   b. fairness – whereby all the stakeholders shall be treated fairly and equitably. This shall apply to shareholders and IAs and their respective classes and categories alike;

   c. fiduciary responsibilities – whereby the institution as a whole, and its organs of governance and management in particular, shall ensure that they appropriately discharge their fiduciary responsibilities (in the capacity of Mudarib, working partner, agent etc.) towards all stakeholders, including IAs (and different classes and categories of IAs, e.g., common IAs vs. treasury IAs or high net worth IAs), in an unbiased manner, particularly emphasising on determination of profits and losses in line with Shari'ah principles and rules, regulatory requirements, contractual arrangements, financial reporting requirements and customary practices (in the same hierarchy). This shall include the mitigation of risk of conflict of interest with regard to different stakeholders;

   d. accountability – whereby all the organs of governance including the SSB, TCWG and the management shall have accountability for their respective functions;

   e. risk management – whereby a sound system of risk management with regard to IAs, under due oversight of TCWG, shall be implemented including setting the risk appetite, development of appropriate policies, systems and processes for identification, measurement, analysis, reporting and mitigation of risks (including control activities, maintenance of risk reserves, etc.);

   f. internal controls – whereby a sound internal control framework shall be implemented that shall include an effective control environment with particular emphasis on Shari'ah compliance controls, commensurate with the risk assessments and subject to an effective oversight mechanism;

   g. transparency and disclosures – whereby high standards (including financial reporting standards) shall be adopted in respect of transparency and disclosures, and all contracts, policies and procedures, transactions, as well as, financial and operational reporting with regard to the IAs shall be transparent, and adequately disclosed to all relevant stakeholders. Any changes in the business and operational matters having an impact on the IAs, shall be adequately and timely disclosed;

   h. responsibility – whereby the institution and its organs of governance and management shall all function in a responsible manner towards all stakeholders;

i. investment strategy – whereby an institution shall set a clear Shari'ah compliant investment strategy, according to the respective risk appetite of different categories of IAs, which shall be appropriately disclosed to relevant stakeholders, with an appropriate implementation mechanism being in place;

j. proportionality principle – whereby the governance requirements as contained in this standard may be adequately customised so as to be commensurate with the nature, scale, complexity and risk profile of the institution and the respective HRIA and LRIA offered; and

k. code of conduct and ethics – whereby an institution shall adopt policies and procedures consistent with Shari'ah principles and rules to adopt and implement a suitable code(s) of ethics and conduct[30] ensuring ethical and responsible behaviour by the institution, as well as, all employees and individuals being part of different organs of governance and management, with an emphasis on the governance and management of IAs.

Additional considerations for HRIAs

7. Additional considerations in respect of HRIAs while applying the core principles of governance of IAs shall include the following:

   a. transparency and disclosures – whereby, the relevant risk factors applicable on HRIAs shall be transparently disclosed, and additional financial and operational reporting measures shall be taken; and

   b. investment strategy – whereby an institution shall, where applicable, have specific Shari'ah compliant investment strategy for HRIAs or each class or category of HRIAs and the same shall be adequately communicated to the respective stakeholders along with the risk factors involved.

Organs of governance and management

8. An institution may generally have the following organs of governance and management involved in the functions related to IAs:

   a. TCWG – normally comprising of the board of directors (or their equivalent) and including IAs committee (as constituted in line with the recommendation of this standard), audit and governance committee and other relevant committees;

   b. governance organs reporting to TCWG, including:

      i. internal audit function;

[30] "AAOIFI Code of Ethics for Islamic Finance Professionals", along with any other suitable code of ethics / conduct including IFSB-10 "Guiding Principles on Conduct of Business for Institutions Offering Islamic Financial Services"

ii. internal Shari'ah audit function;

c. Shari'ah supervisory board (SSB);

d. management – including:

i. senior management;

ii. respective management committee(s), e.g., asset liability management committee (ALCO), risk management committee(s), etc.;

iii. compliance department;

iv. risk management department(s);

v. Shari'ah compliance department;

e. external auditors; and

f. external Shari'ah auditors (where applicable).

9. The respective organs of governance and management shall be responsible and accountable for compliance with the requirements of this standard along with the requirements of other applicable AAOIFI GSs in their respective area of responsibilities.

Part B: IAs strategy and policy framework

Development of IAs strategy and policy framework

10. An institution shall have in place an appropriate strategy and policy framework in respect of the governance and management of IAs, in line with the requirements of this standard, other applicable AAOIFI GSs, relevant regulatory requirements and Shari'ah principles and rules (including AAOIFI Shari'ah Standards (SSs)).

Considerations during the development of IAs strategy and policy framework

11. The IAs strategy and policy framework shall be developed in accordance with the requirements of this standard, relevant regulatory requirements and Shari'ah principles and rules.

12. The IAs strategy and policy framework shall be well-defined, duly vetted by the SSB and approved by TCWG.

13. The IAs strategy and policy framework shall be developed in a manner that the practices of offering HRIAs in addition to LRIAs shall be encouraged instead of offering only LRIAs in order to follow the true spirit of Islamic banking and finance. However, this shall not compromise the consideration related to the risk appetite of the IAHs and different classes and types of IAs, in line with the requirements of this standard.

Components of IAs strategy and policy framework and significant considerations

14. Significant components of IAs strategy and policy framework shall include, but are not limited to, the following:

    a. solicitation of funds for IAs and respective prerequisites (see paragraph 16);

    b. IAs risk management policy (see paragraphs 17-20);

    c. creation of investment pool(s) and identification and segregation of funds and assets (see paragraphs 21-22);

    d. commingling of funds (see paragraphs 23-26);

    e. priority for investment of funds (see paragraphs 27-28);

    f. determination of PSR and weightages for distribution of profits (see paragraphs 29-33);

    g. Movement / transfer of assets between investment pools (see paragraphs 34-35);

    h. tangibility criteria (see paragraphs 36-37);

    i. profit and loss computation, attribution and distribution (see paragraphs 38-39);

j. Profit smoothening / capital protection techniques and maintenance of risk reserves (see paragraphs 40-46);

k. promotional gifts and prizes (see paragraphs 47-50);

l. IAs Takaful schemes (see paragraphs 51-53);

m. termination / early redemption (see paragraph 54);

n. transparency and disclosures (see paragraph 55); and

o. internal controls relevant to IAs (see paragraphs 56-57).

15. An institution shall apply the significant considerations prescribed in paragraphs 16-57, while developing its IA policy, as applicable.

Solicitation of funds for IAs and respective prerequisites

16. An institution shall not launch a public solicitation of funds for IAs and their respective classes / categories unless it has:

a. ensured compliance with the requirements of this standard, particularly with regard to the development and implementation of IAs strategy and policy framework, as well as, the pre-commencement considerations (see paragraphs 68-73);

b. secured necessary approvals from the SSB with regard to the respective product;

c. secured necessary regulatory approvals; and

d. has made necessary arrangements for commingling of its equity (as applicable) and identification and segregation of underlying assets of the respective investment pool(s).

IAs risk management policy

17. An institution shall develop specific aspects of the risk management policy related to IAs, in line with Shari'ah principles and rules, the requirements of this standard, relevant regulatory requirements and the global best practices[31]. Such policy shall be aligned with the overall risk management policy of the institution and the institutional objectives.

18. The risk management policy shall include, in particular, considerations with regard to the management of the rate of return risk and displaced commercial risk. It shall also include the consideration for the management of the fiduciary risk (being the risk of failure to comply with the fiduciary responsibilities).

[31] Including relevant IFSB standards

19. Firstly, the risk management policy shall cover the approach as to how these risks shall be managed, through:

    a. careful solicitation of funds for IAs and appropriate planning and projections;

    b. appropriate identification and segregation of underlying assets;

    c. management of risks related to underlying assets (including credit, market, equity investment risks, as well as, where appropriate, related operational and business risks); and

    d. better management of liquidity risk (including liquidity profile management and matching) and other ancillary risks.

20. Secondly, but no less importantly, it shall cover the approach towards managing these risks (particularly, the displaced commercial risk) including profit smoothening techniques (see paragraphs 40-46).

Creation of investment pool(s) and identification and segregation of funds and assets

21. An institution shall ensure to incorporate, inter-alia, the following considerations while creating the investment pools for IAs:

    a. insofar as practicable, the number of investment pools shall be kept at a minimum to avoid complexities and to address Shari'ah compliance, fairness and equity related issues [Explanation: a single investment pool for LRIAs would be preferred in most circumstances];

    b. insofar as practicable, constitution of short-term, time-bound investment pools shall be discouraged to avoid increased possibility of non-compliance of Shari'ah principles and rules and the requirements of this standard;

    c. authorities of related functions shall be expressly defined for the creation and management of a new investment pool;

    d. each RIA offering shall be kept in a separate investment pool[32] and appropriately ring-fenced;

    e. HRIAs, considering their risk appetite and the target asset classes, shall be kept in one or more separate investment pools commensurate with the respective risk characteristics; and

    f. each investment pool shall be considered a fully segregated virtual reporting entity and be subject to appropriately segregated book-keeping and financial reporting in line with Shari'ah principles and rules and reflecting the respective rights and

[32] At times multiple RIAs of the same category and investment characteristics may be pooled together in a single investment pool, in line with Shari'ah principles and rules and contractual arrangements.

obligations of various parties in accordance with the requirements of relevant AAOIFI Financial Accounting Standards (FASs).

22. Each investment pool shall be created by an institution subject to specific constitution documents (e.g., investment pool creation memorandum), incorporating, at least, the following:

a. identification and determination of underlying assets, target asset classes, etc.;

b. identification of risk appetite of the IAs and the risk characteristics of the underlying assets – particularly clarifying the nature as LRIAs or HRIAs;

c. identification of intended tenure of the investment pool (e.g., time bound or ongoing);

d. identification of income streams etc., particularly, if the investment pool includes service revenues as well;

e. underlying Shari'ah compliant contract, e.g., restricted Mudaraba, unrestricted Mudaraba, Al-Wakala Bi Al-Istithmar or Musharaka, along with principal terms and conditions;

f. summary of profit and loss computation and distribution mechanism, particularly, where the mechanism is different from other investment pools and general policies applied by the institution in this respect, including:

i. PSRs, weightages and the mechanism of changes in PSRs and weightages;

ii. limits on PSRs and weightages;

iii. the expectation of Hiba and limits thereon; and

iv. the creation of reserves etc., in line with the relevant requirements of this standard.

g. accounting policies and related aspects, only when different from the normal accounting policies of the institution (e.g., charging of allowances for impairment and credit losses, fair value gains and losses treatment or any other accounting adjustments to avoid accounting mismatches etc.);

h. currency of the investment pool, and in case of multiple currency IAs to be offered, when allowed under Shari'ah principles and rules, the translation mechanism into / from the currency of the investment pool ensuring that such translation does not result, in any manner whatsoever, in partial or full guarantee of capital or any other Shari'ah non-compliance;

i. commingling of owners' equity[33], other participatory stakeholders' funds, including funds obtained under a different contract (e.g., Al-Wakala Bi Al-Istithmar funds commingled with Mudaraba), etc.; and

j. any specific liquidation mechanism for the investment pool, particularly in case of time bound investment pool (e.g., mechanism and pricing for transfer of underlying assets to another investment pool or to the owners' equity).

Commingling of funds

23. An institution may commingle its equity funds and / or funds of other participatory stakeholders (including another class of IAs or funds based on Al-Wakala Bi Al-Istithmar) with the funds of IAHs in an investment pool, subject to relevant contractual arrangements and regulatory requirements and respective Shari'ah principles and rules.

24. Commingling of funds of different classes of IAs with equity funds and other participatory stakeholders' funds shall be performed only in a manner that:

a. the interests of respective IAs or classes of IAs are not jeopardised;

b. the relevant regulatory requirements and contractual arrangements are conformed to; and

c. the respective Shari'ah principles and rules are complied with.

25. Insofar as possible, the funds obtained under different contracts shall be kept under respective investment pools, and in case of necessary commingling (e.g., commingling of Al-Wakala Bi Al-Istithmar funds with Mudaraba funds or commingling of Shari'ah compliant preference shares / Sukuk funds with common IAs funds), the same shall take place only after:

a. having documented an internal investment contract (i.e., defined terms and conditions), preferably approved by TCWG;

b. ensuring maximum safeguard of the interests of respective classes of stakeholders warranting that such arrangements take place at an arm's length basis; and

c. having obtained explicit permission of respective IAs and other stakeholders[34].

[33] Owners' equity in the specific context of this standard for the purpose of determining equity contribution to an investment pool, may, in line with Shari'ah principles and rules and contractual arrangements, include the owners' equity (including share capital / contributed capital, reserves, etc.) along with other funds under disposal of the owners (i.e., funds acquired under liability contracts like current accounts (based on Qard), as well as, Murabaha, Tawarruq or Salam contracts) as contributed / allocated to the respective investment pool.

[34] For further details refer to paragraphs 75(c)(iv)-75(c)(v).

26. Equity funds of an institution, for the purpose of the requirements of this standard, shall include the following, subject to relevant Shari'ah principles and rules:

  a. capital of an institution or allocated capital in case of an Islamic window and related reserves and accumulated profits; and

  b. funds obtained by an institution under a liability contract, including:

    i. under a Qard or similar contract, e.g., current accounts or any interest-free loan;

    ii. under a margin or security deposits or similar contract, whereby permission to use exists; and

    iii. under another type of liability contract with or without returns, e.g., Tawarruq / commodity Murabaha or Salam contract; and.

    iv. any retained liability where contract is not defined.

Priority for investment of funds

27. An institution shall specify, and disclose to the relevant stakeholders, the policy related to the assignment of priority for investment of institution's own funds and those of IAHs, particularly in case of excess liquidity with the institution. Such policy shall clarify the aspects within an investment pool and on an overall basis for the identification and segregation of assets for investment pools. This shall also include the aspects of maintaining liquid cash within the respective investment pool, as a matter of the institution's policy or as per the relevant regulatory requirements.

28. If such policy, in any manner, does not give priority, or at least equitability, to the IAs funds in this respect, or allows for keeping idle funds for maintaining liquidity, the same shall be in compliance with Shari'ah principles and rules, explicit contractual arrangements and regulatory requirements.

Determination of PSRs and weightages for distribution of profit

29. An institution shall, at a minimum, consider the following factors for determination of PSRs and weightages:

  a. the PSRs (including the Mudarib's share) and the weightages applicable to IAs and the owners' equity (where applicable) shall be based on a fair and equitable approach towards distribution of profits based on average balances (see paragraph 39);

  b. net losses, if any, attributable to an investment pool shall be allocated disregarding the PSRs and weightages, based on average balances of the IAs and the owners' equity;

c. determination of PSRs may take into consideration the following, subject to other requirements of this standard:

i. any regulatory requirements and limits with regard to the determination of PSRs;

ii. expected yield of the underlying assets of the investment pool;

iii. a relevant (preferably, Shari'ah compliant) benchmark rate applicable to equivalent investment assets;

iv. indirect expenses or operational costs incurred by the institution in managing the IAs in the respective investment pool; and

v. any other rational and objective parameter / factor resulting in a fair and equitable treatment amongst different stakeholders;

d. once determined for a PLC period, the PSRs and weightages should not be changed unilaterally. Any change for a subsequent PLC period in respect of the PSRs and weightages shall take place before the beginning of such PLC period, subject to the requirements of paragraph 83;

30. Determination and allocation of different weightages (or where applicable, PSRs) to different classes of IAs within an investment pool shall be subject to the following considerations:

a. an institution shall maintain a suitable range / ratio between minimum and maximum weightages, for each investment pool, in line with the relevant regulatory requirements. In case of LRIAs, the maximum weightage applied to a class of IAs shall not be in the excess of 2.5 times of the minimum weightage applied to any other class of IAs (unless a stricter requirement is imposed by the respective RSA or is self-imposed by the institution itself, as a policy matter);

b. the weightages, as far as practicable, shall be denominated in easily understood numbers, e.g., as 1.0 to 2.50 times or in terms of percentages i.e., 100% to 250%, to make them more understandable to the stakeholders;

c. the differences in weightages within the same investment pool shall be justified, only in, and to the extent as justified under, either of the following situations:

i. a higher weightage to a class of IAs with a longer investment period (or the element of profit payments at maturity or at longer intervals) – commensurate with the benefit to the institution and in the greater interest of all stakeholders, by way of management of liquidity risk, decreased operational costs, ability of the institution to take risk on long-term underlying assets, etc.; or

ii. a reasonably, but not significantly, higher weightage to a class of IAs with higher average amounts of investment as compared to other IAs –

commensurate with the benefit to the institution and in the greater interest of all stakeholders, by way of reduced operational costs; or

iii. a reasonably, but not significantly, higher weightage to a class of IAs due to social and environmental, but not commercial considerations. This may include, e.g., IAs held by widows, orphans, senior citizens, Waqfs, charitable organisations, in line with the overall sustainable finance strategy of the institution.

31. An institution shall apply the following considerations to the Mudarib's share applicable to each investment pool:

a. Mudarib's share shall not be variable; it must be fixed and disclosed before the commencement of a PLC period;

b. any voluntary reduction in Mudarib's share, during or after the completion of a PLC period, applied as a profit smoothening technique, shall be subject to similar considerations as specified for general and specific Hiba in line with the requirements of this standard (see paragraphs 43-44);

c. there must be a cap on maximum Mudarib's share, in line with the relevant regulatory requirements. In the absence of relevant regulatory requirements, an institution, considering the market factors, shall put, and adequately disclose, an internal cap on maximum Mudarib's share which shall not exceed 50% of the distributable profit for the respective PLC period;

d. in case of different Mudarib's shares being applied to different classes of IAs within the same investment pool, in addition to the requirements of paragraphs 31(a)-31(c), it shall be ensured that the requirements of fair and equitable weightages, as contained in paragraphs 29-30 are not avoided by using a different Mudarib's share mechanism.

32. Commingled equity related funds, including other funds attributable to equity (e.g., funds available to the institution on Qard basis), as well as, other commingled funds (e.g., commingled Al-Wakala Bi Al-Istithmar funds in a Mudaraba based investment pool) may not be assigned any weightage, and accordingly, proportionate profits shall be first allocated to all such funds, based on average balances, before application of Mudarib share and weightages to different classes of IAs within the investment pool[35].

33. In case of HRIAs, the following specific considerations shall apply:

a. as far as practicable, different HRIAs shall not be subject to different PSRs or weightages based on the amount of investment as the risk of loss is higher and hence, it is only fair and equitable to keep the profit shares commensurate with the risk of losses. Even if different weightages may be justified due to other elements in

[35] See Appendix C: Profit calculation and distribution process flow (illustration)

line with the requirements of paragraph 30(c), the maximum weightage applied shall not be in the excess of 1.33 times of the minimum weightage applied; and

b. the Mudarib's share shall, in no case, be in excess of 33% for all HRIAs and 20% for all RIAs, unless different limits are specified by the relevant RSA.

Movement / transfer of assets between investment pools

34. The following shall be considered while transferring underlying assets between various investment pools:

a. the practice of transfer of assets between investment pools shall be kept minimal and shall be in case of necessity only, with appropriate documentation having strict controls and subject to internal authorisation at appropriate levels;

b. any transfer of assets shall not take place on post-facto basis (and hence, must take place either at the beginning of the respective PLC period, or in certain circumstances, based on necessity, on a real time basis during the continuity of the respective PLC period);

c. any transfer of assets among different investment pools may not take place, unless the same is in compliance with:

i. the requirements of relevant Shari'ah principles and rules (particularly, the tangibility criteria (see paragraphs 36-37);

ii. the contractual arrangements;

iii. the relevant regulatory requirements; and

iv. the relevant internal controls and the requirements of the IAs strategy and policy framework;

d. an institution shall ensure, insofar as possible, that IAs' returns are not adversely affected (and in no case, materially adversely affected) by any transfer of assets between investment pools or by creation of new investment pool(s);

e. in case of the dire need due to shortage of liquidity and justified reasons, in the greater interest of the institution including all relevant stakeholders, a transfer of high-yielding asset(s) from an investment pool to another may be performed under the criteria covered in the approved policy or with the approval of senior management and SSB as an exemption / special case;

f. any transfer of underlying assets among different investment pools shall be carried out at a value which:

i. approximates the fair value of the respective underlying assets (or bundle of assets, in case of receivables being part of assets transferred having regard to the tangibility criteria); or

ii. is a value determined in line with the institution's approved policy and explicit contractual arrangements, which in no case shall be materially different from fair value;

g. any short-term transfers of underlying assets from an investment pool to another investment pool (generally a time-bound investment pool), with expected return of the respective underlying asset to the original investment pool shall be avoided to ensure that no buy-back transaction prohibited by Shari'ah principles and rules takes place. In case of inevitability of such a transfer, the same shall take place at fair values without a prior buy-back arrangement; and

h. all transfer of assets shall be accounted for and disclosed appropriately in line with the requirements of relevant AAOIFI FASs[36].

35. For the purpose of application of paragraph 34, the following considerations shall apply:

a. the authorised personnel responsible for evaluating such transfers shall preferably be different authorised individuals acting on behalf of different investment pools, who shall not be reporting to the same person;

b. each transfer shall be vetted by the relevant control functions, including in particular, the Shari'ah compliance function;

c. each transfer shall take place on an arm's length basis while maintaining fairness and equitable treatment in the greater interest of all stakeholders, without compromising the interest of one or different classes of stakeholders; and

d. in the event of an inevitable transfer impacting the interest of one or more stakeholders, in the greater interest of all stakeholders, additional authorisation from the IAs committee and necessary approvals from the SSB shall be obtained. [Explanation: Additional authorisation controls, e.g., involvement of senior management (more than one individual, safeguarding interest of a class of stakeholders), or involvement of the IAs committee, or approval of the SSB, may be considered necessary for this purpose.]

Tangibility criteria

36. An institution shall define, and disclose, tangibility criteria as uniformly applicable to all investment pools and any flexible ranges to be applied in case of specific investments pools, in line with the requirements of Shari'ah principles and rules, with particular emphasis on avoidance of sale of debt. Such tangibility criteria are necessary to enable the IAHs to invest and redeem their investments from the respective investment pools, as well as, to enable the institution to transfer certain assets from one investment pool to another. [Explanation: Tangibility requirements shall be developed in line with the requirements of relevant Shari'ah principles and rules, particularly, considering the requirements of AAOIFI Shari'ah

[36] FAS 27 "Investment Accounts" and FAS 47 "Transfer of Assets Between Investment Pools"

Standard (SS) 59 “Sale of Debt”, whereby a debt directly or through bundling with tangible assets, unless comprising a legal entity, may not be exchanged against cash / debt / monetary assets. Subject to the requirements of the said standard, certain transactions of exchange of debt with a commodity (with spot delivery) or usufruct or services are acceptable. In particular, the requirements of paragraphs 8/1-8/4 and paragraphs 5/1-5/2 of SS 59 “Sale of Debt” shall be considered. In certain situations, a transfer of debt may take the form of an assignment (Hawala) rather than sale of debt, subject to a condition that such assignment may take place at par value only along with other requirements of AAOIFI SS 7 “Hawala”.]

37. Tangibility criteria may not be applicable, in rare circumstances, if the IAs share in the overall institution (including all of its assets, liabilities, revenues and expenses etc.)[37], instead of an investment pool. Similarly, relaxed tangibility criteria may apply, subject to Shari’ah principles and rules, to the general investment pool of an institution which functions as a going concern.

Profit and loss computation, attribution and distribution

38. Policy for profit and loss computation and distribution shall include, inter-alia, the following significant considerations:

    a. identification of profit and loss computation (PLC) period, applicable to the respective IAs, which may generally be a month, but depending on the nature of the institution, as well as, the type of IAs may be a quarter, half-year or a year. In case the PLC period differs from the calendar month(s) etc., or is shorter than a month, the necessary details shall be specified in the policy;

    b. timing of attribution and distribution of profits (and losses) shall be clearly specified, along with the treatment of un-attributed and undistributed profits (and losses);

    c. accounting policies applicable for the purpose of profit and loss computation shall be specified, identifying any specific accounting policies which are different from normal accounting policies of the institution;

    d. bases of charging and allocating expenses to the IAs (and respective classes of IAs) and to the equity holders, along with the justification, as well as, any limits / caps on the same, in line with Shari’ah principles and rules, shall be specified;

    e. bases of charging and attributing the losses on account of impairment losses, allowances for credit losses and provisions to the IAs (and respective classes of IAs), as well as, their respective reversal shall be specified, in line with the relevant Shari’ah principles and rules. In the event of such policy of charging and attributing impairment losses, allowances for credit losses and provisions to the IAs (and respective classes of IAs) being different from the accounting policies of the

[37] See paragraph 8/1 of AAOIFI SS 59 “Sale of Debt”

institution (or the requirements of the relevant AAOIFI FASs), the rationale for the same, along with the treatment of such differences (including the timing of accounting for such differences, e.g., at the time of actual write-offs, court orders or disposal of collaterals) shall be specified. [Note: There is a presumption that the Shari'ah principles and rules, in line with the requirements of relevant AAOIFI GSs, include the Shari'ah related requirements contained in AAOIFI FASs, and hence, any departure from such treatments shall be explained appropriately, along with its rationale];

f. treatment of temporary fair value losses and gains, and their respective reversals (or actual realisation) in line with Shari'ah principles and rules shall be specified, particularly where different from the accounting policies of the institution.

39. All computations of profit and loss for attribution and distribution purposes shall be based on average balances for the IAs and average balances for equity. The following significant considerations shall be applied on calculation of average balances:

a. daily average balance (or a daily product average balance) during the PLC period, based on the day-end balance, shall be considered for the IAs as the balance applicable for the purpose of profit and loss computations, unless a different method is contractually agreed (e.g., week-end balance or month-end balance, or a moving average mechanism); and

b. minimum balance for a given period shall not be considered as average balance for this purpose, unless specifically approved by the SSB for a specific investment pool if considered suitable to the nature of underlying assets.

Profit smoothening / capital protection techniques and maintenance of risk reserves

40. In principle, an institution has absolute discretion as to whether or not to compensate IAs in case of profits being less than expected, or in case of a loss. Nevertheless, in practice such a compensation is considered to be inevitable in case of LRIAs, and may also become partially relevant in case of HRIAs, due to various reasons generally considered to be beyond the control of the institution, including but not limited to:

a. the changes in market factors, e.g., managing expected rate of return risk or displaced commercial risk;

b. changes in, or risk of changes in, the liquidity profile (including the risk of withdrawals of funds by the IAs) (i.e., managing the liquidity risk);

c. operational expenses attributable to IAs under the contractual arrangements being higher than the expected expenses, and / or the effects of Shari'ah non-compliances, delayed payments by customers etc., resulting in payments attributable to charity (i.e., the effects of the operational risks, including Shari'ah non-compliance risk); or

d. the actual performance of the underlying assets portfolio (including the effects of impairment, credit losses and provisions) being different from the expected performance (i.e., managing the credit, market and equity investment risks).

41. An institution shall have in place and specify the policy adopted in respect of smoothening of profits, particularly for LRIAs (or different classes of LRIAs), in line with the relevant Shari'ah principles and rules, including, but not limited to, the following:

a. maintenance of risk reserves, including IRR and PER in line with the best practices of risk management (see respective AAOIFI FAS[38] and relevant IFSB standards);

b. the payment of general Hiba out of the profits attributable to the owners' equity (subject to the conditions specified in paragraph 43); and

c. in rare circumstances, the payment of specific Hiba out of the profits attributable to the owners' equity or out of the owners' equity (subject to the conditions specified in paragraph 44).

42. Profit smoothening policy as attributable to the respective class of IAs shall be referred to and summarised in the contractual arrangements with the respective IAs (e.g., in the account opening form).

43. The following considerations shall apply on an institution's policy for paying general Hiba to LRIAs out of the profits attributable to owners' equity:

a. general Hiba should not be a common practice and shall be used on need basis only, if and only if, and only to the extent that, other profit smoothening techniques in line with the relevant risk management policies are unable to manage such risks, completely or partially;

b. general Hiba should not be paid beyond a specific percentage of the profits attributable to the owners' equity within the respective investment pool (including the Mudarib's share and the profits attributed to the Mudarib against equity commingled in the respective investment pool). Such specific percentage shall not exceed 50% or a smaller limit specified by the respective RSA, for this purpose;

c. the limit specified in line with the requirements of paragraph 43(b), shall be subject to a specific approval of TCWG as custodians / agents for managing the funds attributable to owners' equity on behalf of the owners of the institution. TCWG, at their discretion, may define a limit smaller than the limit specified in line with the requirement of paragraph 43(b);

[38] FAS 35 "Risk Reserves"

d. in no case general Hiba shall be paid out of owners' equity (including profits for the earlier periods for which constructive liquidation has already taken place, or profits attributable to investment pools other than the respective investment pool);

e. general Hiba should not be used to exactly match the expected rate of return on every PLC period, creating a resemblance to a fixed rate of return;

f. general Hiba should be distributed on a fair and equitable basis to all IAs within the respective investment pool according to the normal profit distribution formula [Explanation: For avoidance of doubt it may be clarified that general Hiba shall not be credited to respective classes of IAs in the investment pool, but rather may be added only to the profit distributable to the respective investment pool as a whole, and accordingly, the effect of Hiba shall be attributed to all the IAs in a fair and equitable way as per the respective profit distribution formula (e.g., by applying the respective weightages, number of days)]; and

g. the policy for general Hiba shall be specifically approved by the SSB, and its compliance shall be subject to periodic review by the SCD.

44. The following considerations shall apply on an institution's policy for paying specific Hiba only to a specific LRIA or a specific class of LRIAs, in rare circumstances, to match the expected (but not promised) returns:

a. specific Hiba may be paid only if allowed by the SSB, and not restricted by the regulatory requirements, and shall never become a common practice;

b. specific Hiba may by paid only out of the profits attributable to owners' equity related to the respective investment pool. In rare circumstances, if the same is paid out of the owners' equity or from profits attributable to owners' equity arising out of other investment pools, the same shall be subject to specific approvals of TCWG and the SSB;

c. specific Hiba should not be paid in a manner that the combined amount of general Hiba and specific Hiba (i.e., total Hiba) attributable to a specific IA or a specific class of IAs becomes more than 50% of the amount of total profit (including such total Hiba) attributed to such specific IA or specific class of IAs, or any smaller limit as defined by the respective RSA or the SSB;

d. specific Hiba should not be used to exactly match the expected (or desired) rate of return on every PLC period, creating a resemblance to a fixed rate of return; and

e. the policy for specific Hiba, including limits thereon and the internal authorities for the same, shall be specifically approved by the SSB, and its compliance shall be subject to periodic review by the SCD.

45. An institution shall not apply the techniques like absorption of expenses and impairment, credit losses and provisions, etc., attributable to an investment pool as a profit smoothening

technique, in general, and shall not bypass the requirements related to Hiba as contained in this standard, in particular. [Explanation: Absorption of expenses and losses by the institution may take place (i) simply by not accounting for the same in the profits and losses attributable to the respective investment pool, or (ii) by way of a guarantee (in whatever form) against performance of the underlying assets (including contractual obligations to monitor or ensure the performance of the underlying assets, or for mis-assessment of the risks associated with the underlying assets). In case of a negligence voluntarily accepted by the management and compensated to the IAs, the IAs committee shall also assess and conclude as to whether such negligence is attributable to the shareholders or to the respective members of the management, as individuals.]

46. It is generally understood that HRIAs, by their very nature, are not subject to compensation by the institution against losses or less than expected profits on their investment. However, certain risk management practices may include adoption of profit smoothening techniques for HRIAs, out of their own profits, to smoothen the profit pay-outs and to hedge for possible losses over a longer period of time. Accordingly, an institution shall specify and disclose the respective profit smoothening policy applicable to HRIAs (or classes of HRIAs) through maintenance of risk reserves, e.g., PER (out of their own profits), IRR (particularly where the impairment and expected credit losses are not booked periodically) and unrealised fair value reserves.

Promotional gifts and prizes

47. Preferably, IAs shall not be accompanied with material promotional gifts and prizes, in order to ensure sanctity of the contract and to avoid the elements of speculation and gambling. Having said that, any promotional gifts and prizes, by whatever name called, may be offered only if, and only in a manner allowed by the relevant Shari'ah principles and rules[39] and as per regulatory requirements.

48. In all situations, any promotional gifts and prizes, shall not be paid / given:

   a. in excess of the total actual share of the institution (i.e., Mudarib's share and proportionate return on equity funds commingled) arising from the respective investment pool, for the respective PLC period [Explanation: any such promotional gifts or prizes are to be paid only out of the owners' / shareholders' funds];

   b. in excess of 5% (or another negligible limit as defined by the RSA for this purpose, but in no case exceeding 15%) of the total IAs' share for the respective PLC period, or material enough to jeopardise the returns attributable to IAs;

   c. unless it is ensured and specifically approved by TCWG and the SSB that such promotional gifts and prizes do not result in jeopardising fair and equitable treatment amongst IAs.

[39] AAOIFI SS 55 "Competitions and Prizes"

49. Any promotional gifts and prizes shall be marketed in an ethical manner so as the same may not be construed as a promotion of speculative and gambling-inspired culture. In particular, these should not create, or appear to be creating, a competition with conventional schemes of speculative promotional gifts and prizes.

50. Any promotional gifts and prizes shall be accounted for in line with the requirements of respective AAOIFI FAS[40].

IAs Takaful schemes

51. An institution shall, as a part of risk management measures, with due consideration to the relevant regulatory requirements, shall ensure a reasonable Takaful coverage for IAs[41].

52. In the absence of a Shari'ah compliant IAs Takaful scheme, an institution may become part of a regulator's deposit insurance scheme, if it is required by the RSA and if it is allowed under the respective Shari'ah principles and rules. The RSAs are advised to offer or facilitate Shari'ah compliant solutions to IFIs in this respect, in the greater interest of the stakeholders at large.

53. The costs related to such Takaful coverage shall be borne according to the contractual arrangements, or as per the relevant regulatory requirements, where applicable.

Termination / early redemption

54. The IAs strategy and policy framework shall include the general considerations in different situations of termination and / or early redemption of IAs, in line with the requirements of paragraphs 111-116.

Transparency and disclosures

55. The IAs strategy and policy framework shall include the general considerations in respect of transparency and disclosures of IAs, in line with the requirements of this standard, particularly paragraphs 119-132, as well as, the relevant requirements of AAOIFI FASs and market best practices (including relevant IFSB standards).

Internal controls relevant to IAs

56. An institution shall establish an effective and efficient internal control system with regard to all functions related to IAs, in line with the requirements of this standard, relevant Shari'ah principles and rules and regulatory requirements, duly commensurate with the overall risk management policy(ies) of the institution.

57. Internal control structure including, in particular, the authorities and responsibilities of different organs of governance and management shall be well documented, disseminated and monitored in line with market best practices[42].

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[40] See [ED of] FAS __ "Promotional Gifts and Prizes"

[41] IAs Takaful scheme is considered to be a Shari'ah compliant alternative to the conventional deposit insurance schemes.

[42] Also see paragraph 38 of AAOIFI GS 9 "Shari'ah Compliance Function"

Responsibilities of respective organs of governance and management

Those charged with governance (TCWG)

58. TCWG shall be responsible for the approval of IAs strategy and policy framework, as well as, to ensure its effective implementation through appropriate oversight and periodic review and update.

59. The functions related to TCWG, in line with the requirements of this standard, may be delegated to a dedicated committee or the audit and governance committee (AGC). Such delegation of responsibilities may not be construed as relieving TCWG from their respective responsibilities in line with the requirements of this standard.

60. The dedicated committee of TCWG may generally be named as "IAs committee", as referred to in this standard, or may be assigned another appropriate name. Terms of reference, and composition, of the IAs committee shall be approved by TCWG in line with global best practices. [Explanation: For the purpose of application of requirements of this standard, the term IAs committee may be considered referring to the existing committee of TCWG, in case a dedicated committee is not constituted.]

61. Significant aspects of the terms of reference of TCWG (through IAs committee or AGC) shall include supervision and monitoring in respect of the following:

    a. compliance with Shari'ah principles and rules;

    b. safeguarding the interests of IAHs along with other stakeholders, and ensuring fair and equitable treatment amongst them in a manner that ensures avoidance of conflict of interest;

    c. effective implementation of the IAs strategy and policy framework and compliance with other requirements of this standard, along with any additional regulatory requirements;

    d. effective financial performance of the institution in fiduciary capacity (as Wakeel, Mudarib or working partner, etc., as applicable);

    e. maintaining appropriate asset / investment management quality to deploy IAs funds; and

    f. ensuring timely, accurate and transparent disclosures to IAs in line with the requirements of this standard (as well as, relevant AAOIFI FASs and IFSB standards).

62. It is highly recommended that TCWG (particularly, the board of directors or equivalent) of an institution which meets the definition of a public interest institution shall include at least 33% independent members. Such independent members, besides their general responsibilities, shall be entrusted with the responsibility of safeguarding the interests of all relevant stakeholders, including in particular, the IAHs in line with the requirements of this standard. Additionally, it is preferable that at least one of the independent members may be

appointed as a representative of IAHs, and such member shall be a part of IAs committee or the AGC, as applicable. Moreover, in such case, the AGC shall comprise of a majority of independent members and shall not include any executive member of the board of directors.

Management

63. The management shall be responsible for the development, periodic update and implementation of the IAs strategy and policy framework for all types and categories of IAs.

64. The management shall also be responsible to appropriately disseminate the IAs strategy and policy framework and enhance the capacity of related staff enabling effective implementation of the same.

65. Where necessary, the management shall appropriately allocate the responsibilities to respective functions' heads and a dedicated management committee (or another management committee, e.g., ALCO and / or relevant risk management committee(s)).

Shari'ah supervisory board (SSB)

66. The SSB shall additionally be responsible for review and approval of the IAs strategy and policy framework in line with Shari'ah principles and rules, and ongoing monitoring and supervision of the implementation of the same.

Shari'ah compliance department (SCD)

67. The SCD shall be responsible to provide input and guidance in the development of the IAs strategy and policy framework and for monitoring its implementation, in line with the requirements of respective AAOIFI GS[43].

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[43] GS 9 "Shari'ah Compliance Function"

Part C: Pre-commencement considerations

Implementation of IAs strategy and policy framework and other requirements of this standard

68. An institution shall, before soliciting funds for IAs, ensure that the IAs strategy and policy framework, as prescribed in paragraphs 16-67, along with other requirements of this standard has been implemented (or is implemented, as and when relevant requirements are fulfilled). In this respect, the management shall submit a report of compliance with such requirements to the SSB and TCWG before the commencement of operations (or as of the effective date of this standard).

Human resources

69. An institution shall, before soliciting funds for IAs, ensure that:

    a. adequate human resources are available to manage the functions related to IAs, including, in particular, the investment pool management and profit and loss distribution functions; and

    b. respective roles and responsibilities have been adequately assigned to different organs of governance and management functions, in line with the requirements of this standard and the respective policies and procedures.

IT infrastructure

70. An institution meeting the criteria of a public interest institution shall mandatorily, and any other institution shall preferably, have an efficient and integrated IT infrastructure appropriately capable to manage the operations and processes of profit and loss calculation and distribution and investment pool management / fund management. Having in place a dedicated investment pool management system / module shall be preferred for all institutions.

71. The IT infrastructure shall be capable of:

    a. establishing controls necessary to ensure compliance with the procedural requirements of this standard and with Shari'ah principles and rules, and any relevant regulatory requirements and contractual arrangements;

    b. complying with the requirements of the relevant AAOIFI FASs and recording and reporting the information necessary for the disclosures required by this standard along with the disclosure requirements of relevant AAOIFI FASs; and

c. analysing and producing data necessary for the risk management purpose, including for the purpose of maintaining risk reserves complying with the requirements of respective AAOIFI FAS[44] and market best practices[45].

72. Institutions, other than public interest entities, shall also consider investing in the IT infrastructure in line with the requirements of this standard, applying the proportionality principle and considering the overall risk assessment at the institution level.

Certification of IT infrastructure

73. IT infrastructure of an institution offering IAs (particularly those meeting the criteria of a public interest institution) including the core banking system, investment pool management system and any other relevant system (or modules, as applicable), shall preferably be certified by a third party, as being capable of complying with the requirements of this standard particularly those enumerated in paragraphs 70-73.

[44] FAS 35 "Risk Reserves"

[45] Including relevant IFSB standards

Part D: Considerations at the stage of contract / account opening

74. An institution shall comply with the requirements of paragraphs 75-80 at the stage of signing a contract or an account opening form. In case of additional investment instruments linked with the original contract or account opening form, the relevant requirements of paragraphs 77-80, particularly with regard to ensuring transparency and disclosure, shall be complied with each time.

Minimum contents of the contract / account opening form

Minimum contents of the contract / account opening form – applicable to all IAs

75. An institution shall ensure that the following terms are clarified, and information is disclosed, at a minimum, to all the IAHs as a part of the contract / account opening form:

    a. clarification that the act of IAH's investment in the respective IAs, by virtue of signing the contract / account opening form, signifies an act of entering into a Shari'ah compliant contract (to be specified, e.g., Mudaraba);

    b. confirmation that IAH's funds shall be invested in the underlying assets in compliance with Shari'ah principles and rules;

    c. clarification of the rights and responsibilities of the institution, including that:

        i. the institution as Mudarib (or working partner or agent, as applicable) has the right of applying discretion with regard to the selection and investment in the underlying assets, and any restrictions on the same (with appropriate details);

        ii. the institution shall be liable for losses arising from its negligence, misconduct or breach of its investment mandate;

        iii. the IAH's funds will be invested as per the investment policy of the institution and in accordance with the terms and conditions agreed in the contract;

        iv. whether or not, and to what extent, the institution has the right of commingling of IAHs funds with other IAHs funds under a similar contract, with similar terms and conditions, and its own funds (including specification of what shall be considered as its own funds, e.g., funds based on current accounts);

        v. whether or not, and to what extent, the institution has the right of commingling of IAHs funds with other IAHs funds obtained under a different contract, or under a similar contact, with different terms and conditions with specification of broader principles applied on such commingling;

        vi. the institution has the right of periodic change in the profit sharing ratio (PSR), weightages, etc., with a due process of notification to the IAHs before any such change takes place, whereby their continued investment shall be considered as a consent for such change;

vii. profits and losses shall be computed in accordance with the accounting policies of the institution in line with the relevant AAOIFI FASs (or another applicable framework to be defined, subject to compliance with Shari'ah principles and rules); and

viii. the institution at its absolute discretion may decide to pay Hiba or reduce its share of profit, from time to time;

d. clarification of the rights of and risks applicable to the IAHs, including that:

i. the funds provided by IAHs shall be treated on a participatory basis, and hence, neither the principal nor the profit can be guaranteed;

ii. any profit shall be distributed according to the agreed PSR, weightages, etc.;

iii. risk reserves (e.g., IRR, PER) may be created out of the profits attributable to the IAHs according to the risk management policies of the institution, in line with the requirements of this standard and the respective AAOIFI FAS (or other applicable standard / regulation, to be specified), and hence their consent is provided for the same; and

iv. IAHs shall bear any loss in proportion to their respective underlying investment;

e. identification of governing laws, regulations and principles:

i. applicable Shari'ah principles and rules (particularly, if different from the hierarchy provided in paragraph 5(aa));

ii. governing law; and

iii. applicable regulations.

Specific contents of the contract / account opening form – applicable to HRIAs (including RIAs)

76. In addition to the general considerations contained in paragraph 75, in the case of HRIAs (including RIAs), an institution shall ensure that at a minimum, the following terms are clarified, and information is disclosed, to all the IAHs as part of the contract / account opening form:

a. characteristics and associated risks profiles of the intended investment pool and the nature of restrictions imposed in the case of RIAs;

b. the experience and capability of the institution (and the management team, or external investment managers, where applicable) in respect of the asset management quality;

c. disclaimers, if any, about the performance of investment portfolio and the respective responsibilities of the institution;

d. details of any arrangement for early withdrawal, redemption or other exit and any costs to respective IAs as a result, along with the option of commingling of the institution's own funds in case of a shortfall, where applicable; and

e. confirmation of the IAH's investment objectives, and a statement that they understand the relevant risks.

Transparency and disclosure requirements at the time of contract / account opening

Minimum disclosures applicable for all IAs at the time of the contract / account opening

77. Before opening an IA with an institution, the potential IAHs shall be adequately advised by the institution of their contractual rights and risks regarding investment account products, including, but not limited to, the following:

a. the institution's investment policy with respect to LRIAs and HRIAs (including RIAs), along with possible associated risk with expected rate of return;

b. overall risk appetite for underlying assets, investment objectives including an identification of target asset classes, general business strategy and risk management policies, as relevant;

c. relevant products underlying the IA and a summary mechanism of profit and loss distribution, including in particular the PSRs and the weightages assigned, as well as, mechanism to change the same (and to get consent for the same);

d. profit smoothening techniques, including in particular, the risk reserves (e.g., PER and IRR, where applicable) maintenance and utilisation mechanisms and treatment of any other reserve(s) (e.g., fair value reserve);

e. commingling of other funds and its potential impact on the IAs;

f. summary of previous periods' declared profits, including the effects of profit smoothening techniques (and any risk reserves available in the respective investment pools);

g. indicative / expected profit rates;

h. mechanism of charging impairment, credit losses and provisions, as well as, direct expenses which are attributable to the investment pool;

i. Zakah deduction method (if applicable);

j. in case of time-bound IAs, the respective pre-mature withdrawal terms and mechanism, and identification of potential losses to the IAHs in the event of such pre-mature withdrawal;

k. complaint lodging and redressal mechanism, if any;

l. other related information, available on IFI's website; and

m. any Shari'ah related conditions for usage of debit card.

78. Any disclosures and communications to the IAs including the terms and conditions of the contract shall be done:

a. in a prominent written communication form (avoiding use of fine print etc.);

b. in a verbally explained form through the front desk staff or other means of communication; and

c. in a language preferred by the IAHs (particularly, where the education levels of the common IAHs are low, and their understanding of the communication language is not certain).

Additional disclosures applicable for HRIAs (including RIAs) – at the time of the contract / account opening

79. The disclosure for all HRIAs shall include the following:

a. true, factual and balanced statements, and not projections or estimates of future performance. These disclosures shall include all explanations, qualifications, limitations and other statements that are necessary to prevent the performance information from misleading investors;

b. information to reflect, at an appropriate level of detail, the direct and indirect fees, expenses, taxes deducted and the net amount receivable by the IAHs based on the profit calculation and identification and segregation methods adopted;

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

d. in case of time-bound HRIAs, the respective pre-mature withdrawal terms and mechanism, and identification of potential losses to the IAHs in the event of such pre-mature withdrawal.

Requirements in respect of know you customer (KYC), anti-money laundering (AML) and combating the financing of terrorism (CFT)

80. An institution shall follow the requirements laid down by the respective RSA and / or global best practices in respect of KYC, AML and CFT issues.

Part E: Ongoing considerations

Considerations for changes in the IAs strategy and policy framework

81. An institution shall develop the IAs strategy and policy framework in a reasonably flexible manner so as to minimise any need for frequent amendments to the same. However, in the event of a significant change to the IAs strategy and policy framework, it shall:

    a. follow the due approval process for the initial development / adoption of the IAs strategy and policy framework, in line with the requirements of this standard; and

    b. obtain an expressed consent from all relevant stakeholders, including the IAs.

82. The requirements of paragraph 81 shall be equally applicable in the event of a change in the contractual arrangements with the IAs, including, in particular, any terms and conditions applicable in respect of profit and loss attribution and distribution.

Before beginning of the PLC period

Changes in PSRs and weightages

83. PSRs and weightages, and any changes thereto[46], shall be disclosed and communicated to all IAHs and other relevant stakeholders (including potential IAHs):

    a. in a transparent manner – including adequate details about the profit and loss computation mechanism, and as to how and to what extent such changes may impact the IAHs;

    b. in a timely manner – at least 15-21 days before the commencement of the respective PLC period, identifying the date of announcement and the PLC periods for which the same is expected to apply;

    c. in a detailed manner – identifying all categories of IAs, respective investment pools and the institution's equity share and the respective PSRs and weightages and where practicable, identifying the expected profit rates in annualised terms, and the actual rates of profit paid / attributed during the preceding PLC period;

    d. through an appropriate means of communication – e.g., through emails, update on the website (while communicating about such update through emails, text messages and / or letters delivered on a timely basis); and

    e. under a deemed confirmation approach – whereby, in case of any changes, the communication provides the IAHs fair and equitable option to either:

        i. implicitly confirm their acceptance to such changes if they do not take any action; or

[46] The same requirements shall apply, as far as practicable, to the first time announcement of the same by an institution or in respect of first time announcement for a new class / category of IAs.

ii. withdraw their investments without any material loss, if such change is not acceptable to them.

During the PLC period

Transfers

84. An institution shall avoid the practice of arbitrary transfers between investment pools during a PLC period.

85. In case of an inevitable transfer of assets between different stakeholders (including investment pools) it shall take place only in strict compliance with Shari'ah principles and rules and shall be subject to the requirements of the IAs strategy and policy framework developed in accordance with the requirements of this standard, while safeguarding the interests of the related stakeholders. (See paragraphs 34-37)

86. Financial reporting in respect of the transfer of assets between different stakeholders shall be performed in line with the requirements of respective AAOIFI FAS[47].

At the end of the PLC period

Periodic computation and attribution of profits and losses

87. At the end of each PLC period, a periodic computation and attribution of profits and losses shall take place as soon as possible (considering compilation of accounting records and preparation of relevant accounting information), but in no case later than a week from the date of end of such PLC period.

88. Accounting records of each investment pool shall be kept in a manner to enable appropriate computation of profits and losses to the institution, respective IAHs and other stakeholders, as applicable, in an adequate and timely manner, consistently following the accounting policies of the institution applicable to such underlying assets (except where a different accounting policy is applied, by virtue of contractual arrangement or regulatory requirement).

89. Once the periodic profits and losses (including gains and losses, not taken to the statement of income, but attributable to the IAs, as per contractual arrangements) are determined, a computation of profits applicable to the institution's equity, IAs and other stakeholders shall be performed, strictly, in the following order:

    a. total profits attributable to each respective investment pool (without charging any expenses or impairment) shall be determined on actual basis (including allocation and attribution in case of commingled assets, etc.), while reconciling total profits of the institution and their attribution to respective investment pools;

[47] FAS 47 "Transfer of Assets between Investment Pools" (also see FAS 45 "Quasi-Equity (Including Investment Accounts)")

b. direct expenses, if any, attributable to each investment pool, e.g., Takaful of respective assets, etc. shall be allocated on an actual basis, as far as practicable;

c. impairment and credit losses, attributable to each investment pool shall be allocated on an actual basis, as far as practicable;

d. allocation of profits in respect of commingled funds (including institution's commingled equity (or funds considered as equity, e.g., current accounts), as well as, investments based on Al-Wakala Bi Al-Istithmar, commingled in the Mudaraba based investment pool) shall be made strictly on a proportionate basis;

e. a transfer to / from PER shall be recorded in respect of the respective investment pool in line with the risk management policies and the contractual arrangements, in accordance with the overall IAs strategy and policy framework;

f. Mudarib's share of profit as per contractual arrangement shall be allocated to the Mudarib (i.e., the institution);

g. a transfer to / from IRR shall be recorded in respect of the respective investment pool in line with the risk management policies and the contractual arrangements, in accordance with the overall IAs strategy and policy framework;

h. only in rare circumstances (see paragraph 43(a)), an amount of Hiba (in whatever form) shall be added to the total distributable profits, at the sole discretion of the institution and subject to the requirements of the IAs strategy and policy framework;

i. the net profit so arrived (after including Hiba) for distribution amongst the IAs shall be allocated according to the weighted average balances of each class / category of IAs (within the investment pool) during the PLC period, in line with the contractual arrangements; and

j. the profit so arrived for each class / category of IAs (within the investment pool) shall be converted into a periodic rate, which shall be applied to each individual IA for profit attribution and distribution purposes.

90. In case of application of different PSRs, instead of weightages being applied to different classes / categories of IAs within an investment pool, the requirements of paragraphs 89(f) and 89(i), shall be adequately replaced in line with the contractual requirements, and applied in a manner that the spirit of the overall requirements of paragraph 89(f) is followed. [Explanation: In other words, different PSRs shall not be used to provide a profit equivalent to specific Hiba or a profit more than the limit defined in paragraph 30(a) (in respect of limit of maximum weightages).

91. In case of losses in an investment pool, the requirements of paragraph 89 shall be applied, except that as per Shari'ah principles and rules and contractual arrangements, there shall

neither be any Mudarib's share nor different weightages to IAs nor different PSRs, and hence, all losses shall be allocated proportionately.

92. Appendix C provides an illustrative example of the flow applied for working for profit and loss computation, which shall be read in conjunction with the requirements of paragraphs 87-91, and shall only be applied subject to, and to the extent of, compliance with the respective contractual requirements and the IAs strategy and policy framework.

Payment of due profits

93. At the end of each PLC period, once the periodic computation and attribution of profits and losses is performed, the profits due for payment under the contractual terms, shall be paid within a week of such computation.

94. Any unjustified delay (in excess to the limit provided in paragraph 93) in payment of profits shall be compensated by including the undistributed profits for the preceding PLC period in the average balances of the IAs for the current PLC period (considering the same to be available from the first day of such PLC period till the time these are actually paid).

Treatment of undistributed profits

95. Any profits that are attributable to (but not distributed / paid) to an IAH, shall be adequately classified and treated in line with the contractual arrangement and the requirements of the IAs strategy and policy framework.

Constructive liquidation

96. Under normal circumstances, at the end of each PLC period, a constructive liquidation shall take place in line with the requirements of Shari'ah principles and rules and the contractual arrangements (duly following the principal procedures defined in the IAs strategy and policy framework).

97. A constructive liquidation shall be reflected in the books of account of an institution in a manner that the rights and obligations related to IAs and the underlying assets of the investment pools are adjusted and re-ascertained for accounting purposes, duly reflecting the effects of such constructive liquidation, in line with the requirements of Shari'ah principles and rules and relevant AAOIFI FASs.

Distribution of profit on account

98. In rare circumstances, whereby the contractual arrangements with the IAHs or the relevant regulatory requirements require that the distribution for a given PLC period is not considered full and final (i.e., no constructive liquidation takes place), and the same is made on-account (or ad-hoc) basis, such amount of attributed profits shall be considered as a receivable in line with Shari'ah principles and rules and relevant contractual arrangements. Such amount shall be subject to a final adjustment at the next constructive liquidation or redemption, as the case may be. Accounting treatment of such on-account profit distribution shall be in line with the relevant AAOIFI FASs.

Unclaimed amounts

99. An institution shall have a proper policy in respect of recordkeeping, reporting and, where appropriate, reinvestment of unclaimed amounts in line with Shari'ah principles and rules, and the contractual arrangements, as well as, related regulatory requirements.

Ongoing responsibilities of respective organs of governance and management functions

Responsibilities and authorities of TCWG

100. TCWG, through the IAs committee, shall always ensure implementation of the IAs strategy and policy framework and compliance with Shari'ah principles and rules and contractual arrangement through ongoing supervision and monitoring of the relevant functions, and through implementation and continuity of adequate control functions.

Shari'ah supervisory board (SSB)

101. The SSB shall have an effective oversight on all the functions related to IAs, particularly with regard to the allocation / attribution of profit and charging of losses relating to IAHs (or not charging of losses on account of negligence or breach of contractual obligations) to ensure compliance with Shari'ah principles and rules, contractual arrangements and other requirements of the IAs strategy and policy framework.

102. All significant issues related to IAs identified by SCD, ISA, ESA and / or Shari'ah compliance inspection conducted by the RSA shall be submitted to the SSB for consideration and prescribing appropriate corrective actions.

Shari'ah compliance department (SCD)

103. SCD shall be responsible to ensure compliance, on an ongoing basis, with the requirements of this standard and relevant Shari'ah principles and rules and the contractual arrangements.

104. The SCD shall be also responsible for enforcement of corrective actions directed by the SSB on any reports of ISA, ESA and RSA's Shari'ah compliance inspection reports.

Part F: Considerations on redemption of investment

105. Redemption or maturity of a time bound IA or a full withdrawal of a demand IA may have two different situations, namely:

  a. redemption or full withdrawal, at the end of a PLC period; or

  b. redemption or full withdrawal, during the continuity of a PLC period.

106. A full withdrawal of investment from an IA generally coincides with the closure of an IA. If a full withdrawal is allowed without closure of respective IA according to the institution's policy and contractual arrangements, then the same shall be considered as zero balance for computation of average balance (see paragraph 39) and shall not be considered a full withdrawal for the purpose of the requirements of paragraphs 111-112.

Redemption at the end of a PLC period

107. Redemption at the end of a PLC period may take either of the two forms:

  a. maturity of all time bound IAs in the respective investment pool, and eventually liquidation of the respective investment pool (which may not necessarily be an end of a normal PLC period); or

  b. redemption of an IA at a date coinciding with the date of the end of a PLC period.

108. Redemption at the end of a PLC period shall be based on the distribution of profits and losses of the respective investment pool, in line with Shari'ah principles and rules, contractual arrangements and requirements of this standard.

Redemption during the continuity of a PLC period

109. A redemption during the continuity of a PLC period, depending on the contractual arrangements with the respective IAs, shall be based:

  a. preferably, on the basis of on-account (ad-hoc) distribution of profits and losses till the date of withdrawal (e.g., based on expected profit, or on last distributed profit), with a final adjustment at the end of the PLC period once the profits and losses for the respective period are calculated; or

  b. alternatively, on the basis of a sale of proportionate underlying assets, whereby a final adjustment is made against a lump-sum price (including adjustments of profits (current and past / already paid) on pre-agreed basis of adjustment).

Adjustments for profit tiers on account of early redemption

110. In case of early redemption of IAs originally invested for longer tenures, an adjustment to the already distributed profits through an adjustment at the time of sale of the respective IAH's undivided share in the underlying assets of the respective investment pool, can be made in line with Shari'ah principles and rules and the contractual arrangements without an unjustifiable loss to the respective IAH. (See explanation in paragraph 115).

Termination / early redemption / withdrawals

Withdrawals from / termination of a demand IA

111. Routine withdrawals from a demand IA during a PLC period shall be treated in a manner that the due benefit (e.g., through being part of the weighted average balances for the respective PLC period) is passed on to the IAH, and no IAH is penalised in an unjustifiable manner, by not allocating any profits for the respective PLC period.

112. Termination of a demand IA can generally take either of the following two forms:

 a. by way of closure of an account during a PLC period – whereby the treatments similar to those related to termination / early redemption of a time bound IA shall apply (see paragraphs 113-115); or

 b. by way of reducing the account balance to zero, or below the minimum balance amount as per contractual requirements – whereby the profit for the current PLC period shall be paid at the end of the current PLC period based on average balance in line with the IAs strategy and policy framework and contractual requirements. Such account may become dormant in due course as per regulatory requirements and / or contractual arrangements, and hence closed in due course.

Termination / early redemption of a time bound IA

113. Termination / early redemption of a time bound IA takes place in line with due contractual and regulatory requirements when either:

 a. the IAH requests for early redemption of a time bound IA, and such request is approved by the institution; or

 b. the IAH exercises its unilateral option of early redemption of a time bound IA, in line with the contractual arrangements or relevant regulatory requirements (after allowing a notice period, as provided contractually or as per the relevant regulatory requirements); or

 c. the RSA orders an early termination, for any reason that it deems fit.

114. A termination / early redemption of a time bound IA shall take place, in line with the following, applying the hierarchy as applicable:

 a. relevant Shari'ah principles and rules;

 b. relevant regulatory requirements; and

 c. the contractual arrangements including the relevant policy and applicable modus operandi.

115. An institution shall ensure that in all cases a termination / early redemption shall not result in an unjustifiable material loss to the IAHs. [Explanation: In order to avoid an unjustifiable material loss to the IAHs in such cases, it is important that firstly, the terms and conditions

applicable to such situations are transparently disclosed in advance, and secondly, the same shall be based on a stepped model of reduction of profits based on invested, as well as, remaining period of investment, without any impact on the originally invested amount, or the attributable amount of already earned profits in the respective investment pool, that would have been attributable if such investment was originally kept for such reduced period.]

Attribution of adjusted past profits

116. In all situations related to early termination or withdrawal, any reversal of past profit through a price adjustment in line with the requirements of paragraph 110, shall revert to the respective investment pool in the respective PLC period, and hence distributed amongst the IAHs and the institution in line with the contractual arrangements (and not to the institution alone).

Part G: Considerations in the event of liquidation of an institution

117. In the event of liquidation of an institution, unless being contradictory to the relevant contractual arrangements and / or relevant Shari'ah principles and rules, IAs shall be liquidated in the following manner:

    a. firstly, any liabilities that may pertain to the respective investment pools related to IAs shall be settled and any effect of losses including investment losses shall be charged to the respective investment pools;

    b. secondly, each investment pool shall be liquidated by:

        i. settling the assets with the respective counter parties or disposing off the assets to independent third parties; or

        ii. if, and to the extent, such settlement or disposal of assets is considered impracticable, then by transferring such assets to the institution at their respective fair values or at the respective carrying values, if not materially different from fair values. Such transfer shall, insofar as possible, take place against cash. However, in case of cash shortfall, any balance amounts payable to IAHs shall be considered as a liability of the institution;

    c. thirdly, by applying any Takaful arrangement available to secure IAs (e.g., a Shari'ah compliant deposit insurance scheme);

    d. fourthly, by negotiating with IAHs (where appropriate, in line with Shari'ah principles and rules and relevant regulatory requirements) for any waivers including adjustments for longer maturity IAs (with mutual consent); and

    e. finally, by settling the net balances due to IAs after such adjustments.

118. Any Sukuk based on participatory structures (sharing the IAs investment pools or having dedicated investment pool), eligible to be classified as either additional Tier-1 or Tier-2 capital, shall be liquidated in a manner that the conversion or perpetuity option (as per contractual arrangements), as applicable, shall be applied, instead of requirements of paragraphs 117(d)-117(e).

Part H: Transparency and disclosures

Overall considerations for transparency and disclosures

119. An institution shall ensure the utmost level of transparency and disclosures in line with the requirements of this standard, the relevant AAOIFI FASs[48], the relevant IFSB standard(s)[49] and the market best practices.

120. The requirements of paragraphs 119 shall be applicable to an institution, in addition to the requirements related to transparency and disclosures provided elsewhere in this standard[50].

Presentation and disclosures in the financial statements

121. An institution shall follow the requirements of relevant AAOIFI FASs while preparing its periodic financial statements.

122. In case an institution is not subject to the requirements of AAOIFI FASs, the presentation and disclosures contained in Appendix D and Appendix E, shall be followed, insofar as practicable.

Periodic communication (including disclosures on an institution's website)

123. The following shall be disclosed by an institution through appropriate means (preferably by adequately and prominently disclosing on its website), at all times, and shall be periodically updated (along with a communication of such update to all IAHs and other relevant stakeholders):

    a. PSRs (including Mudarib's share) and weightages – past record (for at least 24 (but preferably 60) previous PLC periods[51]), as well as, those applicable for the current and upcoming PLC period as applicable to each investment pools and respective categories of IAs [Note: Special investment pools, in which common IAs are not invited, shall not be subject to this requirement]; and

    b. past record (for at least 24 (but preferably 60) previous PLC periods) of performance of institution in terms of profit rates (in annualised term) paid / attributed to different categories / classes of IAHs (identifying separately the amounts of Hiba included in such profits, where in excess of 20% of the amount of respective profits) and building-up and utilisation of risk reserves.

[48] FAS 45 "Quasi-Equity (Including Investment Accounts)", FAS 46 "Off-Balance-Sheet Assets Under Management" and FAS 47 "Transfer of Assets Between Investment Pools"

[49] IFSB Standard No. 22 "Revised Standard on Disclosures to Promote Transparency and Market Discipline for Institutions Offering Islamic Financial Services (Banking Segment)" and any other relevant standard

[50] Paragraph 55, Appendix D and Appendix E

[51] This requirement is based on a general assumption that the PLC periods normally comprise of a month, and accordingly in case of a PLC period being more than a month, such requirement may be proportionately applied (i.e., for minimum of 2 years and preferably 5 years).

General disclosures for IAHs

124. An institution shall disclose to IAHs written procedures / policies for IAs (and their classes, where applicable), including a synopsis of the following:

   a. governance arrangements applicable for IAs;

   b. range of IAs available, and their respective characteristics and intended investor classes and underlying assets portfolio; and

   c. purchase, redemption and distribution procedures and profit adjustment for withdrawals and early redemptions.

125. An institution shall make an adequate and timely public announcement in its annual report, website and mainstream media should they make any material changes to their policies in respect of profit calculation, asset identification and segregation, investment strategies, PSR and mechanics of smoothing the returns (if any) in respect of the investment accounts that they manage.

Financial reporting for HRIA (including RIAs) and off-balance sheet investment accounts

126. An institution shall ensure appropriate financial reporting to IAHs in respect of off-balance sheet investment accounts, in line with the requirements of relevant AAOIFI FASs. The financial reporting shall be performed in a manner that an IAH may be able to assess the performance of the specific investment pool[52].

Considerations by the auditors of the financial statements of an institution

127. Auditors of the financial statements of an institution shall ensure the appropriateness and adequacy of profit and loss computation and attribution to different stakeholders in respect of IAs, in line with the requirements of Shari’ah principles and rules and the contractual arrangements between the stakeholders. The requirements in relation to the performance of an audit, as well as, the reporting requirements as entailed in the respective AAOIFI Standards on Auditing and Assurance (SOAAs)[53] shall be followed in this respect.

External Shari’ah audit

128. The scope of external Shari’ah audit, in line with relevant AAOIFI GSs and AAOIFI SOAAs, includes the aspects of ensuring compliance with Shari’ah principles and rules, and contractual arrangements related to IAs. It is expected that considering the significance of the IAs in respect of IFIs, particularly the Islamic banks and similar financial institutions, the external Shari’ah auditors shall ensure due coverage of the function while performing their respective responsibilities.

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[52] In the absence of a specific FAS on the subject, an institution may take guidance from the requirements of FAS 34 “Financial Reporting for Sukuk-holders” as far as the same is relevant.

[53] [ED of] SOAA__ “Framework of Auditing” and other relevant AAOIFI SOAAs

Consideration in the report of the SSB

129. SSB of an institution, in its annual report, shall specifically report in respect of the IAs and related matters, including its opinion on the appropriateness of profits and / or losses distribution to the IAs (which may be partially based on reliance on the work of external Shari'ah auditors or other organs of governance).

130. The opinion formed by the SSB, shall in particular have a conclusion so as to assure that the institution has complied with its fiduciary responsibilities, including in particular the profit and / or loss sharing with various participating stakeholders (including IAHs, Sukuk-holders, etc.) by applying just and equitable treatment to such stakeholders in line with the relevant contracts, applicable AAOIFI SSs, GSs and FASs and the institution's policies (particularly considering the IAs strategy and policy framework).

Shari'ah compliance and fiduciary rating

131. An institution, meeting the criteria of a public interest institution, shall preferably secure a Shari'ah compliance and fiduciary rating for the institution in line with the requirements of respective AAOIFI GS[54]. Other institutions are also encouraged to secure such rating.

132. An institution shall preferably secure a Shari'ah compliance and fiduciary rating in line with the requirements of respective AAOIFI GS[55], in respect of:

a. any material HRIA (including RIAs) offered to public at large on a retail basis; and

b. in the absence of a Shari'ah compliance and fiduciary rating for the institution, as referred to in paragraph 131, any IAs to be offered to public at large on a retail basis.

Effective date

133. This standard shall become effective for all institutions for the financial reporting periods beginning on or after 1 January 2026. Earlier application is encouraged.

Transitional provisions

134. All the requirements of this standard shall become applicable on the effective date of the standard on a prospective basis. The following exemptions from any newer requirements contained in this standard may be allowed subject to a condition and to the extent that these do not result in any non-compliance of the requirements of this standard in respect of other IAs (e.g., due to commingling of funds with common investment pool attributable to URIA):

a. any participatory investment instruments other than IAs, which are already in issue for a definite term, till their intended maturity; and

[54] GS 10 "Shari'ah Compliance and Fiduciary Rating for Islamic Financial Institutions"
[55] GS 17 "Shari'ah Compliance and Fiduciary Ratings of Sukuk and Other Islamic Finance Instruments"

b. in rare circumstances, subject to specific approval of the SSB, any term IAs which are already in issue for a definite term, till their intended maturity.

Appendices

Appendix A: Adoption of the standard

This standard was presented for the approval in the AAOIFI Governance and Ethics Board (AGEB) meeting No.____________, corresponding to _________ and was duly approved and adopted.

Members of the board

1. Mr. Mohammad Farrukh Raza (chairman)
2. Dr. Walid Hegazy (deputy chairman)
3. Dr. Abdulbari Mashal
4. Mr. Abdullah AlMoqbel
5. Dr. Abozer Magzoub
6. Dr. Ahmet AlBayrak
7. Dr. Ali AlSartawi
8. Ms. Ibtihal Al-Shamali
9. Dr. Kabir Hassan
10. Mr. Mohammad Shoaib
11. Mr. Moosa Khoory
12. Mr. Muzammil Kasbati
13. Mr. Sohaib Umar
14. Mr. Wael Merza
15. Dr. Zahid ur Rehman Khokher

Reservation

The standard was approved unanimously.

Working group members

1. Dr. Zahid ur Rehman Khokher (chairman)
2. Mr. Muzammil Kasbati
3. Mr. Moosa Khoory
4. Dr. Saad Bakkali
5. Mr. Faizan Ahmed
6. Dr. Mohammad Habibur Rahman

7. Mr. Mezbah Uddin Ahmed
8. Dr. Mohammad Kabir Hassan
9. Mr. Adnan Shafi email
10. Dr. Muhammad Qaseem
11. Mr. Dalip Kumar Kaul
12. Dr. Fares Djafri

Executive team

1. Mr. Omar Mustafa Ansari (AAOIFI)
2. Ms. Zahra Jassim (AAOIFI)
3. Ms. Alyaa Adel (AAOIFI)
4. Mr. Mohammed Islam Ahmed (Senior Research Associate)

Appendix B: Basis for conclusions

BC1 [To be updated later]

Appendix C: Profit calculation and distribution process flow (illustration)

[To be updated later].

Appendix D: Presentation and disclosures – on-balance-sheet investment accounts

[To be inserted later in line with the requirements of FAS 45 “Quasi-Equity (Including Investment Accounts)”]

Appendix E: Presentation and disclosures – off-balance-sheet assets under management

[To be inserted later in line with the requirements of FAS 46 “Off-Balance-Sheet Assets Under Management”]

Appendix F: Adequate level of risk reserves

[In line with the requirements of FAS 35 “Risk Reserves”]

Profit Equalisation Reserve (PER)

PR1 PER maintained in line with the requirements of this standard, for each category of stakeholders, shall be considered adequate, if it is sufficient to absorb the combined monetary effect of rate of return risk and displaced commercial risk applicable to such category of stakeholders. This combined monetary effect shall be calculated according to the respective accounting policies of the IFI. A sample computation approach is provided in Table “A”. Such policies shall be developed according to the best practices of risk management and shall reflect a prudent approach.

Investment Risk Reserve (IRR)

PR2 IRR maintained in line with the requirements of this standard, for each category of stakeholders, shall be considered adequate if it is sufficient to absorb the combined monetary effect of credit risk, market risk and equity investment risk applicable to such category of stakeholders. This combined monetary effect shall be calculated according to the respective accounting policies of the IFI. A sample computation approach is provided in Table “B”. Such policies shall be developed according to the best practices of risk management and shall reflect a prudent approach.

The impact computations in line with the sample "Table A" and "Table B" shall be made according to the best practices of risk management.

Table A: Sample computation for adequate level of PER		
	The best estimate of maximum impact of rate of return risk i.e., change in average rate of return – on asset side	A
Add:	The best estimate of maximum impact of rate of return risk i.e., change in average rate of return – on investment accounts (deposit) side	B
Add:	Additional impact of displaced commercial risk (including, where applicable, liquidity considerations) – if any	C
	Total possible impact	D=A+B+C
	The expected level of absorption of "A" by IRR related to the respective class of stakeholders – subject to the maximum amount of IRR actually maintained	E
Add:	The expected level of absorption of "A" by combined amount of allowances for credit losses, impairment, NRV adjustment and provisions developed in line with the requirements of FAS 30 "Impairment, Credit Losses and Onerous Commitments"	F
	Total expected possible impact absorption by "E" and "F" (limited to a maximum amount being equivalent to "A"	G=E+F (but in no case more than A)
	Adequate level of PER	D-G

Table B: Sample computation for adequate level of IRR		
	The best estimate of maximum impact of credit risk	A
Add:	The best estimate of maximum impact of market risk – based on value at risk	B
Add:	The best estimate of maximum impact of equity investment risk – based on value at risk and the business risk	C
	Total possible impact	D=A+B+C
Less:	The expected level of absorption of "D" by combined amount of allowances for credit losses, impairment, NRV adjustment and provisions developed in line with the requirements of FAS 30 "Impairment, Credit Losses and Onerous Commitments"	E
	Adequate level of IRR	D-E

The above tables shall, in all cases, be considered as a sample computation guidance only, and IFIs are independent to adopt any suitable computation methods in line with best practices of risk management.

Guidance for determining the period of building up reserves

The period during which an IFI may build-up reserves to an adequate level shall generally be linked with suitable timing which can typically be a proportion of the weighted average liquidity profile of the respective stakeholders' investments. For example, it can be a period equal to 3 or 5 times the average liquidity profile of the respective stakeholders' investments if these are mostly short-term investment accounts. Any other suitable approach is also considered acceptable.

Appendix G: Brief history of the preparation of the standard

H1 The secretariat proposed developing a standard on management of investment accounts in the 23rd meeting of AGEB held on 24-25 Rabi' II 1443H, corresponding to 29-30 November 2021, via video conferencing. The members agreed that there is a need in the market and approved the initiation of the project and the formation of a working group.

H2 Following the board's approval, two working group meetings were held to discuss the preliminary study of the standard on 11 Ramadan 1443H, corresponding to 12 April 2022 and 23 Ramadan 1443H, corresponding to 28 April 2022. The members discussed the preliminary study and agreed on conceptual issues. The working group approved the preliminary study.

H3 Following the approval of the preliminary study, the development process of the exposure draft started. The working group held three meetings to discuss the exposure draft. The meetings were held on 19 Muharram 1444H, corresponding to 17 August 2022, 17 Shawwal 1444H, corresponding to 3 May 2023 and 18 Shawwal 1444H, corresponding to 4 May 2023.

H4 AGEB held its 30th meeting on 20-21 Shawwal 1444H, corresponding 10-11 May 2023, via video conference and provided their comments and recommendations to the working group for further enhancement and content enrichment. The working group held its meeting on 17 Dhul Hajjah 1444H, corresponding to 10 July 2023 to continue the discussion on the exposure draft.

H5 AGEB held its 31st meeting on 2-3 Muharram 1445H, corresponding 19-20 July 2023, via video conference and AGEB 33rd meeting on 19-20 Rabi' I 1445H, corresponding to 4-5 October 2023, via video conference and approved the issuance of the exposure draft. The board directed the secretariat to make the necessary changes in light of the comments of the AGEB members and the discussions during the meeting. After due process, the exposure draft was issued on 18 Jumada ll 1445H, corresponding to 31 December 2023.