

## LEGISLATION UPDATE

### GUIDELINES ISSUED ON ISLAMIC BANKING REGULATIONS

**MAS provides summary of banking regulations and directives relating to Islamic financing; also explains treatment of various Islamic banking structures**

#### Introduction

The Monetary Authority of Singapore (the “**MAS**”) has issued the Guidelines on the Application of Banking Regulations to Islamic Banking (the “**Guidelines**”).

The Guidelines consolidate the various banking regulations (the “**Banking Regulations**”) and written directions relating to Islamic finance issued pursuant to the Banking Act (the “**Banking Act**”). They clarify that a single regulatory framework applies to all banks in Singapore regardless of whether they offer conventional or Islamic banking products. To determine the applicable regulatory treatment for an Islamic banking product, the MAS assesses the economic substance and risks of that product and applies regulations relevant to similar conventional banking products with necessary amendments for *Shariah* compliance. The same regulatory approach is taken when the MAS decides whether to approve a bank’s application to operate in Singapore, or whether to impose capital adequacy requirements.

#### Regulatory Treatment of Islamic Funding Structures, Financing Structures and Investments

The following Banking Regulations clarify the treatment of certain Islamic banking transactions (the “**Transactions**”) under the Banking Act:

- Regulation 4A – a *murabaha* deposit is prescribed as a “deposit” under the Banking Act;
- Regulation 22 – a *murabaha* financing business is prescribed as a permitted business which a bank may carry out under Section 30 of the Banking Act (a “permitted business”);
- Regulation 23 – a *murabaha* deposit business is prescribed as a permitted business;
- Regulation 23A – a *murabaha* interbank placement business is prescribed as a permitted business;

- Regulation 23B – an *ijara wa igtina* financing business is prescribed as a permitted business;
- Regulation 23C (with effect from **7 May 2009**) – a diminishing *musharaka* business is prescribed as a permitted business; and
- Regulation 23D (with effect from **7 May 2009**) – a spot *murabaha* business is prescribed as a permitted business.

The Guidelines set out each Regulation in full, describe the function of each Transaction and provide a diagrammatical representation of how it works. (We have summarised Regulations 23, 23A and 23B in an earlier update dated 23 January 2009. Please click [here](#) to read that summary.)

Regulations 23C and 23D, which have just been issued pursuant to the Banking (Amendment) (No.2) Regulations 2009, came into operation on 7 May 2009.

The Guidelines also state, among other things, that the following Banking Act provisions, MAS Notices and MAS Guidelines apply to all banks in Singapore, including Islamic banks or banks offering Islamic banking products:

- Section 29 Banking Act in relation to large exposure limits;
- Section 33 Banking Act in relation to property-related exposure limits;
- MAS Notice 612 in relation to Credit Files, Grading and Provisioning;
- MAS Notice 613 in relation to Minimum Liquid Assets;
- MAS Notice 626 in relation to the Prevention of Money Laundering and Countering the Financing of Terrorism;
- MAS Notice 637 in relation to Risk Based Capital Adequacy Requirements for Banks Incorporated in Singapore;
- MAS Notice 640 in relation to Minimum Asset Maintenance Requirements; and
- Guidelines on Risk Management Practices.

Notably for MAS Notice 637, the Guidelines also specify the capital treatment for each of the financing Transactions and also for *sukuk* (Islamic financial certificates). All the abovementioned financing Transactions give rise to credit exposure and the standardised approach to credit risk under MAS Notice 637 is to be applied to such exposure. *Sukuk* may be treated as giving rise to a credit exposure or an equity exposure, depending on the facts of the case. Accordingly, either the standardised approach to credit risk or the standardised approach to equity exposure would apply under MAS Notice 637.

The Guidelines mention that a unique risk faced by Islamic banks is *Shariah* compliance, i.e. the possibility that a financial service or product is or will not be in compliance with

established *Shariah* principles. The MAS has not provided any guidance on managing such risks, but expects Islamic banks to manage them as part of their overall risk management process.

### Banking (Amendment) (No.2) Regulations 2009

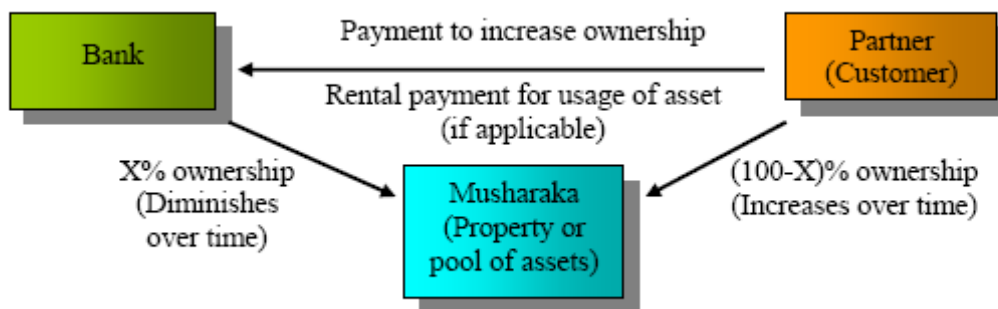
The Banking (Amendment) (No.2) Regulations 2009 came into effect on 7 May 2009. They prescribe diminishing *musharaka* financing and spot *murabaha* transactions as businesses which any bank in Singapore may engage in.

#### *Diminishing musharaka transactions (Regulation 23C)*

A diminishing *musharaka* (a “DM”) transaction is a joint ownership arrangement between a bank and a customer under which the bank gradually sells its portion of the jointly owned asset to the customer, allowing its share of the asset to decrease over time until finally, the customer owns the whole asset. The sum of rent and instalment payments made by the customer to the bank should exceed the original price at which the bank purchased the asset, with the excess representing a return to the bank for providing financing. The bank is required to appoint the customer or a third party to take on the obligations in connection with the use of the asset, including maintenance and insurance.

DM transactions are often combined with leasing arrangements, thus allowing the customer-lessee to use the asset while redeeming ownership of it from the bank over a period of time. The asset could be immovable property, vehicles, machinery or commodities.

#### *Example of a DM structure (diagram extracted from the Guidelines)*



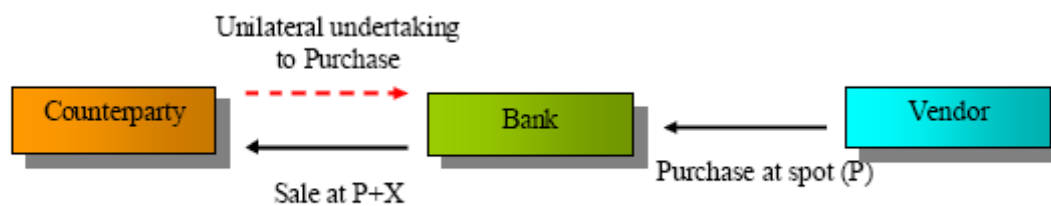
#### *Spot murabaha transactions (Regulation 23D)*

As their name suggests, in spot *murabaha* transactions, the purchase price is paid upfront and not on a deferred basis (as in the other *murabaha* transactions found in the Banking Regulations). Spot *murabaha* transactions are used together with unilateral undertakings from either a bank or its counterparty to effect immediate payments as part of financial transactions (e.g. commodities trading, hedging or other derivative-type investments). The unilateral undertakings are used to fix the formula to calculate the ultimate payout, which is then executed through a spot *murabaha* transaction. The financial transactions in question must fall under the definition of the activities permitted under section 30(1) (a), (b) and (c) of

the Banking Act (i.e. banking business or business regulated or authorised by the MAS, or any business incidental to either of these businesses).

Please refer to the diagram below for an example of a spot *murabaha* transaction. Please note that this relates to the “customer purchase undertaking”, one of the four types of unilateral undertakings mentioned in Regulation 23D.

*Example of a spot murabaha transaction (diagram extracted from the Guidelines)*



## References

Please click on the links below to access the relevant documents:

1. [Guidelines on the Application of Banking Regulations to Islamic Banking](#)
2. [The MAS' Press Release on the Guidelines dated 7 May 2009](#)
3. [Banking \(Amendment\) \(No.2\) Regulations 2009](#)

If you have any queries on this update, or wish to discuss how it may potentially affect you or your business, please feel free to contact the corporate and finance lawyers in Drew & Napier LLC (please refer to the Directors' Profiles on our [website](#)), or any of the following lawyers:

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