PART A: OVERVIEW

1. Purpose

1.1 The Guidelines on Property Development and Property Investment Activities by Islamic Banks set out the expectation of Bank Negara Malaysia on Islamic bank's exposure to property development and property investment activities, with particular emphasis on strengthening the governance and risk management aspects for such activities undertaken by Islamic banks.

1.2 The requirements specified under the Guidelines have taken into consideration the specific nature of property development and property investment activities, as well as the recommendations outlined in the Capital Adequacy Requirements for Sukuk, Securitisations and Real Estate Investment issued by the Islamic Financial Services Board in January 2009.

2. Applicability

The Guidelines is issued under section 53(A) of the Islamic Banking Act 1983 (IBA) and shall be applicable to all Islamic banks licensed under section 3(4) of the IBA.

PART B: POLICY REQUIREMENTS

3. Scope of Exposure

3.1 For the purpose of these guidelines, **real estate business** refers to property development and property investment activities; defined as follows:

Property development activities	:	Direct undertaking of construction or development of land into residential and commercial properties for Islamic banking business activities. It also includes onward sale or lease.
Property investment activities	:	Acquisition of completed properties or land for the purpose of Islamic banking business activities, that includes onward sale or lease (with binding and non-binding financing contracts).

3.2 Other consequential and related financing activities to real estate business extended either to the property development company or to the end customers are not covered within the scope of these guidelines and shall be subject to other relevant regulatory and prudential guidelines issued by the Bank from time to time.

4. Applicable Structure

Exposures to real estate business shall be subject to the following applicable structure and the investment limit prescribed under paragraph 7.1 of this Guidelines:

(i) Islamic banks and their subsidiaries are not allowed to undertake or carry out **direct property development activities**. However, Islamic banks may participate in property development activities through joint venture with, or through equity participation with reputable property development companies that are not subsidiaries of the Islamic banks. Please refer to

Appendix 1 for an illustration of permissible structure of property development activities by Islamic banks.

(ii) There is no restriction for Islamic banks to undertake direct or indirect exposure to **property investment activities**.

5. Governance

5.1 The Board and senior management of the Islamic banks are expected to perform effective oversight over the bank's exposure to the real estate business activities.

5.2 Islamic banks are required to put in place clear internal policies and procedures to govern the exposure to real estate business that should be consistent with the Islamic bank's business strategies, level of expertise and risk management capabilities. Full adherence to Shariah principles must also be ensured. The internal policies must be approved by the Board and at minimum should address the following:

(i) A set of criteria on allowable exposures to real estate business based on the Islamic bank's business strategies;

(ii) Assurance that the Islamic banks shall not engage in the speculative activities involving land and properties;

(iii) Internal limits to individual developer, allowable investment limits, types of properties and overall sectoral exposure;

(iv) Criteria of reputable property development companies[1];

(v) Adequate guidance on decision making, monitoring and assessment process to ensure that the real estate business is

[1] For the purpose of undertaking joint venture or equity participation related to property development activities, Islamic banks are expected to establish internal criteria for allowable types of reputable property development companies. Such criteria shall require rigorous assessment on experience of the management team and track records of the property development company, which include *inter alia,* no history of abandoned project and no previous incident on breach of contractual obligations.

permissible under Shariah principles. The policies should also provide appropriate measures to address potential non-compliance to Shariah requirements;

(vi) A clear line of responsibility with effective reporting procedure on decision making authority and approval process for new investments, and on any breach of internal limits; and

(vii) Clearly defined responsibility of internal audit in assessing the effectiveness of the internal control systems put in place to control risk.

5.3 The governance process and structure on real estate business should comply with all applicable guidelines issued by Bank Negara Malaysia, that include inter alia;

(i) Guidelines on Corporate Governance for Licensed Islamic Banks;

(ii) Governance of Shariah Committee for the Islamic Financial Institutions; and

(iii) Guidelines on Musharakah and Mudharabah Contracts for Islamic Banking Institutions.

6. Risk Management

6.1 Islamic banks are expected to develop a robust risk management process to clearly identify, measure monitor and control the risks associated with real estate business. The risk management process shall take into account different types of risk profiles arising from property development and property investment activities undertaken by Islamic banks. The list of functions that are expected to be conducted by Islamic banks with respect to the exposure to real estate business is provided in **Appendix 2**.

Equity risk

6.2 Islamic banks shall assess all material risk relating to having equity position in companies undertaking property development activities. Such assessment would require appropriate infrastructure to enable the bank making informed investment decision and having safeguards against excessive risk exposure:

(i) Sound measurement and valuation framework on the equity position held by the Islamic banks;

(ii) Strong management information system which facilitates monitoring of actual risk taking against predetermined internal limits and risk tolerance levels;

(iii) Strong monitoring process on the underlying activities of the invested entities, which is supported by a trigger mechanism and clearly defined action plans in the event of portfolio deterioration;

(iv) A rigorous stress testing framework that enable periodical assessment on the invested entities and its implication to the equity position of the Islamic banks; and

(v) An appropriate exit strategy/ mechanism in the event of non-favourable circumstances of the companies invested (e.g. prolonged deterioration in financial strength) or the underlying real estate business (e.g. increased likelihood of project non-completion).

Sectoral exposure risk

6.3 To avoid excessive sectoral exposure risk, Islamic banks shall institute appropriate and effective control to continuously assess and conduct stress testing as to whether the overall exposure to real estate business is consistent with the bank's business strategies and within the tolerance level defined by the internal policies as approved by the Board.

6.4 In conducting the stress testing exercise, Islamic banks shall take into account plausible scenarios on real estate or property sector and continuously assess any potential adverse implications on the exposures based on prevailing market conditions.

Risk of the underlying assets

6.5 The Islamic banks shall take appropriate measures to mitigate all risks associated with the underlying asset, which may include:

(i) Proper identification of the properties or land prior to acquisition;

(ii) Ongoing monitoring of the underlying assets based on sound valuation techniques; and

(iii) Well-defined marketing strategies for the purpose of onward sale or lease of the properties. The Bank's expectations with respect to marketing function of Islamic banks are deliberated further in paragraph 7 to 9 of **Appendix 2.**

Legal risk

6.6 Islamic banks are expected to clearly define and properly document the contractual relationship, rights and obligations of the respective parties involved in the real estate business. The documentation shall be consistent with the requirements of the Shariah.

6.7 Islamic banks shall execute all legal documentation in the correct flow or sequence to effectively reflect the underlying Shariah transactions. Any attempt to simplify the processes or sequence due to practical grounds should not compromise or affect the sanctity of the Shariah contract.

6.8 Islamic banks shall ensure that the appointed legal firms, in-house legal personnel and operations staff have the necessary knowledge, skills and experience in executing Shariah contracts and transactions involved in the real estate business.

6.9 In the preparation of the legal documentation or any legal proceedings, the Shariah Committee should be consulted to ensure all aspects of Shariah compliances are appropriately addressed to avoid any doubt with regard to the Shariah aspect.

7. Prudential Requirements

Investment limits

7.1 Islamic banks are required to observe the following investment limits:

(i) Investment in each real estate business shall not exceed 25% of the licensed Islamic bank's eligible capital base[2]; and

(ii) the aggregate book value of investment in shares, interest-in-shares, collective investment schemes and immovable properties[3] shall not exceed 50% of the Islamic bank's eligible capital base.

7.2 The equity exposures in property development activities shall be subjected to the prudential limits specified in the Guidelines on Investment in Shares, Interest-in-Shares and Collective Investment Schemes for Islamic banks. Exposures that are funded by profit sharing investment account (PSIA) may be excluded from the prudential limits provided that the Islamic banks satisfy the requirements specified in the Guidelines on Recognition and Measurement of PSIA as Risk Absorbent.

[2] Eligible capital base is subject to similar definition used for the purpose of risk-weighted capital ratio (RWCR) computation.
[3] Include completed properties and land acquired under property investment activities.

Capital Requirements

7.3 For the purpose of the risk weighted capital ratio (RWCR) computation, Islamic banks are required to assess the appropriate risk weight that should be accorded to the exposures at different stages of the real estate business, subject to the treatment stipulated under the Capital Adequacy Framework for Islamic Banks. An example of the capital adequacy requirement for exposure to real estate business is provided in **Appendix 3.**

7.4 Credit and market risk weighted assets for real estate business exposures funded by PSIA and fulfill the requirements specified in the Guidelines on Recognition and Measurement of PSIA as Risk Absorbent can be excluded from the RWCR computation of the Islamic bank.

Source of funding

7.5 For the purpose of funding the real estate business, the allowable sources of fund are limited to shareholders' fund of the Islamic bank, specific investment accounts (SIA) and general investment account (GIA)[4].

7.6 However, the use of GIA as a source of fund for real estate shall be limited up to 15% of total GIA fund of the Islamic bank. The Board of Islamic banks shall provide attestation that the following expectations and requirements have been met prior to utilisation of GIA fund:
- (i) The permitted proportion of GIA used for real estate business shall be mobilised from new or rollover deposits offered to sophisticated investors;
- (ii) Prior consent from GIA holders is obtained and relevant information are disclosed to facilitate assessment of risks and

[4] SIA is also known as restricted investment account, while GIA is also known as unrestricted investment account.

return profile of investment portfolio, and monitoring of investment performance;

(iii) Islamic banks must take adequate steps to control mis-selling risk, including a requirement to conduct suitability assessments to ensure that the risks associated with such GIA products offered to new consumers are appropriate to the consumer's needs and level of sophistication;

(iv) Islamic banks possess the ability to clearly identify each real estate business assets against the funding sources, in order to identify and measure the resultant risks and returns associated with such assets;

(v) GIA fund that is earmarked for real estate business purposes shall be managed separately from other source of funds; and

(vi) The Asset and Liability Committee/ Function of the Islamic bank is satisfied that the bank can effectively manage any potential liquidity mismatch arising from differences between the tenor of GIA fund and the tenor of the underlying real estate business.

Disclosure

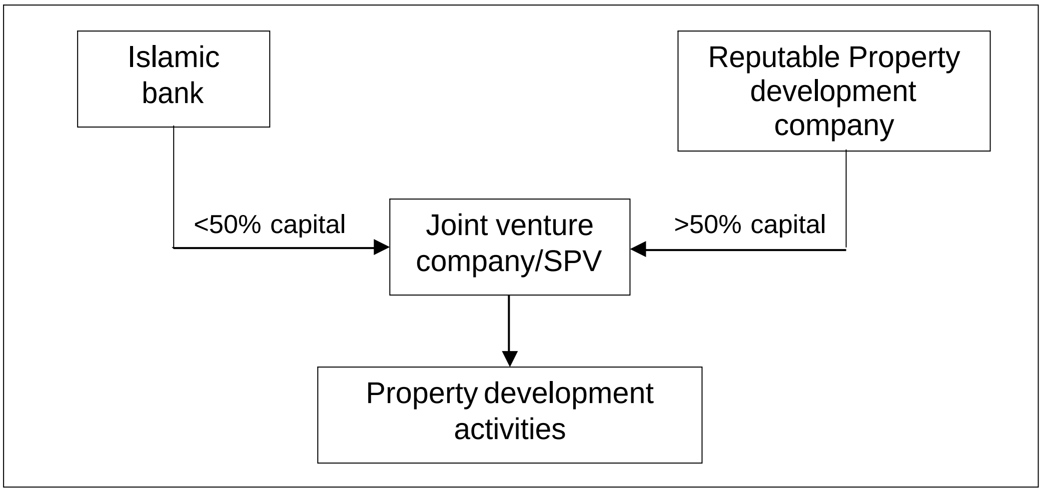
7.7 Islamic banks shall adequately disclose key information with respect to the exposure to the real estate business encompassing total exposure amount, any material changes in the risk profiles, measurement basis used in determining valuation of the properties, basis for depreciation methodology and impairment policy of the properties.

7.8 Such disclosures shall be consistent with the requirement of Guidelines on Financial Reporting for Licensed Islamic Banks and the relevant accounting standards as approved by Malaysian Accounting Standard Board.

APPENDICES

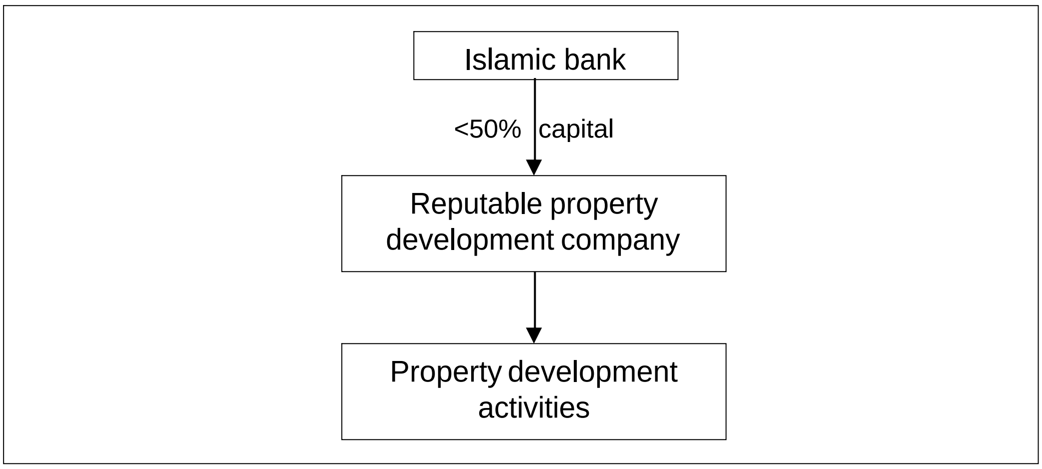
Appendix 1: Illustration on permissible property development activities by Islamic banks

1. Participation in property development activities through joint venture with reputable property development company.



Islamic bank may also acquire the land and sell the land to the joint venture company (which is part of property investment activity) for the purpose of subsequent development or construction on the land.

2. Equity participation in reputable property development company that is not a subsidiary of the Islamic bank.



Appendix 2: List of functions to be undertaken by Islamic banks on exposure to real estate business

1. This appendix sets out the Bank's expectation on the key functions that Islamic banks shall have in place with respect to the involvement in real estate business.

2. Depending on each Islamic bank's business models and nature of risks to which it is exposed, the Islamic bank is expected to:

   (i) Have in-house expertise (such as creation of specialised unit) to provide technical advice, undertake research, conduct valuation and execute marketing strategies for the real estate business; or

   (ii) Outsource such functions to be conducted by the qualified external parties, in the event where in-house expertise is not available.

In-House Expertise

3. At minimum, the in-house expertise unit is expected to undertake the following functions:

   (i) Property research function, which shall perform ongoing research and monitoring of the real estate business;

   (ii) Property valuation function, which shall execute an assessment mechanism and processes to regularly value the land or property; and

   (iii) Marketing strategies function, which shall ensure effective marketing of the properties acquired for the purpose of onward sale and lease.

Property Research Function

4. The property research function shall be manned by officers who have sufficient experience in the real estate business and responsible to perform the following tasks:

   (i) Identify the sites for development or acquisition of the properties;

   (ii) Conduct feasibility study to identify possible issues and risks in relation to the site or property; and

   (iii) Value the site or property prior to acquisition;

5. For Islamic banks involved in property development activities, the property research function shall also:

   (i) Identify and evaluate viability of the location, including construction contracts requirements, insurance/ takaful and bonding requirements during construction phases;

   (ii) Appoint a representative in the project management office established by the separate entity;

   (iii) Review and evaluate proposals on the development project including architect's plan and drawings, costing, marketing program and its compliance with regulatory requirements; and

   (iv) Monitor the fund disbursement and stages of project completion.

Property Valuation Function

6. The property valuation function shall be headed by qualified property valuer with adequate working experience in the property market business. Islamic banks are expected to assess the reasonableness of the market value of a property derived from valuation model and the reliability of data used for purpose of valuation. It is crucial for Islamic banks to develop the following:

(i) Ability to understand the underlying assumptions used in an appraisal or valuation;

(ii) Awareness and frequent monitoring of the factors that may cause changes to an appraisal, which may include price volatility of properties in the vicinity, availability of financing and environmental contamination; and

(iii) Procedure to test checks the result of valuation which is either performed in-house or provided by external parties against an independent source (e.g. Property Market Report). Any material variances on the valuation should be further investigated and rectified accordingly.

Marketing Strategies Function

7. To facilitate an effective onward sale or lease of the properties, Islamic banks shall consider setting up a competent property marketing team comprising of individuals with experience and ability to market the properties effectively.

8. The marketing process should be initiated at the initiation stage of the real estate business. The marketing team is expected to:

(i) Liaise with the property research function specified in paragraph 4 to 5 of this appendix to undertake project or asset feasibility studies and evaluate the macro and micro factors affecting the demand and supply of the properties; and

(ii) Establish internal marketing policies that set out approval limits for the marketing expenditures, appropriate control mechanism on each phases of project management.

9. Islamic banks shall have in place a comprehensive marketing strategy plan that specifies realistic goals and objectives as endorsed by the Board. The marketing plan should include, among others:

(i) Definition of the marketing mix (i.e. basic and tactical components of a marketing plan which has the elements of price, place, product, and promotion) and marketing activities on the properties;

(ii) An overview of the property market with focus on factors that have impact on Islamic banks or marketing strategy;

(iii) Identification of target market;

(iv) Marketing position of Islamic banks in the property market; and

(v) A summary of Islamic banks advertising strategies by market segment and campaign encompassing the objectives, description of content and acceptable period of the advertising campaign.

Outsourcing to External Parties

10. Islamic banks may outsource to external parties to undertake the functions outlined in paragraph 3 to 9 of this appendix.

11. Islamic banks shall ensure that the scope of activities that can be outsourced comply with the restrictions and the conditions under the Guidelines on Outsourcing of Islamic Banking Operations, in respect of the functions recommended for exposure to real estate business. It is crucial for Islamic banks to perform due diligence review on the capabilities and expertise of the outsourcing vendor. In terms of the outsourced function, Islamic banks are required to ensure that the processes which relate to critical decision-making function are retained within the institution.

12. Islamic banks are expected to have in place sufficient internal control mechanism to monitor the effectiveness of functions and conduct performed by the external parties, including mechanism to ensure effective information escalation to the board and senior management.

Appendix 3: Examples on Capital Adequacy Requirement for Exposure to Property Development and Property Investment Activities

The computation of capital adequacy requirement on the exposures to property development and property investment activities is subject to the requirements specified under the Capital Adequacy Framework for Islamic Banks. Please note that the examples of capital adequacy requirement for each scenario provided in this appendix are applicable only for Islamic banks adopting standardised risk measurement approach for credit and market risk.

Indirect exposures (where real estate business are conducted by separate entities)

No.	Scenarios	Capital adequacy requirement
1.	Involvement in real estate business through joint venture with, or equity participation with a reputable property development company.	Exposure amount shall be assigned the following risk weight (RW): ▪ 100%RW for publicly-traded equity investment; or ▪ 150%RW for non-publicly traded equity investment.
2.	Islamic banks undertake property investment activities through subsidiary set-up.	Amount of equity investment in the subsidiary shall be deducted from capital base.

Direct exposures by Islamic banks

No.	Scenarios	Capital adequacy requirement
1.	Islamic banks acquire a completed property and subsequently sell it to end customer: (i) Property sold under Murabahah or non-binding Murabahah for Purchase Order (MPO) contract.	<u>Property acquired and available for sale (booked in balance sheet of Islamic banks):</u> ▪ 15% market risk capital charge applied for inventory risk exposure. <u>Property has been sold and selling price is due from the end buyer:</u> ▪ Credit risk weight assigned based on customer's rating.
	(ii) Property sold under binding MPO contract.	<u>From the time of property acquisition and throughout the contract::</u> ▪ Credit risk weight assigned based on customer's rating.
2.	Islamic bank acquired completed property and subsequently lease it to end customer: (i) Property leased under Ijarah contract.	<u>Property acquired and available for lease (prior to signing a lease contract):</u> ▪ 15% market risk capital charge applied for inventory risk exposure. ▪ For binding agreement to lease, credit risk weight based on prospective lessee's rating assigned to property acquisition cost. <u>Upon signing Ijarah contract and the lease rental payments are due from lessee:</u> ▪ 8% market risk capital charge for inventory risk applied to the residual value of the property.

		▪ Credit risk weight based on lessee's rating is assigned to the property acquisition cost. Upon maturity of contract term and the leased property is returned to Islamic bank: ▪ 15% market risk capital charge for inventory risk exposure applied to the carrying value of the property.
	(ii) Property leased under Ijarah Muntahia Bittamleek / Al-Ijarah Thumma Al-Bai' contract.	Property acquired and available for lease (prior to signing a lease contract: ▪ 15% market risk capital charge applied for inventory risk exposure. ▪ For binding agreement to lease, credit risk weight based on prospective lessee's rating is assigned to acquisition cost of the property. Upon signing Ijarah contract and the lease rental payments are due from lessee: ▪ Credit risk weight assigned to the acquisition cost of the property based on lessee's rating.