مصرف الإمارات العربية المتحدة المركزي
CENTRAL BANK OF THE U.A.E.

معيار متطلبات إدارة المخاطر في المصارف الإسلامية

STANDARD RE RISK MANAGEMENT REQUIREMENTS FOR ISLAMIC BANKS

TABLE OF CONTENTS

Article (1)
Introduction

1.1 This Standard re risk management requirements for Islamic banks ("the Standard") forms part of the Risk Management Regulation (Circular 153/2018) issued by the Central Bank on 27th May 2018. Licensed banks that conduct all or part of their activities in accordance with the provisions of Islamic Shari'ah ("Islamic Banks and Banks Housing an Islamic Window" both referred to hereafter as "IBs") must comply with this Standard. This Standard is mandatory and enforceable in the same manner as the Regulation.

1.2 Banks housing an Islamic Window should comply with the provisions of this Standard in relation to the Shari'ah compliant businesses and activities. Banks housing an Islamic Window must integrate the risk management requirements stated in this Standard within the existing risk management framework and apply these requirements to the existing modes and contracts within the Islamic Window.

1.3 This Standard should be read in conjunction with the other risk management standards issued by the Central Bank. The Standard elaborates on risk management aspects pertaining to IBs that have not been specifically addressed in other regulations or standards issued by the Central Bank. IBs should comply with the requirements of this Standard in addition to the requirements stated in the other risk management regulations and standards.

1.4 It is crucial for IBs to recognize and evaluate the overlapping nature and transformation of risks that exist between and among the categories of the above-mentioned risks. IBs may also face consequential business risks relating to developments in the external marketplace. Adverse changes in IB' markets, counterparties, or products as well as changes in the economic and political environments in which IBs operate and the effects of different Shari'ah standards are examples of business risk. These changes may affect IBs' business plans, supporting systems and financial position. In this regard, IBs are expected to view the management of these risks from a holistic perspective.

1.5 IBs are exposed to reputational risk arising from failures in governance, business strategy and process. Negative publicity about the IBs business practices, particularly relating to Shari'ah non-compliance in their products and services, could have negative impact on their market position, profitability and liquidity.

1.6 This Standard is issued pursuant to the powers vested in the Central Bank under the provisions of the Decretal Federal Law No. (14) of 2018 Regarding the Central Bank & Organization of Financial Institutions and Activities and its amendments ("Central Bank Law").

1.7 Where this Standard stipulates to provide information, undertake certain measures, or address certain terms listed as a minimum, the Central Bank may impose requirements, which are additional to those outlined in the relevant article of the Standard.

1.8 This Standard elaborates on the supervisory expectations of the Central Bank with respect to risk management for Shari'ah compliant businesses and activities.

Article (2)
Scope of Application

2.1 This Standard applies to all IBs. IBs established in the UAE with Group relationships, including Subsidiaries, Affiliates, or international branches, must ensure that the Standard is adhered to on a solo and Group-wide basis.

2.3 An IB which sets up special purpose vehicles with the objective of conducting specific Shari'ah compliant activity must ensure that the risks arising in the special purpose vehicle are monitored and reported at the group level (risk management on a consolidated basis).

2.4 This Standard must also be read in conjunction with the Standards and Resolutions issued by the Higher Shari'ah Authority (HSA).

Article (3)
Definitions

a. **Affiliate:** An entity that, directly or indirectly, controls, or is controlled by, or is under common control with another entity. The term control as used herein to mean the holding, directly or indirectly, of voting rights in another entity, or of the power to direct or cause the direct of the management of another entity.

b. **Board:** The Islamic Bank's board of directors.

c. **Central Bank:** The Central Bank of the United Arab Emirates.

d. **Central Bank Law:** Decretal Federal Law No. (14) of 2018 Regarding the Central Bank & Organization of Financial Institutions and Activities and its amendments.

e. **Central Bank Regulations:** Any resolution, regulation, circular, rule, standard or notice issued by the Central Bank.

f. **Credit Risk:** The potential that a counterparty fails to meet its obligations in accordance with agreed terms. Credit risk includes the risk arising in the settlement and clearing transactions.

g. **Compliance with Islamic Shari’ah** refers to compliance with Shari’ah in accordance with :

a. resolutions, fatwas, regulations, and standards issued by the Higher Shari’ah Authority in relation to licensed activities and businesses of IBs (“HSA’s Resolutions”), and

b. resolutions and fatwas issued by Internal Shari’ah Supervision Committee (“ISSC”) of the respective IB, in relation to licensed activities and businesses of such institution (“the ISSC’s Resolutions”), provided they do not contradict HSA’s Resolutions.

h. **Displaced Commercial Risk:** Risk where the IB may be under market pressure to voluntarily pay a return that exceeds the rate that has been earned on assets financed by Investment Account Holder when the return on assets is under-performing as compared with competitors’ rates.

i. **Equity Investment Risk:** Risk arising from entering into a partnership for the purpose of undertaking or participating in a particular financing or general business activity as described in the contract, and in which the provider of finance shares in the business risk.

j. **Fiduciary responsibilities** and duties refers to the responsibilities of IB to treat all their fund providers appropriately and in accordance with the terms and conditions of their investment agreements.

k. **Fiduciary Risk:** Risk that arises from IBs’ failure to perform in accordance with explicit and implicit Standards applicable to their fiduciary responsibilities.

l. **Fund Providers:** Refers to the deposits received by IB and that includes (a) current account holders; and (b) Investment Account Holders.

m. **Group:** A group of entities which includes an entity (the ‘first entity’) and:

a. any Controlling Shareholder of the first entity;

b. any Subsidiary of the first entity or of any Controlling Shareholder of the first entity; and

c. any Affiliate, joint venture, sister company and other member of the Group.

n. **Internal Shari’ah Audit:** Regular process to inspect and assess the IB’s compliance with Islamic Shari’ah and the level of effectiveness of the IB’s Shari’ah governance systems.

o. **Internal Shari'ah Supervision Committee (ISSC):** A body appointed by the IB, comprised of scholars specialized in Islamic financial transactions, which independently supervises the transactions, activities, and products of the IB and ensures they compliance with Islamic Shari'ah in all its objectives, activities, operations, and code of conduct.

p. **Internal Shari'ah Control Division (or Section):** Technical division (or section) in the IBs with a mandate to support the ISSC its mandate.

q. **Investment Risk Reserve:** Investment risk reserve is the amount appropriated by the IBs out of the income of Investment Account Holder (IAH), after allocating the Mudarib's share, in order to cushion against future investment losses for IAH.

r. **Investment Account:** Refers to the deposits accepted by IBs on the basis of Mudarabah or Wakalah contract or any other profit generating contract.

s. **Islamic Window:** Refers to the licensed activities that are conducted in accordance with the Islamic Shari'ah that are carried by financial institutions for their account or for the account of or in partnership with third parties which comply with the regulatory requirements stated in this Standard and other regulations issued by the Central Bank.

t. **Market Risk:** Refers to the potential impact of adverse price movements such as benchmark rates, foreign exchange (FX) rates, equity prices and commodity prices, on the economic value of an asset.

u. **Parent:** An entity (the 'first entity') which:
   a. Holds a majority of the voting rights in another entity ('the second entity');
   b. Is a shareholder of the second entity and has the right to appoint or remove the majority of the board of directors or managers of the second entity; or
   c. Is a shareholder of the second entity and controls alone, pursuant to an agreement with other shareholders, a majority of the voting rights in the second entity; or
   d. If the second entity is a subsidiary of another entity which is itself a subsidiary of the first entity.

v. **Profit Equalization Reserve:** The amount appropriated out of the Mudaraba profits, in order to maintain a certain level of return on investment for the Mudarib and unrestricted investment account holders and mitigate displaced commercial risk.

w. **Rate of Return Risk:** Overall balance sheet exposures where mismatches arise between assets and balances from fund providers.

x. **Restricted Investment Accounts:** The account holders authorize the IBs to invest their funds based on Mudaraba or Wakala contracts with certain restrictions as to where, how and for what purpose these funds are to be invested.

y. **Risk Appetite:** The aggregate level and types of risk an IB is willing to assume, decided in advance and approved by the Board and within its risk capacity, to achieve its strategic objectives and business plan.

z. **Risk Limits:** Specific quantitative measures that must not be exceeded based on, for example, forward-looking assumptions that allocate the bank's aggregate risk appetite to business lines, legal entities or management units within the bank or group in the form of specific risk categories, concentrations or other measures as appropriate.

aa. **Risk Profile:** Point in time assessment of the bank's gross (before the application of any risk mitigants) or net (after taking into account risk mitigants) risk exposures aggregated within and across each relevant risk category based on current or forward-looking assumptions.

bb. **Risk Governance Framework:** As part of the overall approach to corporate governance, the framework through which the Board and management establish and make decisions about the bank's strategy and risk approach; articulate and monitor adherence to the risk appetite and risk limits relative to the bank's strategy; and identify, measure, manage and control risks.

cc. **Risk Management Function:** Collectively, the systems, structures, policies, procedures and people that measure, report and monitor risk on a bank-wide and, if applicable, group-wide basis.

dd. **Senior Management:** The executive management of the Bank responsible and accountable to the Board for sound and prudent day-to-day management of the Bank, generally including, but not limited to, the chief executive officer, chief financial officer, chief risk officer and heads of the compliance and internal audit functions.

ee. **Shari'ah Non-Compliance Risk:** Probability of financial loss or reputational damage that IB might incur or suffer due to not complying with Islamic Shari'ah.

ff. **Subsidiary:** An entity (the 'first entity') is a subsidiary of another entity (the 'second entity') if the second entity:

a. Holds a majority of the voting rights in the first entity;
b. Is a shareholder of the first entity and has the right to appoint or remove the majority of the board of directors or managers of the first entity; or

c. Is a shareholder of the first entity and controls alone, pursuant to an agreement with other shareholders, a majority of the voting rights in the first entity; or
d. If the first entity is a subsidiary of another entity which is itself a subsidiary of the second entity.

gg. **Unrestricted Investment Accounts:** The account where the holders authorize the IBs to invest their funds based on Mudaraba or Wakala (agency) contracts without laying any restriction on how the investment is to be managed. The IBs can commingle these funds with their own funds and invest them in pooled portfolio.

Article (4)
Risk Governance Framework for IB

4.1 An IB must establish, implement and maintain a risk governance framework that enables it to identify, assess, monitor, mitigate and control risks. The risk governance framework consists of policies, procedures processes, systems, controls and limits. The risk governance framework must be comprehensive and address the specific risks associated with Shari'ah compliant businesses and activities.

4.2 IBs that are branches of foreign licensed financial institutions must adhere to this Standard or establish equivalent arrangements to ensure regulatory comparability and consistency. The equivalent arrangement, if applicable, should include the matters related to general assembly, the Board and its Committees without contradicting the prevailing laws in the UAE. The equivalent arrangements must be submitted to the Central Bank for approval.

4.3 IBs must ensure an adequate system of controls with appropriate checks and balances are in place. The controls must (a) comply with the Islamic Shari'ah, (b) comply with applicable regulatory and internal policies and procedures; and (c) take into account the integrity of risk management processes.

4.4 In addition to the minimum elements of the risk governance framework stated in the Central Bank's Risk Management Standards (153/2018), IBs must incorporate the following minimum elements into the risk governance framework:
a. Internal Shari'ah Supervisory Committee,
b. Internal Shari'ah Compliance, and
c. Internal Shari'ah Audit.

4.5 In defining and assessing risks, IBs must consider both the probability of the risk materializing and its potential impact on the IB. In addition to the factors to be assessed in the context of the potential risk impact as stated within Central Bank's Risk Management Standards (153/2018) the IB must also assess the ability to meet its fiduciary responsibility to Investment Account Holders (IAH), both restricted and unrestricted investment accounts.

4.6 IBs risk governance framework must address all material risks which at a minimum must include the following items:

a. Credit Risk;
b. Market Risk;
c. Liquidity Risk;
d. Operational Risk and Shari'ah Non-compliance Risk;
e. Displaced Commercial Risk;
f. Equity Investment Risk;
g. Rate of Return Risk;
h. Risks arising from its strategic objectives and business plans; and
i. Other risks that singly, or in combination with different risks, may have a material impact on the IB.

4.7 The Board is ultimately responsible for developing the IB's Shari'ah compliant risk governance framework. The framework must incorporate a "three lines of defense" approach. In addition to the stated requirements within the Central Bank's Risk Management Standards (153/2018) the IB's approach should also include provisions relating to:

- Internal Shari'ah Supervision Committee (ISSC);
- Internal Shari'ah compliance, and
- Internal Shari'ah Audit.

4.8 The risk appetite statement must reflect a written articulation of the aggregate level and types of risk that an IB is willing to accept, or avoid, in order to achieve its business objectives. However, an IB should have no tolerance toward Shari'ah non-compliance risk. In addition to the minimum items set-out within Central Bank's Risk Management Standards (153/2018), an IB's risk appetite statement must also cover the following risks:

- Shari'ah Non-Compliance Risk,
- Displaced Commercial Risk,
- Rate of Return Risk and
- Equity Investment Risk.

4.9 IBs must define and document roles and responsibilities towards IBs' risk governance framework.

4.10 The Board’s Risk Committee (“Risk Committee”) is responsible to review and approve the establishment of framework for managing all material risks as part of the overall risk management framework of the IB and must oversee its implementation by the Senior Management.

4.11 The Risk Committee must supervise and monitor the management of Shari’ah non-compliance risk and set controls in relation to this type of risk, in consultation with the ISSC and through the internal Shari’ah control division, or section.

4.12 The Risk Committee must ensure there is an information system that enables the IB to measure, assess and report all risks including but not limited to Shari’ah Non-Compliance Risk, Equity Investment Risk and Displaced Commercial Risk. Reports must be provided on a timely manner to the Board and Senior Management, in formats suitable for their use and understanding.

4.13 In addition to the minimum items set-out within Central Bank’s Risk Management Regulation, IBs must include in its documented ICAAP, within the Internal Control review, provisions relating to the Internal Shari’ah Audit function.

4.14 IBs should manage risks in accordance with the Shari’ah rules and the scope determined by the contracts IBs use as basis for their financial transactions. IBs may not transfer risks to counterparties, or avoid responsibilities and ownership risks, which result from using specific contracts. IBs may manage these risks by other means that do not conflict with the provisions of Islamic Shari’ah.

Article (5)
Risk Management Function of IBs

5.1 The head of the risk management function, the Chief Risk Officer (CRO) or equivalent is responsible for assisting the Board, board committees, executive committee (including the Internal Shari’ah Supervision Committee), senior management (including Internal Shari’ah Control Division or Section and Internal Shari’ah Audit) to develop and maintain the risk governance framework applicable to its IB.

5.2 In addition to the key activities set out within the Central Bank’s Risk Management Standards (153/2018), IBs must include identifying, assessing, monitoring and reporting risks associated specifically to Shari’ah compliant business and activities.

Article (6)
Risk Measurement and Use of Models for IBs

6.1 The risk assessment and measurement processes undertaken by IBs must specifically address the risk of loss arising from Mudaraba, Musharaka and Wakala contracts, where applicable. Rigorous risk evaluation (including due diligence) must be adequately conducted in view of the exposure to capital impairment.

Article (7)
Stress Testing of Material Risks for IBs

7.1 IBs must ensure that risks arising from the provision of Shari’ah Compliant business and activities are appropriately captured in the IBs’ forward-looking stress-testing program.

Article (8)
Information Systems and Internal Reporting for IBs

8.1 IBs must ensure that an adequate system of controls with appropriate checks and balances are in place. The controls must:

a. Ensure compliance with the provisions of Islamic Shari’ah, and
b. Take into account the integrity of risk management processes.

Article (9)
Strategic and Operational Decisions

9.1 As part of the IBs’ overarching approval process, the following at a minimum must be undertaken by IBs:

a. New Product Approvals must include a risk assessment with a variety of scenarios, particularly with more pessimistic assumptions than the base-line case. The assessment should take into consideration the legal consequences of the underlying Shari’ah structure/contract throughout the life span of the products and services e.g. event of default, restructuring and rescheduling scenarios.
b. Mergers and acquisitions, disposal and other changes must include adequate due diligence that identifies post-transaction risks or activities conflicting with the IBs’ Governance Framework and other specifities relating to IBs. An IB must have a strategy towards alleviating over-dependence on few types of underlying structures/contracts that may present limitations in terms of tradability and flexibility in the events where risk emerges (e.g. dependence on monetization products).

Article (10)
Disclosures of IBs

10.1 In addition to the requirements set out within Central Bank's Risk Management Standards (153/2018) regarding disclosures, IBs must make appropriate and timely disclosure of information to Investment Account Holders. The disclosure should include information related to Profit Equalization Reserves and Investment Risk Reserves, if applicable, so that the investors are able to assess the potential risks and rewards of their investments and to protect their own interests in their decision-making process. Applicable international financial reporting standards must be used for this purpose.

Article (11)
Credit Risk

11.1 IBs must have in place:

- an appropriate credit strategy, including pricing and tolerance for undertaking credit risks exposures;
- a risk management structure with effective oversight of credit risk management; credit policies and operational procedures including credit criteria and credit review processes, acceptable forms of risk mitigation, and limit setting;
- an appropriate measurement and careful analysis of exposures, including market and liquidity-sensitive exposures; and
- a system (a) to monitor the condition of ongoing individual credits to ensure the financings are made in accordance with the IBs' policies and procedures, (b) to manage credit challenges according to an established remedial process; and (c) to ensure adequate provisions are allocated.

11.2 IBs must have in place an appropriate framework for credit risk management and reporting in respect to all assets. This includes credit risk related to different stages of the Shari'ah compliant products and investments. IBs must apply the credit risk principles to credit risks associated with securitization and investment activities.

11.3 The risk assessment and measurement processes undertaken by IBs must also be applicable to profit sharing assets (Mudaraba and Musharaka) which are classified under equity investments. Rigorous risk evaluation (including due diligence) and controls of these investments are necessary in view of their exposure to capital impairment. This must not contradict the risk sharing nature in these instruments as prescribed by Islamic Shari'ah.

11.4 IBs must have in place a strategy for financing, using various instruments in compliance with Shari'ah, whereby the strategy recognizes the potential credit exposures that may arise at different stages of the various financing agreements.

11.5 IBs must manage and account for the credit risk arising from Shari'ah compliant instruments where:
- no Shari'ah compliant compensation can be imposed, and/or
- the profit cannot be increased/continued.

11.6 IBs must have a policy for carrying out a due diligence review in respect of counterparties prior to deciding on the choice of an appropriate Shari'ah compliant financing instrument.
This has to be carried in particular, for transactions involving:
- New ventures with multiple financing modes: IBs should carry out due diligence processes on customers using multiple financing modes to meet specific financial objectives designed to address Shari'ah, legal or tax issues of customers.
- Creditworthiness that may be influenced by external factors: Where significant investment risks are present in participatory instruments, especially in the case of Mudarabah financings, additional counterparty reviews and evaluations will focus on the business purpose, operational capability, enforcement and economic substance of the proposed project including the assessment of realistic forecasts of estimated future cash flows. IBs should put in place risk mitigating structures in place to the extent possible.

11.7 IBs must have in place Shari'ah compliant credit risk mitigating techniques appropriate for each Islamic financing instrument. IBs must be aware of the commencement of exposure to credit risk inherent in different financing instruments such as the non-binding nature of certain contracts. Risk management techniques should not change the nature or the Shari'ah aspects of the contract in order to mitigate the risk.

11.8 IBs should clearly define their credit risk-mitigating techniques including, but not limited to, having in place:
- a methodology for setting mark-up rates according to the risk rating of the counterparties, where expected risks should be taken into account in the pricing decisions;
- permissible and enforceable collateral and guarantees;

- stipulating the counter party's commitment to donate in case of default in the legal documentations in accordance with the applicable Shari'ah resolutions and standards;
- clear documentation as to whether or not purchase orders are cancellable; and
- clear procedures for taking account of governing laws for contracts relating to financing transactions.

11.9 In a financing involving several related agreements, IBs must be aware of the binding obligations arising in connection with credit risks associated with the underlying assets for each agreement. IBs must ensure that all components of a financial structure comply with the Shari'ah parameters applicable to combination of contracts.

11.10 IBs must establish limits on the degree of reliance and the enforceability of collateral and guarantees subject to the provisions set-out within the relevant rules of Islamic Shari'ah.

11.11 IBs must have appropriate credit management systems and administrative procedures in place to undertake early remedial action in the case of financial distress of a counterparty or, in particular, for managing bad credits, potential and defaulting counterparties. This system should be reviewed on a regular basis. Remedial actions will include both administrative and financial measures.

Administrative measures may inter alia include:

- negotiating and following-up pro-actively with the counterparty through maintaining frequent contact with the counterparty;
- setting an allowable timeframe for payment or to offer rescheduling (without an increase in the amount of the debt in debt based instruments) or Shari'ah compliant restructuring arrangements;
- using a debt-collection agency;
- resorting to legal action, including the attachment of any credit balance belonging to defaulters according to the agreement between them; and
- making a claim under Shari'ah -compliant insurance as applicable.

Financial measures may include, among others:

- invoking commitment to donate clauses, where applicable, in accordance with the relevant Shari'ah parameters,; and
- establishing the enforceability of collateral or third party guarantees.

11.12 IBs must set appropriate measures for early settlements.

11.13 IBs must have policies to define adequately the action to be taken by the IB when a customer cancels a non-binding purchase order.

11.14 IBs should assess and establish appropriate policies and procedures pertaining to the risks associated with their own exposures in parallel transactions.

11.15 IBs must ensure, whenever possible or applicable, that there is sufficient Shari'ah-compliant insurance coverage of the value of the assets.

11.16 IBs must have in place an appropriate policy for determining and allocating provisions for (a) non-performing debt categories, including counterparty exposures; and (b) estimated impairment in value of assets.

Article (12)
Market Risk

12.1 Requirements on market risk must be read in conjunction with the Market Risk Regulation and accompanying Standards (Circular 164/2018).
IBs must have in place an appropriate framework for market risk management in each stage of the contract, including reporting in respect of all assets held, particularly those that do not have a ready market and/or are exposed to high price volatility.

12.2 IBs must establish a sound and comprehensive market risk management process and information system, which (among others) comprises:
- a conceptual framework to assist in identifying underlying market risks;
- guidelines governing risk taking activities in different portfolios of restricted IAH and their market risk limits;
- appropriate frameworks for pricing, valuation and income recognition; and
- a strong management information system for controlling, monitoring and reporting market risk exposure and performance to appropriate levels of senior management.

Given that all the required measures are in place (e.g. pricing, valuation and income recognition frameworks, strong MIS for managing exposures, etc.), the applicability of any market risk management framework that has been developed should be assessed taking into account consequential business and reputation risks.

12.3 IBs must adhere to the fiduciary duty to apply the same risk management policies and procedures to assets held on behalf of restricted Investment Account Holders as they do for assets held on behalf of shareholders and unrestricted Investment Account Holders.

12.4 IBs must be able to quantify market risk exposures and assess exposure to the probability of future losses in their net open asset positions.

12.5 IBs must take into consideration the specifics of each Shari'ah compliant instrument in the following manner:

a. In operating Ijarah contracts, a lessor is exposed to market risk on the residual value of the leased asset at the term of the lease or if the lessee terminates the lease earlier (by defaulting), during the contract
b. In Salam, an IB as a buyer is exposed to commodity price fluctuations on a long position after entering into a contract and while holding the subject matter until it is disposed of. In the case of parallel Salam, there is also the risk that a failure of delivery of the subject matter by the counterparty which exposes the IBs to commodity price risk as a result of the need to purchase a similar asset in the market in order to honor the parallel Salam contract.
c. Before acquisition of financial assets not actively traded with the intention of selling them, an IB must analyze and assess the factors attributable to changes in liquidity of the markets in which the assets are traded and which give rise to greater market risk.

IBs may hedge foreign exchange fluctuations arising from general FX spot rate changes in both cross-border transactions and the resultant foreign currency receivables and payables using Shari'ah compliant methods.

12.6 In the valuation of assets where no direct market prices are available, IBs must incorporate in their own product program a detailed approach to valuing their market risk positions. IBs may employ appropriate forecasting techniques to assess the potential value of these assets.

Where available valuation methodologies are deficient, IBs must assess the need (a) to allocate funds to cover risks resulting from illiquidity and uncertainty in assumptions underlying valuation and realization; and (b) to establish a contractual agreement with the counterparty specifying the methods to be used in valuing the assets

Article (13)
Equity Investment Risk

13.1 IBs must establish an adequate framework towards the management of market risks inherent in the holding of Mudaraba, Musharaka, and Wakala instruments for investment purposes. This includes consideration of quality of the partner, underlying business activities and ongoing operational matters.

13.2 IBs must have in place appropriate mechanisms to safeguard the interests of all fund providers. Where IAH funds are commingled with the IBs' own funds, the IBs must ensure that the bases for asset, revenue, expense and profit allocations are established, applied and reported in a manner consistent with the IB's fiduciary responsibilities.

13.3 In performing the due diligence review, IBs must consider in evaluating the risk in Mudarabah, Musharakah, and Wakala instruments and the capabilities and risk profiles of potential partners (Mudarib or Musharakah partner). Such due diligence is essential to an IBs' fiduciary responsibilities as an investor of IAH funds in profit sharing and loss-bearing instruments (such as Mudarabah, Musharkah and Wakala).

13.4 IBs must consider factors relating to the legal and regulatory environment affecting the equity investment performance during risk evaluation. These factors include policies pertaining to tariffs, quotas, taxation or subsidies and any sudden policy changes affecting the quality and viability of an investment.

13.5 IBs risk mitigation techniques attaching to lack of reliable information must require its investor to take an active role in monitoring the investment, or the use of specific risk mitigating structures.

13.6 IBs must define and set the objectives of, and criteria for, investments before using profit-sharing and loss-bearing instruments (such as Mudarabah, Musharkah and Wakala), including the types of investment, tolerance for risk, expected returns and desired holding periods.

13.7 IBs must have, and keep under review, policies, procedures and an appropriate management structure for evaluating and managing the risks involved in the acquisition of, holding and exiting from loss bearing investments. IBs must ensure proper infrastructure and capacity are in place to monitor continuously the performance and operations of the entity in which IB invest as partners. These should include evaluation of Shari'ah compliance, adequate financial reporting by, and periodical meetings with, partners and proper recordkeeping of these meetings.

13.8 IBs must identify and monitor the transformation of risks at various stages of investment lifecycles, for example, where the investee's business involves innovative or new products and services in the marketplace.

13.9 IBs must analyze and determine possible factors affecting the expected volume and timing of cash flows for both returns and capital gains arising from equity investments.

13.10 IBs must use Shari'ah compliant risk-mitigating techniques, which reduce the impact of possible capital impairment of an investment. This may include the use of Shari'ah permissible security from the partner.

13.11 IBs must ensure that their valuation methodologies are appropriate and consistent and must assess the potential impacts of their methods on profit calculations and allocations. The methods must be mutually agreed between the IB and the Mudarib and/or Musharaka partners.

13.12 IBs must assess and take measures to deal with the risks associated with potential manipulation of reported results leading to overstatements or understatements of partnership earnings.

13.13 IBs must define and establish exit strategies in respect of their equity investment activities, including extension and redemption conditions for Mudaraba, Musharaka and Wakala investments, subject to the approval of the institution's Internal Shari'ah Supervision Committee.

13.14 IBs must be aware that the risks arising from the use of profit-sharing instruments for financing purposes do not include credit risk in the conventional sense but share a crucial characteristic of credit risk because of the risk of capital impairment.

Article (14)
Rate of Return Risk

14.1 Requirements in this area must be read in conjunction with the Interest Rate and Rate of Return Risk in the Banking Book Regulation and accompanying Standards (Circular No. 165/2018). IBs must establish a comprehensive risk management and reporting process to assess the potential impacts of market factors affecting rates of return on assets in comparison with the expected rates of return for IAH.

14.2 IBs must take necessary steps to ensure that the management processes relating to the identification, measurement, monitoring, reporting and control of the rate of return risk (including appropriate structure) are in place.

14.3 IBs must be aware of the factors that give rise to rate of return risk. The primary form of rate of return risk to which IBs are exposed comprises increasing long-term fixed rates in the market. IBs must have in place appropriate systems for identifying and measuring the factors, which give rise to rate of return risk.

14.4 IBs must employ a gapping method for allocating positions into time bands with remaining maturities or repricing dates, whichever is earlier.

14.5 IBs' rate of risk return measurement must highlight the importance of cash flow forecasting for instruments and contracts where IBs are required to simulate and assess their behavioral maturity, underlying assumptions and parameters, which must be reviewed periodically for reliability. The materiality of potential threats to future earnings and the usefulness of the resulting information must be considered in determining the type and extent of forecasted behavior for IBs.

14.6 IBs are encouraged to employ balance sheet techniques to minimize their exposures using the following strategies, among others:

a. determining and varying future profit ratios according to expectations of market conditions;
b. developing new Shari'ah-compliant instruments; and
c. issuing securitization tranches of Shari'ah permissible assets.

Article (15)
Displaced Commercial Risk

15.1 IBs must have in place an appropriate framework for managing displaced commercial risk, where applicable.

15.2 IBs must have in place a policy and framework for managing the expectations of their shareholders and IAH.

15.3 IBs must develop and maintain an informed judgement about an appropriate level of the balances of Profit Equalization Reserve, bearing in mind that its essential function is to provide mitigation of displaced commercial risk.

Article (16)
Operational and Shari'ah Non-Compliance Risk

16.1 IBs must have in place an appropriate framework, adequate systems, controls and limits for Operational and Shari'ah Non-Compliance Risk management.

16.2 IBs must consider the full range of material operational risks affecting their operations, including the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. IBs must also incorporate possible causes of loss resulting from Shari'ah non-compliance and the failure in their fiduciary responsibilities.

16.3 IBs must be aware of being exposed to risks relating to Shari'ah non-compliance and risks associated with the IBs' fiduciary responsibilities towards different fund providers. These risks expose IBs to fund providers' withdrawals, loss of income or voiding of contracts leading to a diminished reputation or the limitation of business opportunities.

16.4 IBs' must be prudent towards Shari'ah compliance and such compliance requirements must permeate throughout the organization and their products and activities. The perception regarding IBs' compliance with Shari'ah rules and principles is of great importance to their sustainability.

In this regard, Shari'ah compliance is considered as falling within a higher priority category in relation to other identified risks. If IBs do not comply with Shari'ah rules and principles, the impacted transactions should be referred to the ISSC to decide on the appropriate treatment (remedy of contracts, derecognition of profit, etc.) and if needed such incidents may be escalated to the HSA.

16.5 IBs must ensure that their contract documentation complies with Shari'ah with regard to formation, termination and elements possibly affecting contract performance such as fraud, misrepresentation, duress or any other rights and obligations.

16.6 IBs must keep track of income not recognized due to Shari'ah non-compliance and assess the probability of similar cases arising in the future and ensure that appropriate controls are in place to avoid recurrences. This may include monitoring of income not recognized due to origination from Shari'ah non-compliant activities.

16.7 IBs must establish and implement a clear and formal policy for undertaking their different and potentially conflicting roles in respect of managing different types of investment accounts. The policy relating to safeguarding the interests of their IAH may include the following:

- identification of investing activities that contribute to investment returns and taking reasonable steps to carry on those activities in accordance with the IB's fiduciary and agency duties and to treat all their fund providers appropriately and in accordance with the terms and conditions of their investment agreements;
- allocation of assets and profits between the IB and their IAH will be managed and applied appropriately to IAH having funds invested over different investment periods;

- determination of appropriate reserves at levels that do not discriminate against the right for better returns of existing IAH; and
- limiting the risk transmission between current and investment accounts.

16.8 IBs must adequately disclose information on a timely basis to their IAH and the markets in order to provide a reliable basis for assessing their risk profiles and investment performance.

Article (17)
Compliance with the Standard

17.1 The IBs should comply fully with these standard requirements within 180 days from publishing this Standard.

17.2 The Regulatory Development Division of the Central bank shall be the reference for interpretation of the provisions of this Standard.

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