

# **Musharakah financing as addressed in IFSB Standard : A Regulatory Perspectives**

Prepared by

**Dr. Abdussalam Ismail Onagun**<sup>1</sup>

CEO, at Qitmeer Smart Consultancies, & College of Business,  
University of Modern Sciences Dubai, UAE.

## **Abstract**

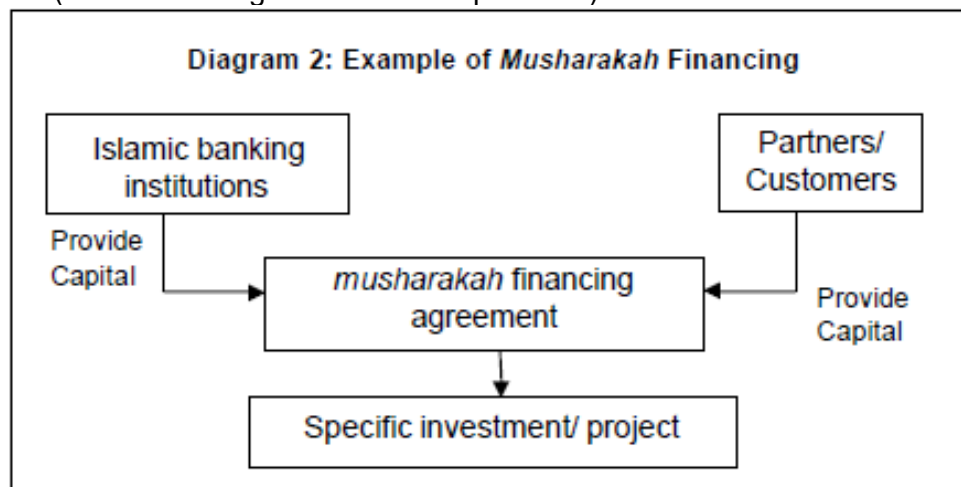
Islamic finance has continued to expand and demonstrated its resilience in the current more challenging international financial environment. However, this expansion has been confined in terms of debt based contracts, rather than employing equity based contracts such as a *Musharakah* contract. Principally Islamic finance promotes transactions that are based on profit and risk sharing through *Mudarabah* (partnership of work and capital) and *Musharakah* (joint venture) contracts, thus, encouraging participatory finance and promoting participation in the risk-reward and financial results. However, statistics suggests that the industry has put more weight on the debt financing instruments. There are several reasons and rationales put forward by the IIFS for the non-existence of the *Musharakah* contract. Some of these reasons will be discussed. This research paper will analyse the *Musharakah*-related and challenges from mainly two facets: *Shari'ah* perspective and regulatory perspective. *Shari'ah* perspective will highlight the main *Shari'ah* issues and minimum *Shari'ah* requirements that need to be observed while employing *Musharakah* contract in IIFS. While the regulatory perspective will underscore the significance of risk management dimension, minimum capital adequacy, and *Shari'ah*-compliant securitisation related to *Musharakah* exposures. Finally the paper will conclude on the role of supervisory authority in implementing Equity based contract (*Musharakah and Mudarabah*).

---

<sup>1</sup> Professor and Managing Director at Qitmeer smart Management Consultancies and University of Modern Sciences, Dubai, UAE. Email [abdussalam@qitmeersca.com](mailto:abdussalam@qitmeersca.com) or [abdussalam3@yahoo.com](mailto:abdussalam3@yahoo.com)

## Definition of Musharakah

Musharakah financing which is equity based participation is executed by Islamic banks to their clients in form of partnership contracts where both parties share profits and losses in comparison with the conventional banks' system which are interest based banking. Musharakah literally means sharing which is originated from an Arabic word "shirkah". However, it technically means a form of partnership agreement between two or more parties which are the Islamic bank and its clients where they contribute their capital to a specific venture in which the profits generated are shared based on the pre-agreed terms in the Musharakah contract while the losses are shared in regard to the capital contribution ratio of each party (Bank Negara Malaysia, 2010). The ventures that the parties contribute their capital in must be Shariah compliant such as trading, investments and construction. In addition, "Islamic banks use this contract on the liability side to attract deposits through investment accounts" (Ibrahim, 2012). Furthermore, the below diagram explains the process of a Musharakah financing in Islamic banking institutions (Islamic banking and Takaful Department).



## Legality of Musharakah financing

The legality of Musharakah contract is based on Quran, Sunnah and consensus by Muslim jurists. As for the Quran, several verses indicate the legitimacy of Musharakah contract such as in (Surat Al-Nisa':12): "but if more than two, they share in a third".

The legality of Musharakah financing in the Sunnah is based on several narrations such as the narration by Abu Hurayrah that the Prophet SAW said: "I am the third (partner) of the two partners as long as they do not betray each other. When one of them betrays the other, I depart from them". Concerning the consensus of Muslim jurists, the consensus of the legality of Musharakah contract is mentioned by one of the Muslim jurists Imam Ibn al-Munzir in his book which is: "And they (Muslim jurists) agree on the validity of partnership where each of the two partners contributes capital in dinar or dirham, and co-mingles the two capitals to form a single property which is indistinguishable, and they would sell and buy what they see as (beneficial) for the business, and the surplus will be distributed between them whilst the deficit will be borne together by them, and when they really carry out [as prescribed], the partnership is valid" (Bank Negara Malaysia, 2010).

## TYPES OF MUSHARAKAH

For the purpose of determining the minimum capital adequacy requirement, IFSB-2 makes distinctions between the three main categories of *Musharakah* and provides guidance how to apply appropriate risk weight for such investments to calculate minimum capital requirements for *Musharakah* exposure under three categories, explained below:

(a) Private commercial enterprise to undertake trading activities in foreign exchange, shares and/or commodities. This type of *Musharakah* exposes the IIFS to the risk of underlying activities, namely foreign exchange, equities or commodities.

(b) Private commercial enterprise to undertake a business venture. This type of *Musharakah* exposes the IIFS to the risk as an equity holder, which is similar to the risk assumed by a partner in venture capital or a joint-venture, but not to market risk. As an equity investor, the IIFS serves as the first loss position and its rights and entitlements are subordinated to the claims secured and unsecured creditors.

(c) Joint ownership of real estate or movable assets (such as cars) is divided into two sub-categories

(i) ***Musharakah with Ijarah sub-contract***: Ownership of such assets can produce rental income for the partnership, through leasing the assets to third parties by means of *Ijarah* contracts. In this case, the risk of the *Musharakah* investment is essentially that of the underlying *Ijarah* contracts, i.e. credit risk mitigated by the collateral represented by the leased assets. However, in some cases the lessee is not a third party but the IIFS's partner as customer. The existence of such an *Ijarah* sub-contract in addition to a *Musharakah* exposes the IIFS to credit risk in respect of the partner's obligation to service the lease rentals.

(ii) ***Musharakah with Murabahah sub-contract***: The IIFS is entitled to its share of revenue generated from selling the assets to third parties by means of *Murabahah* contracts that expose the IIFS to credit risk in respect of the *Murabahah* receivables from the buyer/counterparty.

## SHARĪAH REQUIREMENTS

The details below are the *Sharīah* requirements in the implementation of *Musharakah* investment/financing which include but not limited to the following list:

### a) Capital contribution in *Musharakah* contract

- All forms of debts shall not qualify as *Musharakah* capital. All account receivables and payment due from other partner or third parties are considered as debt.
- A non-monetary asset with an integral debt component to the asset may be contributed as a *Musharakah* capital provided that the integral debt is less than 50% of the asset value.

- The issue of funds placed with the Islamic financial institutions in the form of deposits may be invested as capital in a musharakah contract.
- The rights, obligation and liabilities of all assets contributed to the musharakah venture shall be jointly and severally assumed by partners.
- The issue of any loss of capital in the course of the venture shall be recognized as capital impairment.
- The capital of the IIFS is to be invested in *Sharī'ah* compliant investments or business activities.

**b) Profit sharing in Musharakah**

- Priority of profit distribution in *musharakah* contract that stipulates a pre-determined fixed amount of profit to one partner which deprives the profit share of the other partner.
- The profit sharing ratio may be revised either subject to the mutual consent of the partners or subject to a certain benchmark agreed upon by the partners as the case may be. The profit expressed in the form of a certain percentage should not be linked to the capital amount.
- A profit sharing ratio may be ultimately translated into a fixed percentage based on the capital investment amount once profit is realized. A partner who has agreed to a certain profit sharing ratio may waive the rights to profits to be given to another partner on the basis of principle of Mubarahat (waiver) at the time of profit realization and distribution as well as at the time of the contract.
- The mechanism for estimating profit on Musharakah capital employed may be benchmarked to conventional benchmarks, such as but not limited to Base Lending Rate (BLR) in order to determine the indicative profit rate. Profit may be distributed from actual or realized profits through the sale of assets of the Musharakah partnership (al-tandhid alhaqiqi or al-fi'li). Profit distribution may also be on the basis of constructive valuation (al-tandhid al-hukmi) on the assets including accounts receivables.

**c) Guarantee in Musharakah contract**

- All partners in a Musharakah contract maintain the assets on trust basis. Therefore, in the case of misconduct, negligence or breach of contract of managing partner, is it acceptable to impose capital charge on him if he can't provide any evidence.

*Shari`ah issues*

- The issue of the managing partner to bear direct/indirect expenses and expenditures of the asset with the increase in his profit, in order to facilitate the accounting procedure.
- The issue of permissibility for a partner in Musharakah contract to stipulate that another partner provides a personal guarantee to cover cases of misconduct, negligence or beach of contract.
- The extending of guarantee in the cases of misconduct, negligence or beach of contract to the expected profits, supported by the feasibility study, and not confined to the guarantee of losses.
- Mechanisms and practical applications for the use of Musharakah contract as alternative to overdrafts.

**d) Diminishing Musharakah (also known as Musharakah Mutanaqisah)**

- The issue of permissibility for partners in diminishing Musharakah to give a binding promise that entitles the other partner to acquire, on the basis of a sale contract, his equity share gradually, according to the market value/face value or a price agreed at the time of acquisition.
- The issue of permissibility for a partner in diminishing Musharakah to rent or lease the share of the other partner for a specified amount and for whatever duration and responsibility of periodical maintenance of this share. (Dr Abdussalam: do you think I have addressed these two issues in the table below?)

*Shari`ah issues*

Item	<i>Shari`ah</i> requirement	Observation
Two agreements in one	Shari`ah prohibits the combination of two agreements in one transaction that are made conditional upon each other	It is still permissible for the contracting parties to combine the two contracts of musharakah and ijara into one document as long as both were concluded separately and do not overlap.
Refinancing	The transaction may be seen as two contracts (old and new contract) in one.	It is akin to having a new partner in a new partnership in the same venture/ asset, albeit with different value. The first Musharakah financing must be terminated for the new Musharakah to take place.

Ownership	<p>As a partner in the ownership of the property, the financier shares the responsibility and risks arising from the said property. In an ijara relationship, the owner (lessor) has to bear the cost of basic and structural maintenance while the occupying party (customer/lessee) shall bear the routine and operational maintenance of the property.</p> <p>The general principle expounds that takaful of an asset is the responsibility of the owner, however some stresses that it should be at the expense of the hirer.</p>	<p>Since the customers' ultimate objective of engaging in the transactions is to own an asset, and not merely to rent it for a certain period of time, it has been arguably accepted that the customer should bear all the costs, particularly when the customer is acknowledged as the sole legal owner in the document of title.</p> <p>Some Shari'ah legal opinions affirmed that it is lawful to make the hirer responsible for a known amount of insurance as it may then become part of the lease payment.</p>
Wa'ad (unilateral promise)	By virtue of the wa'ad, the customer shall be obliged to acquire the bank's ownership share in the property at the buyout amount when there are changes in circumstances resulting in illegality, even if it is not caused by the customer.	In contemporary juristic opinions, wa'ad becomes legally binding if it is made conditional upon the fulfilment of an obligation and the promisee has already incurred expense on the basis of such a promise
Compensation	Some view penalties for late payment of rentals as not permissible.	<p>The AAOIFI Shari'ah Rules for ijara and ijara muntahiya bittamlik provided that the lessee shall undertake to donate a certain amount or percentage of rental due in the case where there is no good reason for late payment.</p> <p>There are slight divergences in the legal documentations, while a legal documentation explicitly requires such compensation to be donated to any registered charitable organisation or utilised for any charitable purpose; the other documentation is silent in this regard.</p>
Sale of share in the case of	The bank may exercise its rights as trustee to sell off the	As redemption and failure to redeem are always the two common scenarios,

non-indebtedness	<p>property and the proceeds/ loss should be shared between the partners according to stated ratios.</p> <p>As a Shari'ah requirement, the redemption sum or formula has to be certain and fixed in advance. Hence, any reference to the market price at the point of redemption may trigger issues of riba.</p>	<p>the partners will be stuck with the business in the event that the redeeming party fails to do so. This explains why agreements are slanted in favour of banks over the redeeming party.</p>
Event of loss on property	<p>The loss will be shared by the bank and customer according to the last ownership ratio if there is shortfall in the recovery of payment.</p>	<p>The customer usually pays to the bank the difference between the amount due to the bank and the amount so realized.</p> <p>Until payment of such differential amount, the customer shall pay late payment compensation charges on the differential sum until the date of actual payment made.</p>
Event of default (in the case of developer's winding up or property abandoned)		<p>The customer shall be obligated to acquire the bank's ownership share in the property at the buyout amount for matters such as 'developer's winding up' and 'property abandoned', which are not the fault of the customer.</p> <p>This resembles a conventional loan whereby the customer will continue to make payments if the property is destroyed until the insurance proceeds are received.</p>

## REGULATORY REQUIREMENTS OF MUSHARAKAH FINANCING

### a) Risk Management

The distinct risk profile of *Musharakah* contract, which is a form of equity participation, exposes the IIFS to various types of risks, such as counterparty credit risk, market risk, liquidity risk and reputational risk. An IIFS acts as a partner in a *Musharakah* contract and is exposed to the risk of losing its capital upon making payment of its share of capital in a *Musharakah* contract. A *Musharakah* can expose the IIFS either to capital

impairment risk or to 'credit risk', depending on the structure and purpose of the *Mushārah* and the types of asset in which the funds are invested.

In addition, when IIFS employ different financing instruments (where one of which include *Mushārah*) at different contract stages, as different stages may give rise to different risks, in all cases, IIFS should give considerations as to the quality of the partner (i.e. the risk profiles of potential partners: *Muḍārib* and/or *Mushārah* partner), underlying business activities and ongoing operational matters.

IFSB has recognised the significance of this contract and the Guiding Principles of Risk Management (IFSB-1) provides a set of guidelines of best practices for establishing and implementing effective risk management in IIFS including *Musharakah*, which give practical effect to managing the risks underlying the business objectives that IIFS may adopt.

The capital invested through *Mushārah* may be used: (i) to purchase shares in a publicly traded company or privately held equity; and (ii) invested in a specific project, portfolio or through a pooled investment vehicle. In the case of a specific project, IIFS may invest at different investment stages.

In short, a number of operational challenges will be faced by the IIFS when employing *Musharakah* contract, among other things:

1. **Identifying and monitoring the transformation** of risks at various stages of *Mushārah* investment lifecycles;
2. Lack of due diligence because of **lack of reliable information** on which to base their investment appraisals. Such due diligence is essential to the fulfilment of IIFSs' fiduciary responsibilities as an investor of IAH funds on a *Mushārah* basis;
3. **Sharī'ah compliant risk-mitigating techniques** (e.g. quality of the *Takaful* or insurance coverage), which reduce the impact of possible capital impairment of an investment;
4. **Potential manipulation of reported** results leading to overstatements or understatements of partnership earnings;
5. **Inappropriate and inconsistent valuation** methodologies;
6. Lack of **stress analysis and cash flow predictability** in *Musharakah* exposures;
7. **Strength of the *Musharakah* partner** (i.e. ineffective management and substandard partners' quality. Management and partner difficulties have contributed to difficulties in managing properties);
8. **Divestment and liquidation** (i.e. criteria for exit strategies, including the redemption of equity investments and the divestiture of under-performing investments);
9. **Political, legal, and regulatory environment** (i.e. government support and project/business venture's importance for the country, favourable and stable regulatory environment, well-defined property rights to function efficiently, unfair treatment in taxation is also considered to be a major obstacle, secondary markets for trading in Islamic financial instruments, particularly *Musharakah*, are non-existent, and enforceability of contracts).

## **b) Capital adequacy requirements**

The IIFS that is exposed to the risks inherent in *Mushārah* activities is required to hold sufficient capital. The Capital Adequacy Standard (IFSB-2), which complements Pillar I in Basel II, provides guidelines on minimum capital requirements for exposures in various contracts including *Musharakah* that enable an IIFS to measure the extent to which its capital position is commensurate with its overall risk profile and business strategy, thereby assessing its ability to absorb a reasonable level of unexpected losses before becoming insolvent.

These requirements cover the risk of losing invested capital arising from entering into contracts or transactions that are based on the *Mushārah* and Diminishing *Mushārah* where the IIFS and their customers/partner(s) contribute to the capital of the partnership and shares its profit or loss.

For the purpose of determining the minimum capital adequacy requirement, IFSB-2 makes distinctions between the three main categories of *Mushārah* and provides guidance how to apply appropriate risk weight for such investments to calculate minimum capital requirements for *Mushārah* exposure under three categories, explained below:

(a) Private commercial enterprise to undertake trading activities in foreign exchange, shares and/or commodities. This type of *Mushārah* exposes the IIFS to the risk of underlying activities, namely foreign exchange, equities or commodities.

(b) Private commercial enterprise to undertake a business venture. This type of *Mushārah* exposes the IIFS to the risk as an equity holder, which is similar to the risk assumed by a partner in venture capital or a joint-venture, but not to market risk. As an equity investor, the IIFS serves as the first loss position and its rights and entitlements are subordinated to the claims secured and unsecured creditors.

(c) Joint ownership of real estate or movable assets (such as cars) is divided into two sub-categories

(i) ***Mushārah* with *Ijarah* sub-contract:** Ownership of such assets can produce rental income for the partnership, through leasing the assets to third parties by means of *Ijarah* contracts. In this case, the risk of the *Mushārah* investment is essentially that of the underlying *Ijarah* contracts, i.e. credit risk mitigated by the collateral represented by the leased assets. However, in some cases the lessee is not a third party but the IIFS's partner as customer. The existence of such an *Ijarah* sub-contract in addition to a *Mushārah* exposes the IIFS to credit risk in respect of the partner's obligation to service the lease rentals.

(ii) ***Mushārah* with *Murabahah* sub-contract:** The IIFS is entitled to its share of revenue generated from selling the assets to third parties by means of *Murabahah* contracts that expose the IIFS to credit risk in respect of the *Murabahah* receivables from the buyer/counterparty.

In addition to applying simple risk-weight method (i.e. 400%) as stated in the IFSB-2, in appropriate cases, the supervisor may permit an IIFS to employ an alternative approach, namely the supervisory slotting criteria approach. Under this method, an IIFS is required to map its internal risk grades into four (i.e. between 90-270% RW ) supervisory categories for specialised financing as set out in Appendices of the IFSB-2, and each of these categories will be associated with a specific risk weight.

#### Regulatory Issues

- Some regulatory authorities view the 300-400% RW is too high.

### **SHARI'AH-COMPLIANT SECURITISATION OF MUSHĀRAKAH RELATED EXPOSURES**

Apparently *Musharakah* based contracts demands higher capital adequacy requirements, but IIFS can also benefit from taking exposures in *Musharakah* in terms of capital relief through *Shari'ah*-compliant securitisation. The IFSB has recognised this under IFSB-7, where business ventures organised as *Musharakah* partnerships by IIFS can be securitised, and the resultant *sukuk* are tradable. This is to relief from higher capital requirements on these exposures, however, an originating IIFS may exclude securitised exposures from the calculation of its risk weighted assets only if all of the condition have been met as set under asset derecognition criteria in IFSB-7.

### **ROLE OF THE SUPERVISORY AUTHORITY**

The role of supervisory authority is also important to be underlined. The supervisory authority should satisfy itself that adequate policies and procedures are in place for *Musharakah* exposures risk management, taking into account the IIFS's appetite and tolerance for risk. In addition, the supervisory authority should also ensure that IIFS have sufficient capital when engaging in equity investment activities. In regard to calculating minimum capital requirements for *Musharakah* exposures, supervisory should provide adequate guidance to IIFS, who wish to employ supervisory slotting criteria approach as stated in IFSB-2.

### **CONCLUDING REMARKS**

In concluding remarks, there is compelling need to diversify the IIFS's portfolio with right mix of debt and equity contracts. This diversification can be achieved by following IFSB guidelines. However, IIFS should be familiar and competent, to offer development finance products based on *Mudarabah* and *Musharakah* principles, which supposedly would open the access to capital for entrepreneurs who are committed towards their business but are hampered by their lack of asset collaterals. The existences of *Musharakah* instrument in IIFS will be in compliant not only with the profit-motive of the IIFS but also with socio-economic objectives.

**Table: Comparison of Shariah and Regulatory issues**

<b>Musharakah Category</b>	<b>Regulatory Perspective</b>	<b>Shariah Perspective</b>
<i>Musharakah</i>	<ul style="list-style-type: none"> <li>○ Credit risk, market risk, liquidity risk and reputational risk</li> </ul>	<ul style="list-style-type: none"> <li>○ <i>What are the general Shari'ah requirements (such as <b>nature of business, terms and conditions, estimating profit on Musharakah to be benchmarked with conventional benchmarks, termination and dissolution, PSR, partner guarantee vs. third party guarantee, non-binding repurchase undertaking, delays and penalty</b> etc) while undertaking Musharakah activities in the IIFS?</i></li> <li>○ <i>What are the <b>Shari'ah compliant risk-mitigating techniques</b> available to IIFS to mitigate this risk?</i></li> </ul>
<i>Musharakah</i> in Private commercial enterprise to undertake trading activities in the foreign exchange, share and/or commodity	<ul style="list-style-type: none"> <li>○ Credit risk not applicable</li> <li>○ Market risk capital charge will depend on the underlying asset as set out in the applicable market risk section</li> </ul>	<ul style="list-style-type: none"> <li>○ <i>What are the Shari'ah issues while undertaking trading activities in the foreign exchange, share and/or commodity?</i></li> </ul>
<i>Musharakah</i> in Private commercial enterprise to undertake business venture OTHER THAN trading activities in the foreign exchange, share and/or commodity	<p>Market risk not applicable. However, credit risk is applicable and treatment is shown below:</p> <p>(a) <u>Simple risk-weight method</u> 400% RW of the contributed amount* to the business venture less any specific provisions (If there is a third party guarantee, the RW of the guarantor shall be substituted for that of the assets for the amount of any such guarantee)</p> <p>Or</p> <p>(b) <u>Slotting method</u> Between 90-270% RW of the contributed amount* to the business venture based on the four categories</p>	<ul style="list-style-type: none"> <li>○ <i>What are the Shari'ah issues while undertaking other than trading activities?</i></li> </ul>

<p><i>Musharakah</i> in Joint ownership of real estate and movable assets (<i>Musharakah</i> with <i>Ijarah</i> sub-contract, <i>Musharakah</i> with <i>Murabahah</i> sub-contract)</p>	<p>For market risk reference should be made to the market risk capital charge requirements as set out under the sub-contracts.</p> <p>However, for credit risk, the capital requirements will be based on lessee's (for <i>Ijarah</i> sub-contract) or customer's (for <i>Murabahah</i> sub-contract) rating or 100% RW for unrated lessee or customer.</p>	<ul style="list-style-type: none"> <li>○ <i>What are the potential Shari'ah issues to IIFS while undertaking, <b>Musharakah with Ijarah</b> sub-contract, and <b>Musharakah with Murabahah</b> sub-contract.</i></li> </ul>
---	---	---

## REFERENCES

Bank Negara Malaysia (Central Bank of Malaysia). (2010). Retrieved April 07, 2014, from

[http://www.bnm.gov.my/guidelines/05\\_shariah/04\\_draft\\_shariah\\_parameter\\_spr4.pdf](http://www.bnm.gov.my/guidelines/05_shariah/04_draft_shariah_parameter_spr4.pdf)

Chaudhary, M. (2013, August 16). Islamic Vs Conventional banking system. Retrieved April 09, 2014, from <http://blogs.dunyanews.tv/?p=7008>

Ibrahim, S. (2012). Reporting of Islamic Financial Transactions. Kuala Lumpur: The International Centre for Education in Islamic Finance.

Islamic banking and Takaful Department. (n.d.). Retrieved April 08, 2014, from [http://www.bnm.gov.my/guidelines/01\\_banking/04\\_prudential\\_stds/15\\_mnm.pdf](http://www.bnm.gov.my/guidelines/01_banking/04_prudential_stds/15_mnm.pdf)

Mohammed, R. (2014, April 27). Assistant Manager-Corporate Operations. (A. Aljoker, Interviewer)