

## **Chapter 26: Islamic Finance**

### **BPM7 Chapter 17 – Islamic Finance**

#### **A. General overview**

##### **1. Background**

- 26.1 Islamic finance is distinguishable from traditional finance in several ways, in relation to both financing and insurance activities. Islamic financial institutions, as well as financial institutions with Islamic windows that offer both conventional finance and Islamic finance, are bound by Shari’ah principles. The principles and rules of Shari’ah (or Islamic law) include prohibitions on *Riba* (usually translated as interest), *Gharar* or uncertainty (sometimes translated as “excessive uncertainty”), *Maysir* (gambling), as well as short sales or financing activities that are considered harmful to society. Islamic insurance follows these same principles and is further based on the notion of mutual assistance.
- 26.2 As a result, in economies in which Islamic finance is prevalent, financial corporations have developed specific forms of financing arrangements that are consistent with these principles. In addition, Islamic financial standard setting bodies, including the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB), have developed standards on accounting, auditing, and related regulatory standards and frameworks, to promote greater harmonization of Islamic finance reporting practices across countries.
- 26.3 The historical development of the System of National Accounts, external sector statistics, and other macroeconomic statistics have largely reflected the predominance of conventional financial structures and terminology. Given the rapid growth of Islamic finance in recent years, as suggested by studies and the Islamic Finance Development Indicator (IFDI), it is significant enough to affect the quality of different areas of macroeconomic statistics in several countries. This situation can affect the international comparability of these statistics. To address this, this chapter provides guidance on the statistical treatment of Islamic finance focusing on the national accounts and external sector statistics. More general guidance on financial corporations is provided in Chapter 29.

##### **2. Outline of the chapter**

- 26.4 This chapter presents guidance to properly account for Islamic finance and insurance arrangements in the national accounts and external sector statistics. In doing so, it elucidates by instrument the special types of financing arrangements (sales-based contracts, lease-based contracts, equity-based contracts, or profit/loss sharing) that characterize Islamic finance. It reviews distinct operations of Islamic finance and insurance and addresses issues such as the nature of income on certain Islamic financial instruments (included among deposits, loans, debt securities), the sector classification of Islamic financial institutions, the measurement of output, including FISIM, the treatment of Islamic insurance-like business as well as the instrument classification of select Islamic financial arrangements. This chapter also briefly clarifies the concept of economic ownership in the case of Islamic Finance. The structure of the chapter is as follows: Part B reviews financial institutions and sectoring; Parts C and D provide guidance on the measurement of output and income, respectively; Part E presents Islamic financial arrangements, and how these are reflected in macroeconomic financial instruments; and Part F covers economic ownership.

#### **B. Islamic financial institutions and sectoring**

##### **1. Some basic features of Islamic finance**

- 26.5 Important differences exist between conventional and Islamic finance. Islamic finance must follow certain “Shari’ah” **legal** standards, hence it is often called “Shari’ah-compliant”. The general principles of Islamic finance are: the prohibition of collection and payment of interest or other predetermined returns on investments; the encouragement of investment in real economic activities or trading in goods and services

for profit; sharing rewards and risks between parties involved; the avoidance of profiting from trading in financial assets or “using money to make money”; the discouragement of excessive uncertainty, which may prohibit the use of many types of financial derivatives; and the prohibition on the financing for certain activities that are forbidden by Islam, such as alcohol or drugs. In addition to commercially driven activity, Islamic principles also emphasize the importance of charitable giving, whether through the mandatory welfare due (or *Zakah*) or voluntary charity (*Sadaqah*). Both forms of giving can (but do not have to) be implemented through a type of endowment trust known as a *Waqf*.

- 26.6 To adhere to these principles and to simultaneously accommodate the financing of economic activity, Islamic financial corporations have developed various financing arrangements that are mapped to more generic financial instruments ~~(discussed in Section E, though there are some references below)~~. These financing arrangements are often based on trading models or profit and loss sharing models involving underlying real non-financial assets. ~~Economic ownership of any non-financial assets and changes in economic ownership (discussed in Section F) are fundamental to the compilation of the macro-economic statistics.~~ The recording of such non-financial assets may be reflected on the balance sheet of the Islamic financial institution or an entity which it owns when the (legal) ownership is acquired but this may not be the case for economic ownership as applied in the sequence of economic accounts. ~~can change rapidly afterwards by allocating the non-financial assets to the users of such assets.~~ Economic ownership of any non-financial assets and changes in economic ownership are discussed in Section F and are closely related to the characteristics of the financing instruments discussed in Section E.
- 26.7 In addition, Shari’ah-compliant activities should be segregated from non-compliant activities and funds (i.e., not following Shari’ah principles). This gives rise to some specific treatments. First, the financial statements of Islamic windows of conventional financial institutions are separated from their regular financial activities. Further, off-balance sheet restricted investment accounts of banks and other depository corporations which comply with Islamic finance accounting standards are to be classified as separate institutional units.
- 26.8 Second, there is a distinctive arrangement in which a charitable institution contracts with a fund manager to establish a dedicated, open-ended asset **Waqf Fund** managed according to Shari’ah principles, to which the public can make donations by “purchasing” units of the fund. The charitable institution is the beneficiary of the fund – that is, it is the economic owner of all the units of the fund. Under the agreement, the fund will reinvest or distribute specified amounts of the profits to the beneficiary, and it will charge fund management fees. The donor’s investment in the fund constitutes an irrevocable donation to the beneficiary, and the function of the fund is to provide financial management of the beneficiary’s portfolio of assets. These types of funds are also required to keep a complete set of accounts and constitute institutional units.
- 26.9 Third, there are various schemes in different countries for supporting or enabling pilgrims to save for, or to undertake the Islamic pilgrimage (or *Hajj*). The term **Hajj Fund** is used to describe the case of a market enterprise that undertakes, as a significant part of its activities, the management of long-term savings open to individuals intending to undertake the Hajj pilgrimage in compliance with Shari’ah principles. Such funds are considered as institutional units if they are legally established entities with an autonomous management and keep a complete set of accounts and are classified separately within the financial corporations’ sector. For Hajj savings to meet the conditions of deposits, it is likely that the fund would be a regulated deposit-taking entity (such as a bank or similar entity) with the principal value of the deposit typically protected to some degree. This may not be the most common scenario in many countries, where they are usually treated as non-money market investment funds. Although a **Hajj Fund** might undertake certain secondary non-financial activities, such as the provision of travel, accommodation and related services to pilgrims planning for the Hajj, these activities are expected to be far less significant than its financial activities. Such non-financial activities would normally involve a separate institutional unit outside of the fund.

## 2. Islamic banking and other financial activity, including sectoring

- 26.10 The following guidance focusses on the subsector classification of Shari’ah-compliant financial institutions within the financial corporations’ sector. These subsectors may also include conventional financial institutions as described in Chapter 29. The central bank (S121) and pension funds (S129) are not explicitly discussed below, as these are not specific to Islamic finance except perhaps for some of their investments (discussed in Section E).

## Deposit-taking institutions except the central bank (S122)

### *Organizational considerations*

- 26.11 This subsector is dominated by banks and can include both Islamic banks and other depository corporations, as well as conventional banks and other deposit-taking institutions with Islamic windows. **Islamic banks and other depository corporations** manage funds received to produce returns through investments or financing of transactions for customers. Such operations are sometimes described as *Mudarabah* transactions, the customer is a capital provider, and the financial institution is the entrepreneur (*Mudarib*) that invests the capital. The main inflows include **unrestricted funds** (discussed in Section E) that are commingled with other bank funds, in the same way as deposits in conventional banks. However, unrestricted funds are invested in Islamic financial instruments.
- 26.12 On the other hand, **restricted funds** are managed separately by the bank and segregated from other funds received and typically treated as off-balance sheet – that is, excluded from this subsector. The contracts under which these accounts are created do not give the bank authority over decisions regarding the use and distribution of the funds it receives from account holders. Rather, the bank can only make decisions on the administration and management of the accounts. The only link between the bank’s accounts and the off-balance sheet restricted investment accounts is the share of investment income from these investment accounts (as *Mudarib*), which is recorded as a single item in the bank’s income statement. Restricted funds, while part of the Islamic banks’ business, are almost always treated as a separate institutional unit and included among investment funds.
- 26.13 **Islamic windows of conventional banks and other depository corporations** that accept deposits are also confined to invest the deposits in Islamic financial instruments only. The funds provided under such contracts have the characteristics of deposits, and they provide financing to borrowers using various Islamic financial instruments. Conventional banks are required to maintain a full set of accounts, including a balance sheet, for their **Islamic windows**. They are also obliged to have a Shari’ah Supervisory board, and may have an independent management separate from that of the conventional banks that run them. The reason for this is that the management of the windows requires the existence of a Shari’ah Council as part of its mission to ensure that the funds are not mixed with those funds of the conventional banks. Accordingly, Islamic windows in these cases are considered as institutional units independent of the conventional banks, but within the depository corporation’s subsector.

### *Basics relating to sources and uses of funds*

- 26.14 Unlike conventional banking, there is no common interest rate (nor interest rate ladder) applicable to Islamic deposits that determines the depositors’ returns. Islamic banks and Islamic windows of conventional banks offer Islamic deposit accounts that are closely parallel to conventional accounts, but the banks are also heavily funded by accounts in which returns/losses are shared between the bank and the depositor/investors. Under a profit-sharing model (i.e., participation account), an Islamic bank can withhold part of the depositors’ net profits as a profit equalization reserve. Under SNA accrual rules, these profits should be treated as distributed and subsequently reinvested into the reserve. The depositors in these arrangements therefore acquire a component of the bank’s equity or a different type of bank liability.
- 26.15 Diverse financial instruments, discussed in Section E, can be thought of as sources and uses of funds. Sources of funds are used to generate revenues in different ways - financing of sales, leasing, fees, equity participation, or investment. Some instruments do not have conventional bank equivalents. The returns to Islamic banks and windows on their financing and investments are not guaranteed, but rather depend on the success or failure of their ventures. Returns (and sometimes losses) are divided between the bank and the depositors based on the specific types of Islamic financial instruments used.

## Investment funds (S123 and S124)

- 26.16 Islamic Investment funds are collective investment schemes that issue shares or units to the public, and that are split into two subsectors within the financial corporations' sector. **Money market funds** (MMFs) are invested primarily in Islamic bank deposits. **Non-money market investment funds** (non-MMF), invest in a wider range of Islamic securities.
- 26.17 As noted above, the off-balance sheet **restricted investment accounts** which comply with Islamic finance accounting standards are classified as non-MMF investment funds. This is because the cash of the account holders are placed in an investment fund which is managed independently from the Islamic bank, through which these funds are channeled. In addition, a complete set of accounts for the investment fund, including the financial position which shows the equity of the account holders, is maintained. These restricted Islamic accounts should be treated as investment funds because the clients' money is held in segregated investment funds with any losses borne by the providers of the funds, except if these are due to breach of trust or misconduct by the units managing the funds. Furthermore, like conventional investment funds, these accounts distribute the profits from investments to investors in proportion to the value of their investments.
- 26.18 Collectively organized **Hajj Funds** are also allocated to the non-MMF subsector, provided the general conditions for this classification are met. These conditions include that they are legally established entities with autonomous management, and that they maintain a complete set of accounts. These funds, in concert with their long-term saving character, are not restricted to financial investments and savers bear the risks and rewards of the investments' performance.

### **Other financial intermediaries except insurance corporations and pension funds (S125)**

- 26.19 Islamic investment banks (that do not accept deposits) and investment companies are classified as other financial intermediaries. These entities typically provide Sharia'ah -compliant (advisory) investment banking services, such as structured finance on large projects or financial leasing (such as *Istisna'a* or *Ijarah*), investment placement activities, raising funds in equity and debt markets (often from joint *Mudaraba*), as well as trade finance (often *Murabaha*). Entities involved in installment sales (such as *Bai Muajjal-Ajef*) may also be classified in this subsector.

### **Financial auxiliaries (S126)**

- 26.20 **Takaful (insurance) operators** often constitute the main Sharia'ah-compliant business to be classified as financial auxiliaries. These entities (see paragraphs 26.25-26.26 and 26.44) manage and administer **Takaful (insurance) funds** on behalf of the participants by charging fees to cover their costs. They do not take economic ownership of the assets and liabilities of these funds. Financial auxiliaries may also relate to managers of investment funds, but not the assets they manage.

### **Captive financial institutions and money lenders (S127)**

- 26.21 **Waqf Funds** are a religious/charitable endowment, with the donated assets held by a charitable trust. A Waqf is a charitable institution that contracts with a fund manager to establish a dedicated Waqf Fund, which is open to the public to make donations by purchasing units of the fund. This reflects the fact that the beneficiary is the sole client and that these vehicles are like endowment funds. The financial instrument classification is that the beneficiary has an *Other equity* (F519) claim on the assets of the fund. Purchases of units in the fund by donors should be recorded as miscellaneous current transfers (D75) by donors to the beneficiary. These funds are classified as captive financial institutions.
- 26.22 This subsector can also include any Sharia'ah-compliant money lenders.

## **3. Insurance Corporations (S128)**

- 26.23 There are some parallels between conventional and Islamic insurance (*Takaful*) and re-insurance (*Re-*

*takaful*). At the same time, there are notable differences in the business arrangements. **Takaful** and **Retakaful funds** are included in the insurance corporations' subsector, alongside conventional insurance companies and Islamic windows of conventional insurance companies. *Takaful* and *Retakaful funds* share characteristics with insurance and reinsurance in the SNA, as they collect contributions (which can be considered as the equivalent of premiums in conventional insurance) from participants and have reserves which belong to them. Islamic windows are also included in this subsector, as separate institutional units, given that they maintain segregated financial statements for this activity. In the case of *Light Takaful*, where the arrangements are less complex and do not have to be based on *Tabarru* principles, there is no segregation of operators from funds as is the case with conventional insurance. As noted above, **Takaful operators** with segregated financial statements are included among financial auxiliaries.

### Some basic features of Islamic insurance

- 26.24 In accordance with Islamic finance principles, **Takaful** business arrangements avoid uncertainty (sometimes translated as “excessive uncertainty”), gambling and predetermined interest-based investments. The term *Takaful* means “mutual guarantee”. Islamic insurance can therefore be defined as the process in which a group of people — that is, the participants — who face certain risk(s) agree that each of them contributes a specific amount (based on cooperation) to a non-profit fund that is to be used for compensating anyone of them and/or their beneficiaries for the potential loss encountered if the risk in question materializes. In a such an arrangement, the contract is based on **mutual assistance** (*Ta'awun*) and **reciprocal donation** (*Tabarru'*), rather than the conventional commercial relationship between an insurance company and a policyholder. In conventional insurance the insurer contracts to provide protection (incurs an obligation) against certain losses by leveraging the accumulated premiums paid by the policyholder (insured), including the returns on investment. In contrast, the “participants” in a **Takaful** scheme are considered simultaneously as the insurer and the insured, since the contributions into the **Takaful fund** belongs to the participants and the operator just manages on their behalf.
- 26.25 Islamic insurance is distinguished by two types of contractual relationships. The first is the underlying contract used among the group of participants to govern their relationship on the basis of cooperation and solidarity. Members of the group agree to renounce a certain amount of their contribution paid to a **Takaful fund** as a donation in order to provide mutual indemnity to any fellow participant who suffers a loss covered under the policy. In other words, the group of participants agree to guarantee each other and make contributions to the fund instead of paying premiums to cover themselves individually. The fund is the account established by the company (**Takaful operator**) as the insurance entity to receive (own) the contributions and oversee the reserves and the returns on investment.
- 26.26 The second is the contractual relationship between the group of participants and the **Takaful operator** appointed by the participants to manage and invest the funds for them. The company is not a typical insurer that takes on a liability. In fact, the operator/manager corporation is usually not part of the insurance sector, but rather part of financial auxiliaries. Generally, the operator manages the relationship and maintains separate accounts with respect to the claims (rights) and obligations of the policyholders. Both the operators and the funds maintain separate accounting records, to conform to Islamic finance accounting standards. However, there is one exception to this rule in the case of *Light Takaful*, which presents consolidated financial statements and looks more like conventional insurance arrangements.
- 26.27 The **Takaful** arrangements can encompass several types of structures that govern the relationship, such as profit sharing, payment of fees, return, or a combination of these elements. When a contract involves profit sharing, it is a combination of a *Tabarru'* contract and agency and/or a profit-sharing contract. For the various **Takaful** structures, it is important to emphasize that contributions, returns on investment and the resulting surplus belong to the participants collectively – that is, the returns on investment of contributions belong to the policyholders as a group, after deduction of the administrator's share. Therefore, any surplus can be distributed among participants or given to charity. If claims paid from the fund exceed the amount of premiums, the participants should increase their contributions. The policyholders make the contributions, receive protection (indemnities) against the materialization of risk that has been insured, and can also receive a share of surplus.

## Takaful types

- 26.28 Takaful business types cover general plans and family plans. **General Takaful** provides protection against material loss or any form of damage on a short-term basis (akin to non-life insurance). **Family Takaful** offers a combination of protection and long-term savings, usually covering a period of more than one year. In general, **Family Takaful** is deemed to be a composite plan offering both life and non-life insurance schemes unless specific regulation requires that these schemes be registered separately.
- 26.29 **Retakaful** is an extension that supports **Takaful** business activities as a form of reinsurance based on Islamic finance principles. It aims to mitigate the risks of business loss of Takaful business and to increase the capacity of direct insurance, in particular for high value properties. Considering the relatively small and still developing **Retakaful** domestic market in many Islamic economies, this could lead to a significant cross-border trade in such activities. In many economies, the domestic **Takaful** and **Retakaful** industry is likely to provide services to non-residents. Conversely, resident units can also purchase these same services from non-resident providers. This implies the need to account for such transactions in the external sector statistics.

## Takaful models

- 26.30 The underwriting surplus in **Takaful** arrangements is the amount calculated as the excess of total premium contributions of the policyholders-participants during the financial period over the total indemnities in respect of claims incurred during the period, net of **Retakaful** and after deducting and changes in technical provisions. The surplus should be disposed of in a way that serves the common interest of the participants such as accumulation of reserves, reduction of the contributions, charitable donations and/or distribution among the participants. This also depends on the adopted business model that defines whether the surplus should be transferred only to participants, shared with operators or retained in the fund.
- 26.31 Various **Takaful** models have been designed according to the underlying contracts signed between the participants and the operator, which first and foremost defines how the latter is compensated for the management of the takaful fund. Four main business models are distinguished:
- **Mudaraba-based Takaful**: the operator is ensured a share of profits generated from the investments of takaful funds;
  - **Wakalah-based Takaful**: the operator is paid a fee as a percentage of participants contributions;
  - **Wakalah-Mudaraba-based Takaful** or hybrid model: The operator is ensured both a fee as a percentage of contributions and a share of profits; and
  - **Waqf Takaful**: In contrast to the previous models, provides surplus which is not transferred to the participants but is retained in the **Takaful fund** by the operator.
- 26.32 In general, the business models adopted for **Family Takaful** differ from those offering only **General Takaful** in terms of disaggregation of the fund into the Participants' Risk Fund (PRF) and Participants' Investment Fund (PIF). In family arrangements, participants contribute to the common pool of funds of which a portion is invested as PIF for the purpose of investment and/or savings; and the other part of contribution is allocated to the PRF to meet claims by participants on the basis of mutual assistance or protection intended, settle **Retakaful** charges, or allocated to reserves.

## C. Output of Islamic financial institutions

### Introduction

- 26.33 The methods to calculate the output of Islamic financial institutions depend on how they are allocated to institutional sectors given their financial activities. Methods can include explicit fees, sum of costs, implicit financial services on loans and ~~deposits in financial intermediation services indirectly measured (FISIM)~~, or a combination of approaches. This section first discusses Islamic financial institutions excluding Islamic insurance, and then turns to Islamic insurance.

## 1. Measuring output of Islamic financial institutions (excluding Islamic insurance)

26.34 There are different methods used to measure output across the suite of Islamic financial institutions. Some of these employ the methodology for implicit financial services on loans and deposits, in part or in whole, to account for the implicit services provided. This approach, as it applies to Islamic finance is discussed below.

### **Methodology for implicit financial services on loans and deposits indirectly measured (FISIM) methodology in Islamic Finance**

26.35 The implicit financial services on loans and deposits methodology ~~concept of Financial Intermediation Services Indirectly Measured (FISIM)~~ for Islamic depository institutions parallels that of conventional financial institutions (see the discussion in paragraphs 7.179-7.188). This reflects the fact that, for some types of financial institutions, explicit service charges alone may not account for the full value of their services. Part of the compensation for the provision of services may be implicitly included in the difference between the returns on the funds provided to those that require funding and the returns on the funds provided by those with surplus funds. In the process of intermediating funds between parties with surplus funds and those that require funding, the relevant financial institutions provide services to both parties. The methodology for implicit financial services on loans and deposits provides a way to measure the services that are not explicitly charged for.

#### *Reference rates and instrument scope*

26.36 The general approach is that it is also possible to determine a reference rate, ~~also~~ in the case of Islamic implicit financial services on loans and deposits ~~FISIM~~, which reflects a service-free rate and can be used to derive the service element on deposits and loans with varying characteristics. More specifically, in line with conventional banking, the implicit financial intermediation services provided by Islamic deposit taking corporations can be measured as the difference between the return rate paid to banks by borrowers and the reference rate plus the difference between the reference rate and the return rate actually paid to depositors. The term “return” is used to describe the broader interest-alternative returns on (non-equity) Islamic financial instruments (discussed in Section D).

26.37 This approach could be augmented by using different reference rates ~~may need to be used~~ for conventional and Islamic Shari’ah-compliant finance, in recognition of different risk profiles. Whatever the case, different reference rates should be applied for at least two groups of currencies (national and foreign currency) in cross-border transactions of Islamic deposits and loans – that is exports and imports of such implicit services ~~FISIM~~. The rate should be taken from the financial markets of the home market of the currency.

26.38 With respect to the issue of one or more reference rates, the objective testing results (conducted in 2023) with a select group of Islamic countries generally indicated that the estimates of nominal implicit financial services on loans and deposits and their annual growth rates did not differ significantly between conventional and Islamic finance. Thus, while the principles of Islamic finance prohibit the payment of interest, the nature of financial intermediation services of conventional and Islamic deposit-taking and lending seems to be broadly similar. Accordingly, it is recommended that only one reference rate be used to calculate implicit financial services on loans and deposits which are in the same currency, unless there is evidence to suggest that a different reference rate should be used to calculate implicit financial services on Islamic deposits and loans (see paragraph 7.183).

26.3826.39 These Islamic implicit services ~~FISIM~~ apply ~~ies~~ to total loans and total deposits (where relevant), rather than applying a more complex instrument-by-instrument approach. The latter was considered given that some Islamic instruments pay no investment income (see Section E below for a description of Islamic financial instruments).

## Measures of output for different types of Islamic Financial Institutions

~~26.39~~26.40 The various methods to measure output for Islamic Financial Institutions are summarized below. In the case of implicit financial services on loans and deposits FISIM, the terminology reflects that of investment income (discussed in Part- D).

### *Central bank (S121)*

~~26.40~~26.41 For the Central bank (S121), monetary policy services, supervisory services and other services (financial stability, managing the payments services) are collective services. ~~As such, they are calculated as the sum of cost.~~ Central banks do not undertake intermediation services in the traditional sense. Central banks are atypical financial intermediaries which take on liabilities and engage in lending, but for the purpose of monetary policy and other public functions. ~~Intermediation services employ the FISIM methodology to estimate output.~~ As a result, all of their services are considered non-market output, and they are calculated at the sum of costs (see paragraphs 7.165-7.169). ~~To the extent that there are other services offered, such as supervisory services, explicit fees are used for market output and sum of costs approach is used for non-market output.~~

### *Deposit-taking corporations except the central bank (S122)*

~~26.41~~26.42 Deposit-taking corporations (S122) include Islamic banks and Islamic windows in conventional banks. In these cases, financial intermediation services are estimated as a combination of explicit fees and commissions (direct services) and the implicit financial services on loans and deposits FISIM methodology for implicit services. For the latter, the services on loans and deposits are calculated as follows:

$$\text{FISIM} = (r_L - rr) \times Y_L + (rr - r_D) \times Y_D, \text{ where,}$$

$r_L$  - the lending return rate

$r_D$  - deposit return rate

$rr$  - reference rate

$Y_L$  - average stock of loans

$Y_D$  - average stock of deposits

### *Money market and non-MMF Investment funds (S123 and S124)*

~~26.42~~26.43 In the case of both Shari'ah-compliant **Money market funds (S123)** and **Non-money market investment funds (S124)**, the output is treated in the same way as conventional investment funds. Therefore, output is estimated as the sum of various fees that these funds charge investors on transactions and positions. This includes purchase and redemption fees, exchange fees, account fees, and operating fees. However, for **Hajj Funds** and off-balance sheet restricted investment accounts output is measured as sum of costs, except in the case of implicit services FISIM on any loans on the financial statements such as *Murabaha* or *Ijarah* (see Section E for a discussion of Islamic financial instruments) may need to be calculated.

### *Other financial intermediaries except insurance corporations and pension funds and Shari'ah-compliant money lenders (part of S127 below)*

~~26.43~~26.44 Islamic investment banks and investment companies are included in **Other financial intermediaries (S125)**. For these types of institutions, output includes both explicit and implicit fees. In addition, for any Shari'ah-compliant money lending services included in **Captive financial institutions and money lenders (S127)**, measures of output combine explicit charges and implicitly measured financial services (IFS). For these types of financial institutions, the latter service element can be calculated as follows:



$IFS = (r_L - rr) \times Y_L$ , where  
 $r_L$  - the lending return rate  
 $rr$  - reference rate  
 $Y_L$  - average stock of loans

### *Financial auxiliaries (S126)*

~~26.44~~26.45 For **Financial auxiliaries (S126)** engaged in the management of Shari`ah compliant investments and funds brokerage, such as **Takaful funds** and investment funds, output is measured as the explicit fees charged to clients. For example, the fees payable by the **Waqf Fund** to the fund manager are classified as the output of this financial subsector. In the case of **Takaful operators** included in this subsector, the explicit fees approach is also used. Output is equivalent to the *Wakalah* fees they charge to administer the funds and/or the share of profits earned from the investment of those funds, depending on the structure.

### *Captive financial institutions and money lenders (S127)*

~~26.45~~26.46 For other Sharia`ah compliant institutional units included in **Captive financial institutions and money lenders (S127)**, output is measured as explicit fees or sum of costs. In the case of **Waqf Funds** in this subsector, output is typically measured as the sum of costs. Although the associated fees are costs that are contractually payable by the fund rather than by the beneficiary, they are shown as payable by the beneficiary to the fund because they are payable out of profits (with **Waqf Fund** profits as property income to the beneficiary). For money lenders the implicit financial services on loans are calculated as noted above (26.43).

## **2. Islamic Insurance output**

~~26.46~~26.47 The services provided diverge from those provided by conventional insurance, reflecting the fact that Islamic insurance processes are arranged differently than those of conventional insurance. The Islamic service component would be identified under the *Takaful* contract and different options may be considered depending on the business model adopted. In addition, the output of operators and funds reflect that they are separately classified as institutional units, except in the case of **Light Takaful**.

~~26.47~~26.48 **Takaful operators** manage, administer and invest the funds on behalf of the participants by charging fees to cover their costs. In this case, output is measured as the *Wakalah* fees they charge to administer **Takaful funds** and/or the share of profits earned from investing these funds, as noted above under financial auxiliaries.

~~26.48~~26.49 For **Takaful/Retakaful funds**, including both family and general plans, output is measured as the sum of costs. This is the *Wakalah* fees they pay to takaful operators and/or the share of profits payable to takaful operators plus any other intermediate consumption. Given the similar economic features between **Takaful funds** and **Takaful windows**, the output of windows is also measured as the sum of costs. Given that **Light Takaful** (no distinction between operators and funds) is more like conventional insurance arrangements the methods described in paragraphs ~~7.204~~ to ~~7.220~~ in SNA2025 should be used to measure output.

## **D. The nature of returns on Islamic instruments in the Allocation of income account**

### **1. Background**

~~26.49~~26.50 In the context of Islamic finance, the prohibition of 'riba' (normally translated as interest) means that a provider of finance cannot impose a fixed or unconditional finance charge that is independent of the borrower's use of the funds. Sometimes, a provider of funds may expect a reward from the borrower on a

discretionary basis. For these reasons, terminology such as *profits*, *gifts* or *returns* is typically used instead of interest in Islamic accounting. However, to better integrate into the SNA/BPM, a general term describing such types of returns is required. A generic term like “similar returns” appended to interest is the option chosen. Interest and similar returns can apply to other situations of such non-conventional finance as well as to Islamic Finance.

## 2. Returns on Islamic instruments

### Interest and similar returns

~~26.50~~26.51 The broader SNA/BPM term *Interest and similar returns* (see paragraph xx.xx) accommodates the returns associated with Islamic finance. The concept of “similar returns” complies with Shari'ah principles and is used to describe the broader interest-alternative returns on certain Islamic debt ~~instruments~~liabilities. Retaining the term “interest” in the proposed terminology ensures continuity with the current terminology in the SNA (and BPM) to describe the investment income on conventional deposits, loans, ~~debt securities~~ and exceptionally in other accounts receivable and payable (see paragraph 25.192) ~~and other liabilities~~. This approach enables the integration of Islamic financial instruments and their associated income within the existing macroeconomic statistical frameworks and eliminates the need for developing alternative classification frameworks for Islamic finance. The Islamic financial arrangements that generate investment income are discussed in Section E below. Some of these constitute equity-like instruments and generate equity-like return (e.g., dividends), but do not require introduction of new terminology.

~~26.51~~26.52 There are two key benefits to this approach. First, it preserves the universality of international statistical standards; and second, it accommodates economies with significant Islamic financial activities and incorporates the investment income for relevant Islamic financial instruments. The table below displays additional and supplementary details related to returns on Islamic instruments in SNA and BPM (please see Annex I.

Earned income account in SNA	Earned income account in BPM
D4. Property income	Investment income
D41. Interest and similar returns	Direct investment
D411 Interest	Income on equity and investment fund shares
Deposits	Dividends and withdrawals from income of quasi-corporations
Loans	Reinvested earnings
Debt securities	Interest and similar returns (D41D)
<del>Other interest bearing instruments</del>	Portfolio investment
D412 Similar returns	Income on equity and investment fund shares
Islamic deposits	Dividends on equity other than investment fund shares
Islamic loans-financings	Investment income attributable to investment fund shareholders
Islamic debt securities	Interest and similar returns (D41P)
<del>Other liability instruments subject to Islamic conventions</del>	Other investment
D42. Distributed income of corporations	Withdrawals from income of quasi-corporations
D43. Reinvested earnings on direct investment	Interest and similar returns (D41O)
D44. Investment income disbursements	

	Investment income attributable to policyholders in insurance, standardized guarantees, and pension funds
	Reserve assets
	Income on equity and investment fund shares
	Interest and similar returns (D41R)

## E. The classification of Islamic financial instruments in the accumulation accounts and balance sheet

### 1. Background

[26.52](#)[26.53](#) There are numerous types of Islamic financial arrangements that can be broadly mapped to SNA and BPM financial instruments (please also refer to Annex I). As noted above, lacking a concept of interest earnings, Islamic financial corporations often generate income through arrangements such as the financing of sales or leasing of underlying goods, sometimes including equity financing. These items can generate returns under *Interest and similar returns*, as discussed in Part D. Notably, some of these arrangements may apply to more than one SNA financial instrument depending on variations in the defining characteristics of each contract.

[26.53](#)[26.54](#) Several factors need to be considered in the instrument classifications, including:

- What form of institutional unit represented by the recipient of the finance: an equity classification for an instrument will only be possible for an entity that is a corporation;
- Whether or not the financial instrument is designed to provide a profit that has a comparatively high reliability as compared to its magnitude;
- Whether or not the financial instrument is recorded on the balance sheet of the Islamic financial institution;
- Whether or not the investment account holder has a claim on ventures or funds offered by the issuing institution (and hence the entity has institutional unit type behavior);
- Whether or not the investment account holder has a claim on the residual value of the issuing institution;
- Whether or not the lender is the supplier of the goods or services being financed, which would determine a trade credit or loan classification;
- Whether or not the financial instrument provides negotiable securities, for example in the form of participation term certificates.

The discussion below focusses on the classification of individual Islamic financial instruments in the SNA/ESS. It is clarified that the list of Islamic financial instruments discussed below and listed in Annex I is not exhaustive and the compiling agencies can use the factors in the paragraph to classify Islamic financial instruments which are not in the list.

### 2. Islamic financial instruments classified as currency and deposits (F2)

[26.54](#)[26.55](#) *Qard, Wadiah, and Amanah* deposits can be withdrawn on demand, at par, without penalty or restriction, and are generally usable for making payments by check, draft, giro order, or other direct payment facilities. These types of deposits are not linked to any profit-making ventures and are not part of the profit

and loss sharing schemes. As a result, Islamic financial institutions have the flexibility to use the funds but are required to guarantee the nominal value of the deposits. As a result, these deposits usually offer no returns or, in some cases, very small returns are offered on the basis of gifting (*Hibah*). These instruments may be classified as *Transferable deposits* (F22) or *Other deposits* (F29).

~~26.55~~26.56 **Qard-Hasan** are another form of return-free deposits, voluntarily placed by depositors to participate in the provision of funds for needy individuals or for social purposes. These may also be provided for specific purposes, as determined by the depositor. In all cases, it is interest-free and is meant to help stabilize cash flows or cater to funding needs that cannot be met using commercial arrangements. These are treated as *Other deposits* (F29).

~~26.56~~26.57 **Restricted Mudaraba** funds are funds where the investor restricts the manner as to where, how, or for what purpose the funds are invested. No mixing of funds is allowed from other sources to ensure proper management and accountability of the funds. The Islamic financial institution manages the funds either as **Mudarib** (in which the investor is engaged in risk-sharing), or as **Wakil** (i.e., provision of intermediation services for a fixed fee with no participation in the investment results). Only **Restricted Mudaraba** held on-balance sheet should be classified as *Other deposits* (F29).

~~26.57~~26.58 **Unrestricted Mudaraba** funds are funds where the investor fully authorizes an Islamic financial institution to invest the funds without restrictions as to where, how, or for what purpose the funds should be invested, as long as it is deemed appropriate. The mixing of funds from other sources (including shareholders' funds) is permitted and separate disclosure in the financial statement is therefore required. **Unrestricted Mudaraba** can be divided into three distinct types, two of which are discussed below, while a third type is discussed below under *Shares*.

- **Mudaraba not fixed deposits** are accepted without time frame (not fixed), hence the investors are free to withdraw their money at any time. This type of unrestricted accounts can be considered analogous to saving deposits at a conventional financial institution and should be classified under *Other deposits* (F29).
- **Mudaraba fixed deposits** are accepted for a fixed period that provides an opportunity for Islamic financial institutions to invest in more profitable long-term projects. This type of unrestricted account can be considered as analogous to a time deposit at a conventional financial institution and will usually generate higher returns than for non-fixed period deposits. These are also classified as *Other deposits* (F29).

~~26.58~~26.59 In the case of **Wakalah deposits**, the bank acts as an agent for investment of depositor's funds in exchange for a fee, usually in the 1.5 to 2 per cent range. Depositors are offered an indicative or nominal return. If the actual return is lower, the depositor only receives this latter return; if the actual return is higher, the bank only pays the indicative return and keeps any excess as an "incentive fee". Because of the possibility of the bank earning this incentive, it will often not charge a fee. These instruments can be classified as *Transferable deposits* (F22) or *Other deposits* (F29).

~~26.59~~26.60 **Profit and loss sharing certificates** are investors' deposits that resemble shares but do not provide a claim on the residual value of the Islamic financial institution and participation in its governance. The certificates should be classified as *Other deposits* (F29) if non-negotiable.

### 3. Islamic financial instruments classified as debt securities (F3)

~~26.60~~26.61 **Mudaraba, fixed with mudaraba certificates** are arrangements accepted for a fixed term, by way of negotiable instruments (called investment deposit certificates or Mudaraba certificates). This type of unrestricted investment has characteristics similar to those of conventional market securities and is typically classified as a *debt security*, if not part the own funds of the financial institution. A separate disclosure of off-balance sheet positions is required to be kept by the Islamic financial institution.

~~26.61~~26.62 **Sukuk** are investment certificates issued by Islamic financial institutions to obtain funding. **Sukuk** (plural of *Sakk*), are certificates (commonly known as Islamic bonds), with each representing a proportional undivided ownership right in tangible assets, monetary assets, right to use others' assets (*Usufruct*), services, debts, a pool of predominantly tangible assets, or a business venture (such as *Mudaraba* or *Musharaka*).

These assets, which must be clearly identifiable, may be in a specific project or investment activity in accordance with Shari'ah rules and principles. **Sukuk** might often be thought of as providing a securitization wrapper around an underlying contractual arrangement. If they involve an intermediate legal structure such as a special purpose entity (SPE), then consideration of whether the SPE should be recognized as an institutional unit may be required, depending on the legal and other specific circumstances. The following three types of sukuk contracts are the most prominent: (i) *Sukuk Ijarah*; (ii) *Sukuk Musharaka*; and (iii) *Sukuk Murabaha*, which are all negotiable instruments, although the last type of arrangement only becomes negotiable when certain conditions are met. Different types of *Sukuk* will have fixed income properties, equity-like properties, or more complex types of arrangements for the returns.

- **Fixed Income Sukuk** are instruments which are normally either sale or lease based. Sale based contracts represent a debt, and therefore may not be bought/sold in the secondary market at other than par value. Lease based contracts such as *Ijarah* do not have secondary market restrictions as the revenue streams are based on a tangible underlying asset. *Ijarah Sukuk* also typically have a redemption payment, representing the return of beneficiary's share in the underlying tangible asset back to the issuer. Examples include: *Murabaha* (sale at mark-up); *Salam* (forward commodity sale); *Istisna'a* (manufacturing sale); and *Ijarah* (lease based).
- **Variable profile Sukuk or Wakalah Sukuk** represent an agency arrangement in which the *Sukuk* holder delegates responsibility to the issuer to carry out Shari'ah compliant revenue generating activity. The precise nature of this activity can vary, and it can encapsulate other transaction types within it (e.g., *Ijarah*, *Murabaha*, etc.). The aggregate return on the activity may be either fixed or variable, depending on the agreement between the counterparties.
- **Hybrid Sukuk** may vary in form at different points in their life cycle. For example, *Istisna'a* plus *Ijarah Sukuk* may be used by an issuer to raise funds to first construct an asset before leasing it out.

[26.62](#)[26.63](#) **Profit and loss sharing certificates** are investors' funds that resemble shares but do not provide a claim on the residual value of the Islamic financial institution and participation in its governance. The certificates should be classified as *Debt securities* if they are negotiable.

[26.63](#)[26.64](#) **Participation term certificates** are long-term investment instruments that entitle the holder to a share of an Islamic financial institution's profit. These certificates should be classified as *Debt securities* if the certificates concern debt liabilities of the institution.

#### 4. Islamic financial instruments classified as Loans (F4)

[26.64](#)[26.65](#) **Qard-Hasan financing** is a return-free financing that is made to needy individuals or for some social purpose. This financing is usually extended on a goodwill basis, and the debtor is required to repay only the principal amount of the financing. The debtor may, however, at his or her discretion, pay an extra amount beyond the principal of the financing (without promising it) as a token of appreciation to the creditor.

[26.65](#)[26.66](#) In a **Murabaha financing** contract, an Islamic financial institution purchases goods upon the request of a client, who **usually** makes deferred payments to the financial institution that cover costs and an agreed upon return. These contracts resemble collateralized loans within conventional finance, in which the underlying goods, such as properties or automobiles, are registered under the customer's name and are used as collateral. The disclosure of the cost of the underlying goods is required. The financial institution handles payment to the supplier including direct expenses incurred (delivery, insurance, storage, fees for letter of credit, etc.). Operating expenses of the financial institution are not included. This arrangement can be defined as a sale of goods at cost plus profit margin.

[26.66](#)[26.67](#) **Tawarruq financing (commodity Murabaha)** is a financial instrument in which a buyer purchases a commodity from an Islamic financial institution on a deferred payment basis, and the buyer sells the same commodity to a third party on a spot payment basis. This is an extension of *Murabaha* whereby the financial institution arranges for the sale of the item. The buyer basically borrows the cash needed to make the initial purchase. Later, when cash is secured from the second transaction, the buyer pays the original seller the instalment or lump sum payment he owes (which is cost plus markup).

26.6726.68 **Mudharaba financing** constitutes a partnership between an Islamic financial institution and a client in which the institution provides capital (*Rab al-Mal*) and the client provides skillful labor. This financing is a type of partnership whereby skill and money are brought together to conduct business. Profits generated from the business are shared according to the agreement, while losses are borne fully by the capital provider, except when losses are due to misconduct, negligence, or violation of the agreed conditions by the client. Although this arrangement has features of equity, it has a fixed-term nature and therefore represents a fixed-term claim on the client rather than a claim on any residual value.

26.6826.69 **Musharaka** represents a partnership between an Islamic financial institution and an enterprise in which both parties contribute to the capital (*Rab al-Mal*) of partnership. The financial institution and client agree to share any profits generated from the venture according to the pre-agreed ratio, with any losses shared according to the ratio of contribution. This type of financing can be structured as a *loan* where the financial institution provides financing in the form of working capital to an entity but does not have a claim on the residual value of the debtor enterprise.

26.6926.70 **Mushtarakah** is a combination of both **Musharaka** and **Mudharaba**. It can be treated as *loans* if there is no residual claim on the value of the debtor entity.

26.7026.71 **Bai Muajjal** is a type of financing provided by an Islamic financial institution to its client by supplying desired commodities or services with deferred payments. This contract is classified as *loans* if the supplied commodities or services are from third parties.

26.7126.72 **Bai Salam** is a short-term financing agreement in which an Islamic financial institution makes full prepayments (spot payment) for future (deferred) delivery of a specified quantity of goods on a specified date. The financial institution and a supplier may engage in such a contract, in which the supplier agrees to sell their product prior to the goods being delivered. Generally, the agreed spot price is less than the future price of the goods, which ensures a return to the financial institution. This arrangement should be classified as *loans*, only if the goods or services produced are not for the financial institution's own use.

26.7226.73 **Istisna'a financing** is a partnership between an Islamic financial institution and an enterprise, usually manufacturer or construction company, whereby the financial institution places an order and provides financing to the enterprise to manufacture/construct and or supply certain goods or buildings. Upon or before the delivery of the order, the financial institution usually enters into a contract with another party (the ultimate purchaser) at a price higher than the original contract of the **Istisna'a**, thus generating profits. These arrangements are classified as *Loans*, if the produced goods or constructed buildings are for the use of the ultimate purchaser. **Ju'alah** is an **Istisna'a** contract applicable for services as opposed to a manufactured good. It may be a *Loan* if the services are not for the financial institution.

26.7326.74 **Bai bil wafa or Bai bil-istighlal** are sales (ba'i) in which the seller has the right, as stipulated in the contract, to repurchase the underlying property (real estate) from the buyer by refunding the purchase price. The right of redemption is given to the original seller upon an understanding that the buyer will give (i.e., resell) the property back to the seller and receive the original price. The buyer agrees to honor that understanding and hence the name *Wafa* which means to honor.

26.7426.75 An **Ijarah** is a contract in which an Islamic financial institution purchases capital equipment or property and leases it to an enterprise. The financial institution may either rent out the equipment (**simple Ijarah**) or receive a share of the profits earned through its use. There are two types of **more sophisticated Ijarah**.

- **Ijarah Muntahia Bittamleek (Ijarah MBT)** is a hybrid instrument and can be arranged as a pure operating lease or as a lease-to-own arrangement.
  - In the case of the pure operating lease version of **Ijarah MBT**, the title for the underlying asset is not transferred to the client (lessee), and ownership risks of the assets are borne by the Islamic financial institution (usually through a separate unit that it owns). Operating *ijarah* should be treated in the same way as a conventional operating lease (rental agreement for some non-significant portion of the asset's economic life) and does not give rise to a financial instrument. It is discussed only to distinguish it from *ijarah MBT and Ijarah W-wa-Iktina* below.
  - In the case of the **Ijarah MBT** lease to own arrangement (or financing *Ijarah*), the title for the underlying asset may be transferred to the lessee over the term of the lease or at the end of the lease arrangement. This makes it resemble a conventional financial lease in some ways, however

the risks and rewards incidental to ownership remain with the lessor throughout the lease term until the asset is transferred to the lessee. to this end, there can be both a lease contract and a transfer of ownership contract involved. This arrangement generally constitutes a long-term lease, and the lessee could be considered the economic owner (but not the legal owner) for purposes of the economic accounts. This form of Ijarah should be classified as *Loans* over the period of the lease

- *Ijarah Wa-iktina* is the financing of an acquisition of an underlying asset under a lease-to-purchase arrangement, and it (financial lease) involves two stages. The first stage is the lease of underlying asset over the lease period, which covers the majority of the asset's economic life, and for which the lessee is effectively considered the economic owner (but not the legal owner) in the economic accounts. The second stage is the transfer of ownership of the residual value of the asset at the end of the lease period. This arrangement Financing ijarah, which is similar to resembles a conventional financial lease, should be classified as *Loans* over the period of the lease.

## 5. Islamic financial instruments classified as equity and investment fund shares (F5)

26.7526.76 As noted above, a *Mudaraba contract* is a partnership of the Islamic financial institution and the client. *Restricted Mudaraba* that are held off-balance sheet should be classified as *Shares* (equity) if considered part of the own funds of the financial institution. A separate disclosure of off-balance sheet positions is required to be kept by the Islamic financial institution. *Mudaraba fixed with Mudaraba certificates* constitutes *unrestricted Mudaraba* arranged through negotiable instruments with characteristics similar to those of conventional market securities. and it is classified as *Shares* if considered part of the own funds.

26.7626.77 *Participation term certificates* are long-term investment instruments that entitle the holder to a share of a corporation's profit. These certificates are treated as *Shares* if considered as part of the own funds.

26.7726.78 As noted above, *Sukuk instruments* constitute investment certificates issued by Islamic financial institutions to obtain funding. These should be classified as *Shares*, only in the instance where the owner of the security has a claim on the residual value of the issuing entity. *Equity-like sukuk* are instruments normally based on some sort of partnership arrangement, with the risk/ reward sharing ratio agreed ex ante. In these contracts, it is impermissible for one party to provide a guaranteed fixed payment (either in terms of periodic return or maturity payment) to the other. *Mudaraba sukuk* can resemble *Wakalah* in terms of cashflows, but the contractual relationship between parties will differ. Examples of these arrangements include: *Musharaka* (pure partnership), and *Mudaraba* (silent partnership or 'Commenda').

26.7826.79 *Musharaka* constitutes a partnership between an Islamic financial institution and an enterprise in which both parties contribute to the capital (*Rab al-mal*) of partnership. In this type of arrangement, the financial institution and client agree to share any profits generated from the venture according to the pre-agreed ratio; a loss is shared according to the ratio of contribution. This type of financing is classified as *Shares* when the financial institution acquires a claim on the residual value of the enterprise.

26.7926.80 *Mushtarakah* is a combination of both *Musharaka* and *Mudaraba*. It can be treated as *Shares* if there is a residual claim on the value of the debtor entity.

## 6. Islamic financial arrangements identified as insurance related financial instruments (F6)

26.8026.81 The *Mudaraba Takaful model* is based on the Islamic financial instrument known as *Mudaraba* that relies on profit sharing principle. In this model, the Takaful operator is the entrepreneur (*Mudarib*) providing management skills or labour. The operator is appointed by the participants, who act as investors or fund contributors (*Rab al-mal*). Any surplus or profit resulting from takaful fund investments are shared between the takaful operator and takaful fund according to a pre-agreed ratio, while the possible losses are borne only by the takaful fund unless there is element of negligence from the takaful operator.

[26.81](#)[26.82](#) The *Wakalah Takaful model* is based on the Islamic financial instrument known as *Wakalah* – a contract between the takaful participants and the **Takaful operator** that acts as an agent (*Wakil*). Any surplus realized from the investment of the participants’ funds will go to the participants only, as the takaful operator is entitled to an agency fee for the services rendered on mutual agreement and the predetermined terms in the contract. The profit and the losses derived from the operations of **Takaful fund** and the investments belong to takaful fund only.

[26.82](#)[26.83](#) *Hybrid Takaful* is an Islamic insurance contract that is structured to combine more than one financial instrument.

- The *Wakalah-Mudaraba* model combines the features of two models. According to this hybrid model, the participants and the **Takaful operator** sign two contracts: As per the *Wakalah* contract, the operator is entitled to a fee from the contributions paid by the participants; and as per the *Mudaraba* contract the operator is entitled to the predetermined share of profit gained from the investments of the takaful fund.
- Another hybrid model is *Waqf-Wakalah-Mudaraba* that integrates elements of the charitable endowment *Waqf* in the above arrangement, where no party gets the underwriting surplus so that the original contributions remain in the common pool for the purpose of reinvestment and to enhance sustainability.

## 7. Islamic financial instruments classified as financial derivatives (F7)

[26.83](#)[26.84](#) Financial derivatives have a prominent role in conventional finance, but less so in Islamic finance. The prohibition of gambling and excessive uncertainty/risk as well as short sales or financing activities, significantly limit the use of derivative contracts in this environment. Moreover, although certain types of forward sales are permitted, these are not necessarily considered derivative contracts.

[26.84](#)[26.85](#) That said, derivative contracts whose sole purpose is hedging (that is, to minimize any risk exposures) do not seem to be incompatible with Shari’ah principles. Therefore, Islamic financial institutions may enter into derivative contracts purely for hedging purposes (regardless of what the counterparty’s objective might be), and this is the case in some countries. However, the use of financial derivative types, remains a somewhat open-ended issue in Islamic finance in terms of a general treatment that can apply across economies. As a result, their use varies across jurisdictions, depending upon the domestic Shari’ah regulators and legislation.

## 8. Islamic financial instruments classified as other accounts payable/receivable (F8)

[26.85](#)[26.86](#) *Istijrar* refers to an agreement where the buyer purchases commodities under a single agreement from a supplier from time to time in different quantities. The deal is considered as a sole agreement when all terms and conditions are finalized.

[26.86](#)[26.87](#) *Istisna’a financing* relates to goods or buildings for the Islamic financial institution’s own use and should be classified as trade credit and advances. A **Ju’alah** contract is essentially an *Istisna’a* that applies to services as opposed to a manufactured good.

[26.87](#)[26.88](#) *Bai Muajjal financing* (discussed in paragraph 26.70) is classified as trade credit if it is a direct extension of credit by the supplier.

[26.88](#)[26.89](#) If the associated goods or services in *Bai Salam financing* (discussed in paragraph 26.71) are for use by the Islamic financial institution (lender), the arrangement would be considered trade credit.

## 9. Islamic financial instruments and related investment income under the functional classification of BPM7

[26.89](#)[26.90](#) This section follows the classification of Islamic instruments discussed above but extends it to account for the functional classification used in the external sector statistics. The classification of equity and debt security like instruments to functional categories follows the principles from Chapter 6, *BPM7*.



~~26.90~~26.91 *Qard, Wadiah, and Amanah deposits* are included in the broad category **other investment** under currency and deposits, specifically, *Transferable or other deposits* (F22 or F29). Related income would be reflected under investment income, again under other investment as *Interest and similar returns*. A similar treatment is to be applied for *Qard-Hassan deposits*, under *Other deposits*, although in this case investment income is not relevant.

~~26.91~~26.92 *Restricted Mudaraba funds* are included in the broad category **other investment** under currency and deposits, specifically, *Other deposits, or as portfolio investment Equity*, depending on whether the funds are held on-balance sheet or off balance sheet. *Unrestricted Mudaraba* funds are classified under *Other deposits* for both for both fixed term and non-fixed term arrangements. However, fixed arrangements with *Mudaraba certificates*, should be classified as either *debt* (F3) or *equity* (F5) under **portfolio investment**, while the corresponding investment income is to be recorded as *Interest and similar returns* or *Dividends*. *Participation term certificates* follow the exact same treatment as fixed mudaraba with certificates. *Profit and loss sharing certificates* are included as *Other deposits* (F29) under other investment if not negotiable or *Debt securities* (F3) under portfolio investment if negotiable, with income as *Interest and similar returns* recorded under other investment or portfolio investment.

~~26.92~~26.93 *Sukuk* can take the form of a debt security (F3) or an equity security (F5) under portfolio investment with investment income recorded as interest and similar returns or dividends. *Fixed – income sukuk* constitutes a *Debt security under portfolio investment*. *Equity-like sukuk* is to be recorded, as the name suggests, under **portfolio investment equity security**. *Variable profile sukuk* can be treated as debt or equity security under portfolio investment, depending on the precise nature of the arrangement. Correspondingly, income on the above instruments can be under **portfolio investment** as *Interest and similar returns* (from securities) or *dividends* (from equity securities).

~~26.93~~26.94 *Qard-hasan financing* is to be classified under **other investment** as a loan (F4). *Murahaba financing* also constitutes *Loans*. *Mudaraba financing, tawarruq* (commodity murabaha) as well as *bai bil wafa* and *bai bil istighlal* are all treated as *loans* (F4) in **other investment**. *Bai Muajjal, Bai Salam, Ju'ala, and Istisna'a financing* is to be classified as either *loans* or *trade credits and advances*, the latter only when the commodities are used by an Islamic financial institution. In cases where an optional or required return is paid on these instruments, the investment income is classified as **other investment** as *Interest and similar returns*.

~~26.94~~26.95 *Ijarah Wa-iktina* (akin to a financial lease) or *Ijarah MBT* (financing ijarah) ~~(financial lease)~~ is classified as *Loans* under other investment and the investment income is recorded under **other investment** *Interest and similar returns*. It should be noted that *simple Ijarah or Ijarah Muntahia MBT Bittamleek or in the case of* operating ijarah (operating lease) ~~does~~ not give rise to entries in the financial account. Rather, ~~these# areis~~ treated as *Operating leasing services* in the services account.

~~26.95~~26.96 *Musharaka* and *Mushtarakah* are classified as either *loans* (F4) or *equity* (F5), with the corresponding income flows to be recorded as *Interest and similar returns* or *Dividends*.

## F. Economic ownership of non-financial assets under Islamic financial arrangements

### 1. Special considerations in Islamic Finance and the regulatory framework

~~26.96~~26.97 The SNA and BPM make a clear distinction between legal ownership and economic ownership. The legal owner of assets or products is the institutional unit entitled by law to claim benefits associated with those items. The legal owner may transfer (through a contract) the risks and rewards related to the use of the relevant assets to another economic agent. This other agent then becomes the economic owner and is the institutional unit entitled to claim the benefits, or rewards, associated with the use of the assets over the course of an economic activity by virtue of accepting the economic risks over the relevant period. Usually, the legal owner coincides with the economic owner but, when this is not the case, the relevant assets are allocated to the sector of the economic owner. This distinction is also relevant for Islamic finance in national accounting and external sector statistics, though Islamic accounting standards may suggest otherwise.

~~26.97~~26.98 Islamic finance accounting standards recommend recording the ownership of the underlying non-financial assets in the balance sheets of the Islamic financial institutions (or institutional units who may be lessors). This is the case, even though they may not actually use the assets in their productive activities, or they may hold them only briefly. In other words, the focus in the accounting standards is on legal ownership. Consequently, one interpretation of the financial statements of Islamic financial institutions suggests that they are comparatively more involved in (and more exposed to) non-financial activities than is perhaps the case. Of course, this interpretation also ignores the issue of economic ownership.

~~26.98~~26.99 Another interpretation, arguably more consistent with shared relationships in principles of Islamic finance as well as the related guidance for conventional finance, is that the economic ownership rests with the users of the assets. Therefore, the user of the non-financial asset can be determined to be the economic owner in most cases. Thus, there is a need to account (in a macroeconomic statistical sense) for the role of Islamic financial institutions and instruments under these arrangements as well as the nature of their economic activities under certain arrangements. This provides a means to determine the economic ownership, or changes in economic ownership, of the relevant assets.

~~26.99~~26.100 With respect to the treatment of economic ownership in financing arrangements, it is useful to consider the following two complicating points. First, Islamic financial institutions (banks in particular) undertake various economic activities and may set up separate entities to facilitate these activities, either consolidated in their financial statements or unconsolidated (as separate wholly owned institutional units). Therefore, in some of these arrangements, it is possible that Islamic financial institutions have established a separate institutional units (which could be non-financial entities), ~~(often~~ in partnership with other ~~entities~~units.) which will then be the legal and economic owner of the underlying assets. One example is real estate investment whereby Islamic financial institutions can co-invest in a venture with other units (say, a construction firm) to develop properties which the financial institution's subsidiary temporarily owns (at least until they are sold to the final user). If so, this does not change the arrangement materially. Second, regardless of whether a separate institutional unit is set up, Islamic financial institutions can sometimes act as facilitators by transferring the economic ownership of the items from the seller to the client (the participant with the need to make use of these assets) which would take on financial risk in the process. This possibility does change the arrangement and does allocate economic ownership at the outset. In both cases, not recording the economic ownership of the underlying assets in the balance sheets of Islamic financial institutions (or their wholly owned subsidiaries) helps to better articulate their role as providers of financial services that facilitate the transfer of non-financial assets or products. Besides, the often-brief ownership of such items by Islamic financial institutions could be considered as a form of constructive possession (*Qabd Hukmi*) or physical possession (*Qabd Fe'eli*) and should not be considered as economic ownership.

## 2. Economic ownership under different types of Islamic financial arrangements

### Background

~~26.100~~26.101 This section focuses on the ownership of non-financial assets related to sales, leasing, pure lending and equity financing and its treatment in Islamic finance accounting frameworks. It also touches on other similar Islamic financing arrangements which are typically based on trading models or profit and loss sharing models involving underlying non-financial assets or products. This section invariably relies heavily on the above discussion of financial instruments in Section E.

~~26.101~~26.102 The ultimate purchasers of the underlying non-financial assets are considered as the economic owner of the assets obtained through Islamic financial institutions' arrangements. The economic owners claim the benefits and assume the risks associated with their use. The time of the acquisition of the underlying items is assumed to be the time at which the economic ownership changes hands. When a change of ownership is not obvious, the time at which the assets enter into the books of the transaction partners may be a good indication and, failing that, the moment when physical possession and control is acquired.

### Economic ownership structures

~~26.102~~26.103 A convenient way to group transactions and positions in Islamic financing instruments is an

aggregation by term as well as by characteristics and purpose. From that perspective, economic ownership for the different arrangements can be better assessed. The discussion below is not deemed to be exhaustive but provides a general assessment on the issue of economic ownership.

### *Shorter-term financing*

~~26.103~~26.104 Where the financial institution acquires goods or services for its own use, then it is the economic and legal owner of these products. However, it is more relevant to focus on shorter-term financing related to sales of goods and services where the purchaser/user is the owner, or at least the economic owner, early in the arrangement. In these cases, the Islamic financial institution has only a financial claim on the borrower, especially where the products are of relatively low value. Different treatment may apply, depending on the characteristics of the financial arrangement.

~~26.104~~26.105 Sometimes, the financial institution takes legal ownership of products for a very short period (e.g., *Murabaha*), before selling it. However, the intent of most of these financial arrangements usually is the facilitation of a purchase by the client and ultimate user. When the products are sold, the final user is the legal and economic owner, while the financial institution will have a claim on the client for the amount financed.

~~26.105~~26.106 In other arrangements, the Islamic financial institution holds the products for a period of time. Take the example of a spot purchase of goods for a future sale, sometimes at a higher price (e.g., *Bai Salam*). ~~While t~~The financial institution may become the legal and economic owner for that period only, for economic accounting purposes, the purchasers/users are considered the economic owners (in the case of a loan) of the products since they ultimately claim the benefits and assume the risks associated with their use (see paragraph 26.71). When the goods are subsequently acquired by the users, then they will become the legal and economic owners. Another example is with a Bai bil Wafa / Bai bil-Istigal contract with the financial institution purchaser pledges to sell it back to the client at a fixed future date, which makes the purchaser the legal and economic owner for a (typically short) period of time.

~~26.106~~26.107 A last arrangement to consider is an operating lease (*simple Ijarah*) which is a rental agreement for a period that does not cover a significant portion of the non-financial asset's economic life (see paragraph 26.73). The lessee must return the item at the end of the lease term and does not have an option to purchase. The lessor, in this case the Islamic financial institution, is both the legal and economic owner of the asset (usually through a separate unit that it owns), as it assumes the risks and rewards related to the ownership of the asset.

### *Longer-term financing*

~~26.107~~26.108 Substantive issues with respect to economic ownership of a financed non-financial asset arise in the case of the acquisition of relatively high value goods, construction, or project finance over an extended period of time. That financing can be in the form of *Loans*, such as with *Istisna'a*. One can distinguish a period of time where the Islamic financial institution makes progress payments to the contractor. In this period, the financial institution is the legal and economic owner of the asset. However, for economic accounting purposes, the customers who request the construction or manufacturing of the said non-financial asset are considered the economic owners of the products since they ultimately claim the benefits and assume the risks associated with their use. Nevertheless, Once the asset is complete, economic ownership shifts to the actual user, though the financial institution holds a claim on the asset until the debt is extinguished.

~~26.108~~26.109 Other types of longer-term financing arrangement are *Mudaraba financing*– and *Musharaka* partnerships. In both instances the Islamic financial institution only provides funding, though it may share in the profits (*Musharaka*). Any underlying non-financial assets are economically owned by the party that uses those assets, even though the financial institution can remain the legal owner for the duration of the financing agreement.

~~26.109~~26.110 Financial leases (*Ijara Wa-iktina*) constitute another form of longer-term financing where economic ownership is clear. In this case, while the lessor is the legal owner of the asset, the risks and rewards related to the ownership of the asset are transferred to the lessee over the term of the Loan lease. Further, tThe lease

term typically covers a substantive portion of the economic life of the assets, and the lessee has the option of purchase at the end of the lease period. The instrument is treated as a loan. The lessee is, for economic accounting purposes therefore, is considered the economic owner. The financial lease also provides a return for the lessor, i.e., the Islamic financial institution, to compensate it for providing the financial means to acquire the asset. The lessor is also entitled to the residual value of the leased asset at the end of the lease term, either as payment for the purchase of the depreciated asset by the lessee, or by getting economic ownership of the depreciated asset.

### 3. Economic ownership of non-financial assets in the case of a client's default

~~26.110~~26.111 For items acquired for use by a financing contract, defaulting on the corresponding payments is an issue that may arise in Islamic finance. Given Shari'ah principles' social benefit aspects incorporated in Islamic finance, it stands to reason that, in several cases, economic ownership is unaffected when the economic owners of non-financial assets default on their payments in financing arrangements such as *Murabaha* and *Istisn'a*. It can be argued that the default only relates to the financial payment, not to the full arrangement itself. Any contract with profit sharing or participation cannot be considered in full default, so the user would remain the economic owner. Therefore, it can be assumed that defaulting clients will remain the economic owners, but there are likely some non-mutually exclusive and complicating considerations.

~~26.111~~26.112 It is possible, however, that default actually leads to a change in economic ownership. If, for example, the Islamic financial institution determines that the borrower did not enter into a contract in good faith, then the institution (subject to the clauses of the contract) could repossess the assets and temporarily becomes the economic owner as well as the legal owner, while the borrower could face a penalty. Also, in the case of a shortage of a particular asset (e.g., dwellings), or in the case of neglect of the maintenance of the asset, the financial institution may be able to find a more worthy or needy client. A further consideration might relate to the nature of the default. For example, it could be the case that circumstances indicate that the non-performing loan is a write-off, and the borrower is not expected to ever be able to repay. In this case, a change of economic ownership may be warranted. In other words, it may all depend on the details of the situation, in addition to the type of financing and the actual use of the commodity (e.g., a community building versus a business asset).

~~26.112~~26.113 Lastly, and more specifically, for financial leases or *Ijara Wa-Iktina* the situation might be clearer. It is likely that in some or many of these instances the lessor will seek to find another lessee.

## ANNEX: Classification of Islamic financial instruments and income

Instrument	National Accounts	External Sector Statistics
Qard, Wadiah, and Amanah	FA: Transferable deposits (F22) or Other deposits (F29)  Income: Interest and similar returns (D41)	FA/IIP: Other investment: Currency and deposits: Transferable deposits or other deposits  Income: Primary income: Investment income: Other investment: Interest and similar returns
Qard-hasan	FA: Other deposits (F29)  Income: Interest and similar returns (D41)	FA/IIP: Other investment: Currency and deposits: Other deposits  Income: N/A
Restricted Mudaraba funds	FA: Other deposits (F29) or Equity (F51)  Income: Interest and similar returns (D41) or dividends (D421)	FA/IIP: Other investment: Currency and deposits: Other deposits or Portfolio investment: Equity Income: Primary income: Investment income: Other investment: Interest and similar returns (D41O) or Portfolio investment: Dividends
Mudaraba – fixed	FA: Other deposits (F29)	FA/IIP: Other investment: Currency and deposits: Other deposits
Mudaraba - not fixed	Income: Interest and similar returns (D41)	Income: Primary income: Investment income: Other investment: Interest and similar returns
Mudaraba – fixed with mudaraba certificates	FA: Debt security (F3) or Equity security (F5)  Income: Interest and similar returns (D41) or dividends (D421)	FA/IIP: Portfolio investment – Debt or Equity security  Income: Primary income: Portfolio investment: Debt or equity securities: Interest and similar returns (D41O) or dividends (D42P)
Participation term certificates	FA: Debt security (F3) or Equity security (F5)	FA/IIP: Portfolio investment – Debt or Equity security
Sukuk (generally)	Income: Interest and similar returns (D41) or dividends (D421)	Income: Primary income: Portfolio investment: Debt or equity securities: Interest and similar returns (D41P) or dividends (D42P)
Sukuk (Variable profile)		
Sukuk (Equity-like)	FA: Equity security (F5)  Income: Dividends (D421)	FA/IIP: Portfolio investment – Equity security Income: Primary income: Portfolio investment: Equity securities: Dividends (D42P)
Sukuk (fixed-income)	FA: Debt security (F3)  Income: Interest and similar returns (D41)	FA/IIP: Portfolio investment – Debt security  Income: Primary income: Portfolio investment: Interest and similar returns
Wakalah deposits	FA: Transferable deposits (F22) or Other deposits (F29)	FA/IIP: Other investment: Currency and deposits: Transferable deposits or other deposits

Instrument	National Accounts	External Sector Statistics
	Income: Interest and similar returns (D41)	Income: Primary income: Investment income: Other investment: Interest and similar returns (D41O)
Murabaha financing Qard-hasan	FA: Loans (F4) Income: Interest and similar returns (D41)	FA/IIP: Other investment: Loans Income: Primary income: Investment income: Other investment: Interest and similar returns (D41O)
Istisna'a financing Bai Salam Bai Muajjal	FA: Loan (F4) or Trade credits and advances (F81) Income: Interest and similar returns (D41)	FA/IIP: Other investment: Loans Or Other investment: Trade credit and advances Income: Primary income: Investment income: Other investment: Interest and similar returns
Ijarah	Operating Ijarah: Production account: market output (P11) Financing Ijarah FA – Loans (F4) Income – Interest and similar returns (D41)	Operating Ijarah CA: Trade in Services: Other business services Financing Ijarah FA/IIP: Other investment: Loans Income: Primary income: Investment income: Other investment: Interest and similar returns (D41O)
Musharaka	FA: Loan (F4) or equity (F5) Income: Interest and similar returns (D41) or dividends (D421)	FA/IIP: Other investment – Loans Or Portfolio investment – Equity security Income: Primary income: Investment income: Other investment: Interest and similar returns (D41O) Or Income: Primary income: Portfolio investment: Equity securities: Dividends (D42P)
Mudaraba Financing Tawarruq Bai bil Wafa Bai bil-Istighlal	FA: Loan (F4) Income: Interest and similar returns	FA/IIP: Other investment – Loans Income: Primary income: Investment income: Other investment: Interest and similar returns
Ju'alah	FA: Loan (F4) or Trade credits and advances (F81) Income: Interest and similar returns (D41)	FA/IIP: Other investment: Loans Or Other investment: Trade credit and advances Income: Primary income: Investment income: Other investment: Interest and similar returns
Mushtarakah	FA: Loan (F4) or equity (F5) Income: Interest and similar returns (D41) or dividends (D421)	FA/IIP: Other investment – Loans Or Portfolio investment – Equity security Income: Primary income: Investment income: Other investment: Interest and similar returns Or Income: Primary income: Portfolio investment: Equity securities: Dividends
Istijrar	FA: Trade credits and advances (F81) Income: Interest and similar returns (D41)	FA/IIP: Other investment – Trade credit and advances Income: Primary income: Investment income: Other investment: Interest and similar returns (D41O)

