Concept Paper

Shariah Requirements,
Optional Practices and
Operational Requirements of Musharakah

Issued on: 20 December 2013
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As part of the objectives to strengthen the Shariah-compliance practices among Islamic financial institutions (IFI), Bank Negara Malaysia (the Bank) is developing a Shariah-based regulatory policy with the objective to provide a comprehensive guidance to the Islamic financial industry with respect to end-to-end compliance with Shariah. This Shariah-based regulatory policy consists of two components: Shariah and Operational requirements. The Shariah requirements highlight the salient features and essential conditions of specific Shariah contracts to facilitate sound understanding of a particular contract by the IFI. The Operational requirements set out the expectations with respect to the oversight function, structuring, risk management, reporting and disclosure as well as consumer and market conduct. This Concept Paper (CP) provides both the Shariah and Operational requirements for Musharakah contract. However, this CP is seeking feedback only on the operational requirements of Musharakah contract under Part C and D. For this purpose, the Bank invites IFI to provide written feedback on specific questions set out in this CP as well as any general comments. In addition, IFI may seek clarification on specific issues/areas and highlight alternative proposals for the Bank to consider. The feedback must be supported with clear rationale, accompanying evidence or illustration, as appropriate to facilitate effective review of the standard.

Responses shall be submitted to the Bank by 20 January 2014 to:

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PART A  OVERVIEW

1.  Introduction

1.1 Compliance with all validity conditions specified by Shariah is prerequisite of a legitimate Islamic finance products and services. It is essential for Islamic financial institutions (the IFI) to establish comprehensive operational framework that is consistent with Shariah to govern the conduct of Islamic finance transactions in its financial activities. In this regards, IFI must ensure that its entire financial activities are implemented with good governance, prudent and transparent manner. This will ensure the integrity of Islamic finance transactions and financial stability of IFI continued to be preserved and sustained respectively.

1.2 In Islamic finance, IFI employs several Shariah contracts in carrying out its financial activities. One of the Shariah contracts is musharakah. Musharakah is a partnership between two or more parties, whereby all contracting parties shall contribute capital to the musharakah venture and will share the profit and loss from the partnership.

Objectives

1.3 This policy document outlines the Shariah requirements and optional practices of musharakah as well as key operational requirements governing the implementation of musharakah that are in line with Shariah, to ensure sound financial practices and consumer protection throughout the life cycle of musharakah.

Scope of Policy Document

1.4 This policy document covers all products and services structured using the musharakah contract other than capital market instruments¹.

¹ Under the purview of Securities Commission
1.5 Part B provides the Shariah requirements that must be adhered to in ensuring validity of *musharakah* and its optional practices.

1.6 Part C and D complement the Shariah requirements as per Part B and the relevant existing regulatory framework on governance and oversight, structuring, risk management, disclosure and reporting and consumer and market conduct issued by the Bank. As for Part C, there are five key principles for sound management and operationalisation of *musharakah* as follows:

a) **Principle 1:** IFI must establish comprehensive policies and procedures to facilitate proper oversight arrangement and ensure *musharakah* are conducted with sound practices and compliance with Shariah;

b) **Principle 2:** IFI must ensure the implementation of *musharakah* is supported with comprehensive processes and procedures, adequate systems and robust documentations;

c) **Principle 3:** IFI must ensure sound structuring of *musharakah* which includes conducting the end-to-end process to match the risk & reward profile between sources and usage of funds;

d) **Principle 4:** IFI must institute and implement sound and integrated risk management system to effectively manage risks throughout the life cycle of *musharakah*; and

e) **Principle 5:** IFI must undertake *musharakah* with fair and transparent manner to protect stakeholder's interest.
2. **Applicability**

2.1 This policy document is applicable to all Islamic financial institutions as defined in paragraph 5.2.

2.2 Part B of this policy document shall also apply to a licensed takaful operator under the IFSA.

3. **Legal provisions**

3.1 The requirements in this policy document are:

   a) specified pursuant to section 29(1) and (2) of IFSA; and

   b) directions issued pursuant to section 129(3) of DFIA.

4. **Effective date**

4.1 This policy document comes into effect on 20 December 2013.

5. **Interpretation**

5.1 The terms and expressions used in this policy document shall have the same meanings assigned to them in the FSA, IFSA and DFIA unless otherwise defined in this policy document.

5.2 For the purposes of this policy document:

   “S” denotes a standard, requirement or specification that must be complied with. Failure to comply may result in one or more enforcement actions; and

   “G” denotes guidance which may consist of such information, advice or recommendation intended to promote common understanding and sound industry practices which are encouraged to be adopted.
“Islamic financial institutions” or “IFIs” means:

(a) licensed Islamic banks under the IFSA;
(b) licensed banks and licensed investment banks under the FSA approved under section 15(1)(a) FSA to carry on Islamic banking business; and
(c) prescribed institutions under the DFIA approved under section 129(3) DFIA to carry on Islamic banking business or Islamic financial business; and

for the purposes of Part B only, shall include licensed takaful operators under the IFSA.

5.3 Further interpretation and definition is given in Appendix 1.

6. Related legal and policy documents

6.1 This policy document must be read together with the legal and policy documents listed in Appendix 2.

7. Policies Superseded

7.1 This policy document supersedes the requirements for musharakah in the Guidelines on Musharakah and Mudarabah contracts for Islamic Banking Institutions.
PART B  SHARIAH REQUIREMENTS AND OPTIONAL PRACTICES OF MUSHARAKAH

8. Definition and Nature of Musharakah

8.1 Musharakah\(^2\) refers to a partnership between two or more parties, which may take effect through contractual relationship (\(\text{`}aqd\)) or by operation of Islamic law, whereby all contracting parties will share the profit and bear loss from the partnership.

8.2 Generally, there are two types of Musharakah (shirkah), namely:

(a) **Shirkah al-Milk** (Partnership in joint ownership)

   Partnership in joint ownership refers to possession of an asset by two or more persons with or without prior arrangement to enter into a sharing in joint ownership. Under shirkah al-milk, the partner’s ownership are mutually exclusive. In this regard, one partner cannot deal with other partner’s asset without his consent.

(b) **Shirkah al-`Aqd** (Contractual Partnership)

   Contractual partnership refers to a contract executed between two or more partners to venture into business activities to generate profit.\(^3\) Under shirkah al-`aqd, the partner is an agent to the other partners. In this regard the conduct of one partner in the ordinary course of business represents the partnership.

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\(^2\) The terms of shirkah, sharikah and sharkah are synonymous to Musharakah.

\(^3\) Shirkah al-`Aqd can be divided into:

(i) **Shirkah al-Amwal**: An agreement between two or more persons to invest a sum of money as capital in a business and share its profit according to agreement.

(ii) **Shirkah al-A`maal**: A partnership in which the partners agree to share what they earn by their labor.

(iii) **Shirkah al-Wujuh**: An agreement between two or more persons of good reputation to form a partnership to purchase asset on credit for the purpose of making profit whereby the partners undertake to fulfill their obligation according to the percentages agreed by the partners.
COMPONENTS OF MUSHARAKAH

9. Contracting parties

G 9.1 Parties to a Musharakah contract are the partners who may be a natural person or a legal person.

S 9.2 A partner to a Musharakah contract must have the legal capacity⁴ to execute the contract.

S 9.3 A Musharakah contract shall be concluded by an offer and acceptance between the partners.

G 9.4 A partner to a Musharakah contract may conclude the contract through an agent.

S 9.5 Partners shall be bound by the terms and conditions mutually agreed in the contract provided that they do not contravene the Shariah principle.

10. Management of Musharakah

G 10.1 A Musharakah venture may be managed in the following manner:

(a) Management by all partners; or

(b) Management by certain partners or a single partner; or

(c) Management by a third party.

⁴ The legal capacity of a person is defined as capacity to have rights and responsibilities; and capacity to have legal effect to his action. Among the important conditions are that the person must possess sound mind and the capacity to distinguish between what is harmful or beneficial to one’s interests. Legal capacity of a legal entity is defined as eligibility of an entity to acquire rights and assume responsibilities.
S 10.2 The appointment of a third party as the manager shall be executed in a separate contract.

G 10.3 The appointment of a manager may be executed based on wakalah (agency), *ijarah al-ashkhas* (employment contract) or *Musharakah*.

G 10.4 A managing partner may be entitled to an agreed remuneration and/or any incentive as agreed by the partners for his services as manager in addition to his share in profit sharing as a partner.

S 10.5 A managing partner shall be liable for any loss caused by his misconduct (*ta’addi*), negligence (*taqsir*) or breach of specified terms (*mukhalafah al-shurut*).

G 10.6 Amendments and variations to the *Musharakah* agreement may take effect at any time throughout the tenure of the contract on all issues provided that such amendments and variations are mutually agreed upon by the partners and are in compliance with Shariah.

G 10.7 The *Musharakah* agreement may provide that any amendment to the agreement is valid by a specified approval process such as a majority vote.

### 11. Capital

S 11.1 *Musharakah* capital shall be identifiable, readily available and accessible.

G 11.2 *Musharakah* capital may be in the form of cash or in-kind that may include intangible assets.

S 11.3 Capital in-kind shall be valued in monetary terms by third party, which may include experts, valuers, or as agreed upon by the partners at the inception of the contract.
S 11.4 *Musharakah* capital denominated in different currencies shall be valued based on a specific currency agreed by the partners at the inception of the contract.

S 11.5 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.

G 11.6 Asset with an integral financial liability\(^5\) attached to it may be contributed as a *Musharakah* capital and the liability may be assumed by the partnership.

S 11.7 The risk associated with the assets contributed as capital to the *Musharakah* venture shall be assumed by the partnership.

S 11.8 The total amount of capital to be contributed by each partner shall be known and determined at the time of contract.

S 11.9 Upon the disbursement of capital by the *Musharakah* partners, all partners’ rights and liabilities with regard to the partnership shall be established.

G 11.10 The capital may be fully or partially disbursed as per the terms of the contract.

G 11.11 Notwithstanding paragraph 11.10, additional capital may be injected subject to mutual agreement of all partners. In this regard, the partners may agree to vary or revise the proportion of capital contribution and the profit sharing ratio.

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\(^5\) Integral financial liability of an asset includes maintenance cost, fees, etc.
S 11.12 The effect of a failure of a partner to provide capital under a *Musharakah* contract (defaulting partner) in the following situations shall be as follows:

(a) **No capital has been paid by defaulting partner within the stipulated time.**

The non-defaulting partners may terminate the contract with the defaulting partner and may impose on defaulting partner to indemnify the partnership for any expenses incurred due to his default.

(b) **Musharakah contract involving staggered capital payment.**

In a *Musharakah* contract involving staggered capital payment, where the defaulting partner has made partial capital payment, the non-defaulting partners may, subject to the terms and conditions of the contract:

(i) revise the *Musharakah* contract based on the actual capital paid by the defaulting partner; or

(ii) terminate the contract with the defaulting partner and consequently:

(a) the non-defaulting partner will pay the defaulting partner’s fair share of investment in the *Musharakah*; or

(b) require the defaulting partner to sell his interest to the other partner(s) or a third party; and

(iii) based on agreed terms, the partnership may impose on the defaulting partner to indemnify the partnership for any expenses incurred due to his default.

S 11.13 *Musharakah* capital either cash or kind shall form common and undivided interest of all partners.
11.14 The capital invested shall not be guaranteed by any of the partners and/or managers.

11.15 Any partner acting on his own or as agent who has caused the loss of capital due to misconduct (ta`addi), negligence (taqsir) or breach of specified terms (mukhalafah al-shurut) shall indemnify the loss of the capital.

11.16 Capital loss shall be borne by the partners proportionate to their capital contribution.

A share of Musharakah capital may be transferred to existing partners or a third party according to the agreed terms and conditions of the Musharakah contract.

The Musharakah agreement may impose a condition that compels a partner to offer his share of capital to existing partners based on agreed terms and conditions.

Any gain or loss in the value of capital from the transfer of share capital shall be enjoyed or borne by the partner who disposes the shares.

The Musharakah contract may provide for the partner to withdraw capital during the tenure of the Musharakah contract unless stated otherwise in the Musharakah agreement.

Consequent to capital withdrawal, the loss sharing ratio shall be revised accordingly.

A Musharakah that is specific to a project, where one or more of the partner(s) is involved in multiple projects, only direct expenses attributable to the specific project may be deducted from Musharakah capital.
12. **Profit**

**S** 12.1 Profit is the value created over and above the *Musharakah* capital which is determined based on a method acceptable by market standard or practices.

**S** 12.2 The partners in a *Musharakah* venture shall share profit based on a mutually agreed ratio among them.

**S** 12.3 Profit sharing ratio (PSR) shall be based on proportionate capital contribution by the partners unless mutually agreed otherwise at the inception of the contract.

**G** 12.4 The PSR may be revised during the tenure of the *Musharakah* subject to mutual agreement between the partners. The PSR may be revised either based on the mutual agreement of the partners or based on a certain benchmark agreed upon by the partners as the case may be.

**G** 12.5 The partners may agree on a PSR for a certain threshold of profit. In the event that the actual profit exceeds the threshold, the excess amount may be distributed based on a different PSR agreed by the partners or be paid to any of the partners as per agreement. In the case of profit generated is below the threshold, the profit is shared based on the PSR.

**S** 12.6 *Musharakah* contract shall not stipulate a pre-determined fixed amount of profit to any partners which may deprive the profit share of the other partners.

**S** 12.7 The expected return in the form of percentage which is attributed to the *Musharakah* capital amount is only permissible in the form of indicative profit rate.
The agreed PSR may vary to correspond with different periods of investment, different amount of capital or due to pre-mature withdrawal of capital provided that such conditions are agreed upon at the inception of the *Musharakah* contract.

Any partner may relinquish his right to the profits, if any, to the other partner(s) on the basis of waiver (*tanazul*) provided that the waiver shall be exercised after recognition of the profit.

Profit shall be recognised based on the following methodology:

(a) realised basis by actual liquidation of assets of *Musharakah* partnership (*al-tandid al-haqiqi*); or

(b) constructive basis according to acceptable profit recognition method which may include valuation according to acceptable market methodology or independent valuation or valuation based on estimated figures (*al-tandid al-hukmi*).

In the case of profit recognised based on constructive basis, a profit reserve may be created.

In the case of profit recognised based on constructive basis, a final consolidation and adjustment shall be undertaken at the end of a certain period or at the times of actual realisation of profit to arrive at the actual amount of profit.

It is permissible to distribute a sum of money on account prior to actual or constructive valuation provided that upon rationalisation at the actual profit recognition date, any amount paid which exceeds actual profit must be adjusted.

The partners may agree to set aside the profit as a reserve or for any other purpose.
12.15 In relation to paragraph 12.14, if the reserve fund is distributable to the partners, unless otherwise agreed, the distribution shall be based on the agreed profit sharing ratio.

13. **Loss**

13.1 Loss is depletion from the value of capital.

13.2 Loss shall be borne by the partners proportionate to the capital contribution and the loss is limited to the capital.

13.3 Upon realisation of loss, any partners may voluntarily absorb such loss.

13.4 Loss due to misconduct (ta`addi), negligence (taqsir) or breach of specified terms (mukhalafah al-shurut) by a partner shall be borne by that partner.
ARRANGEMENT OF MUSHARAKAH WITH OTHER CONTRACTS OR CONCEPTS

<table>
<thead>
<tr>
<th>14.</th>
<th>Arrangement for guarantee</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>S</strong> 14.1</td>
<td>Partners in <em>Musharakah</em> shall not guarantee the capital and/or profit.</td>
</tr>
<tr>
<td><strong>G</strong> 14.2</td>
<td>Notwithstanding paragraph 14.1, the following measures may be exercised:</td>
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<tr>
<td></td>
<td>(a) each partner may be required to provide collateral, provided that the collateral can only be liquidated in the event of misconduct (<em>ta’addi</em>) or negligence (<em>taqsir</em>) or breach of specified terms (<em>mukhalafah al-shurut</em>) of contract by the partner(s); or</td>
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<td></td>
<td>(b) the <em>Musharakah</em> venture may require for arrangement of an independent third party guarantee including performance guarantee of the <em>Musharakah</em> venture or guarantee on <em>Musharakah</em> capital.</td>
</tr>
<tr>
<td><strong>S</strong> 14.3</td>
<td>Pursuant to paragraph 14.2 (b), the following requirements shall be observed:</td>
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<td></td>
<td>(a) the guarantee shall be executed as a separate contract and be utilised to cover for any loss or depletion of capital; and</td>
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<td></td>
<td>(b) the third party guarantor shall be independent from the <em>Musharakah</em> venture such that it shall not be a related party where the partner(s) has majority ownership and/or having control in the entity nor shall it be an entity that owns or having controls over the <em>Musharakah</em> venture.</td>
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15. **Arrangement of Musharakah with Wa`d**

G

15.1 *Musharakah* may be arranged with *wa`d* whereby:

(a) a partner undertakes to purchase or sell his share to the other partners’ share upon certain specified event;

(b) an agent (*wakeel*) appointed by the partnership undertakes to purchase or sell the underlying asset of the partnership upon certain specified event; or

(c) a partner undertakes to waive his share of profit to the other partners upon certain specified event.

16. **Arrangement of Musharakah with Wakalah**

G

16.1 *Musharakah* may be arranged with *wakalah* either with or without fee whereby:

(a) the partnership appoints one of the partner as the agent (*wakeel*) to act on behalf of the partnership; or

(b) the partnership appoints a third party as the agent (*wakeel*) to act on behalf of the partnership.

17. **Musharakah Mutanaqisah**

S

17.1 *Musharakah* may be entered into by two or more parties on a particular asset or venture which allows one of the partners to gradually acquire the shareholding of the other partner through an agreed redemption method during the tenure of the contract. Such arrangement is commonly referred to as *Musharakah Mutanaqisah* (diminishing *Musharakah*).
17.2 *Musharakah Mutanaqisah* with the objective of asset acquisition must be governed by the principle of *shirkah al-milk* and therefore must have the effect of *shirkah al-milk* as defined in paragraph 8.2(a).

17.3 *Musharakah Mutanaqisah* with the objective of venturing in profit generating business activities must be governed by the principle of *shirkah al-`aqd* and therefore must have the effect of *shirkah al-`aqd* as defined in paragraph 8.2(b).

18. **Musharakah Mutanaqisah for The Purpose of Asset Acquisition**

18.1 *Musharakah Mutanaqisah* for the purpose of asset acquisition may be arranged with other contracts such as *ijarah* (leasing), *ijarah mawsufah fi zimmah* (advance lease), *bai` musawamah* (selling) and *istikna`* (manufacturing).

18.2 *Musharakah Mutanaqisah* for the purpose of acquiring completed asset may be arranged whereby both partners jointly purchase an asset from a third party. Subsequently, one of the partners will lease his share of ownership to the other partners based on *ijarah*. Simultaneously, the partner who is the lessee will purchase the share of the other partner on gradual basis and ultimately become the sole owner of the asset.

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6 Provisions under this section are based on *Shirkah al-Milk*. 
18.3 *Musharakah Mutanaqisah* for the purpose of acquiring incomplete asset may be arranged with *istikna`* whereby both partners enter into *an istisna`* contract with a third party. Subsequently, one of the partners will lease his share of ownership to the other partners based on *ijarah mawsufah fi zimmah* until the asset is completed. Simultaneously, the partner who is the lessee will purchase the share of the other partner on gradual basis and ultimately become the sole owner of the asset.

18.4 A partner under *Musharakah Mutanaqisah* may lease his share of the *Musharakah* asset to other partners.

18.5 A partner, at the inception of the contract may request the other partner to give a binding promise (*wa`d*) to gradually purchase the former’s share of the asset over an agreed period of time at market value, fair value or any price to be agreed by the partners.

18.6 Partner may agree on a specific method of price calculation in the case where total shares are acquired earlier than the stipulated tenure.

18.7 Pursuant to paragraph 18.6, the lease between the partners is dissolved.

18.8 A partner may pledge his ownership share of the completed asset as collateral to the other partners.

18.9 In the event where a partner (promisor) breaches his promise to acquire the *Musharakah* asset as agreed or fails to pay his rental, the other partner (promisee) may sell the asset to the partner or to a third party as per agreed terms and conditions.
18.10 Pursuant to paragraph 18.9, the sale of the asset to a third party may be conducted based on the following approaches:

**Approach 1**

(a) Promisee invokes the promise to purchase and where the promisor fails to perform the promise; the partners shall jointly sell the asset to a third party.

(b) The proceeds of the sale shall be allocated to all partners based on the ownership share at the point of sale based on following options:

(i) allocation to all partners after deducting all costs related to asset liquidation from the proceeds of the sale; or

(ii) allocation to all partners without prior deduction of costs related to asset liquidation from the proceeds. Under this approach, the cost related to asset liquidation is deducted only from promisor’s share of the proceeds.

(c) The promisee may claim the rental due (if any) from the promisor’s share of the proceeds.

(d) The promisee may claim a compensation amount from the promisor’s share of the proceeds. The compensation amount shall be the difference between the agreed purchase price (as promised) and the realised proceeds portion allocated for the promisee.

(e) In the event where the promisor’s share of the proceeds is inadequate to meet the claim under paragraph (d), the promisee may demand the remaining difference from the promisor if the promisor is financially capable.
(f) If the promisor has proven that he is financially incapable to meet the difference amount, the promisee shall not make any further claim of shortfall from the promisor.

(g) In the event that the promisee’s share of the proceeds is equivalent or higher than the promised purchase price, the provisions on compensation under paragraphs (d), (e) and (f) shall not be applicable.

(h) In the event that promisee's portion of proceeds exceeded the promised purchase price the promisee may share his excess proceeds with the promisor.

**Approach 2**

(a) The promisee may invoke the promise to purchase and where the promisor fails to perform the promise, the promisor may subsequently sells his remaining ownership share to the promisor on credit based on any agreed price by both parties.

(b) The promisee may take the asset as collateral to secure the payments of the deferred price as agreed under paragraph (a).

(c) In the case where the promisee as the creditor liquidates the collateral, the following may be applied:

   (i) The promisee may claim the rental due, the purchase price as agreed in the promise to purchase and costs related to liquidation of the collateral.

   (ii) In the event where the proceeds from the liquidation of the collateral is inadequate to meet the claim under paragraph (i), the promisee as creditor may demand the remaining difference if the promisor is financially capable.
(iii) If the promisor has proven that he is financially incapable to meet the difference amount, the promisee shall not make any further claim of shortfall from the promisor.

(iv) If there is any excess amount from the proceeds of the collateral liquidation after the deduction of claims under paragraph (i), the excess amount shall belong to promisor.

G 18.11 In Musharakah Mutanaqisah for acquisition of asset under construction which is arranged based on paragraph 18.3, if a partner (promisor) breaches his promise to acquire the ownership share of the asset as agreed or fails to pay his rental, and where the construction of asset has been completed, the provisions of paragraph 18.9 and 18.10 shall apply.

G 18.12 In Musharakah Mutanaqisah for acquisition of asset under construction which is arranged based on paragraph 18.3, if a partner (promisor) breaches his promise to acquire the ownership share of the asset as agreed or fails to pay his rental, and where the construction of asset has yet to be completed:

(a) the promisee may invoke the promise and compel the promisor to purchase the promisee’s interest in the Musharakah based on the price agreed in the promise.

(b) the rental paid under ijarah mawsulah fi zimmah may be set off against the purchase price of the promisee’s ownership share of the asset.
### 19. *Musharakah Mutanaqisah* for The Purpose of Venturing in Profit Generating Business Activities

**S** 19.1 *Musharakah Mutanaqisah* with objective of venturing in profit generating business activities must take into consideration all provisions under this document except the provisions under the following paragraphs:

(a) Paragraph 8.2(a); and

(b) Paragraph 18.

**G** 19.2 A partner may request the other partner(s) to give a binding promise (*wa`d*) to gradually purchase his shares of the *Musharakah* venture over an agreed period of time at market value, fair value or any price to be agreed by the parties at the time of purchase.

**S** 19.3 Pursuant to paragraph 19.2, gradual acquisition of share by one partner of the other partners’ share shall not result in a guarantee of capital.

**S** 19.4 Pursuant to paragraph 19.2, in the case where the share acquisition is accelerated, the price determination shall be based on the market value, fair value or any price to be agreed by the parties at the time of purchase.

**G** 19.5 In the event where a partner (promisor) breaches his promise to acquire the share of *Musharakah* venture as agreed, the other partner (promisee) may:

(a) invoke the promise and compel the promisor to purchase the share at market value or fair value; or

(b) sell the share to a third party and claim any actual cost incurred in the process to the promisor.
DISSOLUTION

20. Dissolution of Musharakah

S 20.1 A Musharakah contract may be dissolved under the following circumstances:

(a) Mutual agreement to terminate;

(b) Contract expires upon the maturity date agreed by the partners;

(c) Demise or dissolution of partners or loss of legal capacity;

(d) The total acquisition by one partner of the other partners’ share of Musharakah;

(e) Invalidity of Musharakah.

G 20.2 Notwithstanding paragraph 20.1(c), the remaining partners may agree to continue with the contract according to the terms in the Musharakah deed or agreement.

S 20.3 Upon the termination of the Musharakah contract, Musharakah assets shall be subjected to the liquidation process.

G 20.4 Musharakah assets may be liquidated where the assets are disposed to the market.

S 20.5 Pursuant to paragraph 20.4, the proceeds of the asset disposal shall be used as follows:

(a) payment of liquidation expenses;

(b) payment of financial liabilities of the partnership; and

(c) distribution of the remaining assets, if any, among the partners in proportion to their capital contribution.
PART C OPERATIONAL REQUIREMENTS FOR MUSHRARAKAH VENTURE

21. Background

S 21.1 A musharakah venture occurs in the following circumstances:

a) **Provision of capital via acquisition of shares.** IFI may enter into a musharakah agreement to acquire shares from a separate legal entity (e.g. Single purpose specific purpose vehicle (SPV)) that undertake Shariah-compliant activities;

b) **Provision of capital via cash:** Both partners mutually agree to contribute capital for a general or specific project that is not via ordinary shares.

Please refer to **Appendix 4** on illustrations of musharakah venture.

S 21.2 The regulatory expectations set out in Part C emphasize on instituting effective policies and procedures to facilitate governance and oversight function, structuring, risk management, disclosure and reporting and consumer and market conduct. The policy intent of these operational requirements is to provide adequate safeguard to stakeholders’ interest, promote cohesive implementation of business and risk management strategies and drive the development of necessary systems, processes and control measures while preserving Shariah requirement.

22. Governance and Oversight

S **Principle 1:** IFI must establish comprehensive internal policies and procedures to ensure musharakah are conducted with sound practices, comply with Shariah and facilitate proper oversight arrangement.

S 22.1 All aspects of IFI operations should adhere to and be reinforced by credible corporate governance practices. In this regards, this policy
document complements the existing broad principles and requirements on corporate governance stipulated in Bank Negara Malaysia *Guidelines on Corporate Governance for Licensed Islamic Banks* (Revised BNM/GP1-i) and *Guidelines on Corporate Governance for Development Financial Institutions*.

**S 22.2** IFI is expected to have in place additional requirements on governance and oversight function due to the distinct nature of *musharakah* venture. IFI is required to provide strong understanding of the risk profile as well as to ensure availability of resources with the appropriate knowledge and skill set.

**S 22.3** Sound governance and oversight function requirement for *musharakah* venture consist of a two-pronged approach at IFI's and venture's level.

**IFI’s level**

**S 22.4** While the broad governance and oversight principles can be applied to *musharakah*, greater emphasis needs to be applied due to the complexity and distinct risk profile of *musharakah*. The emphasis includes additional role of Board of Directors, Board committee, Shariah committee and management.

**Board of Directors**

**S 22.5** The Board of Directors (the Board) is responsible to establish sound governance structure to facilitate effective oversight function on the management and implementation of *musharakah* venture. The adequacy of governance arrangement shall commensurate with the nature, complexity and risk profile associated with the *musharakah* venture.
S 22.6 The roles and responsibilities of the Board with respect to musharakah venture shall include the following:

a) set and oversee the business strategy and risk appetite with regard to the musharakah venture;

b) approve and oversee policies and procedures for effective risk management and compliance with regulations on musharakah venture;

c) ensure comprehensive and effective Shariah governance framework is in place; and

d) ensure that there are adequate and qualified personnel with sufficient knowledge and competency on the concept, application and risks associated with the musharakah venture. The Board shall also ensure that the necessary expertise is suitable to the type of business or product where the IFI will be financially involved.

**Board Committee**

S 22.7 The Board has the responsibility to ensure the musharakah venture is effectively managed in accordance with the agreed terms and conditions. Key responsibilities of the committee include assisting the Board in performing the oversight function and provide recommendations in respect of the management, operations and performance of the musharakah venture.

S 22.8 Board Committee shall consist of members with sufficient knowledge, competency and understanding of the application and risks associated with musharakah venture, especially with regard to the type of business or product where the IFI is or will be financially involved.
**Shariah Committee**

22.9 The IFI is responsible to ensure the overall operation of *musharakah* venture is compliant with Shariah.

22.10 Shariah committee shall perform the following roles and responsibilities to ensure activities associated with *musharakah* venture are conducted in line with Shariah requirements. The Shariah committee is to:

(a) endorse that the Shariah requirements are appropriately applied in the relevant policies and procedures governing *musharakah* venture;

(b) validate and endorse that the terms and conditions stipulated in legal documentation and other documents\(^7\) are in compliance with Shariah;

(c) advise or provide clarification to the Board pertaining to issues on Shariah matters;

(d) conduct review on *musharakah* venture periodically and advise the IFI on relevant Shariah rulings, decision or guidelines on Shariah matters issued by the Bank and, if relevant, any other authorities; and

(e) provide Shariah compliance report with regards to the compliance of *musharakah* venture to Shariah. The statement of Shariah compliance shall be prepared in accordance with the requirements stipulated in the *Shariah Governance Framework for Islamic Financial Institutions*, *Guidelines on Financial Reporting for Islamic Banking Institutions* and *Guidelines on Financial Reporting for Development Financial Institutions*.

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\(^7\) Such as information published in promotional materials, product manuals or other publications.
**Senior Management**

22.11 Senior management of IFI is responsible in developing and implementing policies and framework that governs *musharakah* venture.

22.12 The roles and responsibilities of the senior management shall include the following:

(a) formulate and implement business strategies, internal control and risk management requirements in line with IFI business objectives;

(b) establish policies, processes and procedures with regard to proper management of *musharakah* and ensure they are properly delegated to the relevant functions and communicated within the IFI;

(c) establish risk management policies and maintain adequate mechanism that are able to identify, measure and mitigate risk inherent in *musharakah*;

(d) undertake regular review and monitor compliance on the approved policies;

(e) identify, assign and train personnel with the appropriate skill set to manage, monitor and review the performance of *musharakah*; and

(f) ensure timely disclosure of relevant information to the Board.
Dedicated Structure

22.13 Once the musharakah exposure\(^8\) reaches 15% of total capital\(^9\), the IFI is expected to establish dedicated oversight committee at board and management level as well as function/unit (dedicated structure) for musharakah venture to enable greater focus and in-depth deliberation of the various factors affecting musharakah exposures. Illustration of the dedicated structure is given in Appendix 7.

**Question 1**: Do you agree with the threshold set by the Bank for the setting up of the dedicated structure? If not, please provide your justification.

22.14 If a dedicated Board Committee is established, e.g. Board Investment and Risk Committee (BIRC):

(a) the membership shall comprise of at least three individual members, of which at the minimum one third shall comprise of independent members or non-executive member to ensure adequate check and balance; and

(b) the independent member of the Board Committee may consist of a senior management personnel not directly involved in the management and operations of the musharakah.

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\(^8\) Includes non-sale based contracts where IFIs may be exposed to capital loss e.g. mudarabah.

\(^9\) As defined under the Capital Adequacy Framework for Islamic Banks (Capital Components) and the Capital Adequacy Framework (Capital Components).
IFI shall ensure that at least one member in the dedicated board or management committee has the expertise and experience\(^\text{10}\) in the main business segments\(^\text{11}\) that the IFI is involved in.

Dedicated function/unit is a function/unit to specifically conduct *musharakah* venture, in order to ensure better focus given its unique nature and risk profile which differs from other types of contract. The objective of the creation of the dedicated function/unit is not only to facilitate specialisation in terms of skills and expertise but to also allow better concentration on *musharakah* venture which would often require active involvement of the IFI.

The dedicated function/unit shall consist of personnel with appropriate expertise, knowledge and competencies in *musharakah* venture, especially in the type of business or product where the IFI is or will be financially involved.

IFI may source external parties to complement the operations of the dedicated function/unit\(^\text{12}\) in areas or business activities which the IFI has lack of expertise.

\(^{10}\) For example, if the IFI is involved mainly in properties, there must be at least a committee member who has experience in the real estate industry such as involvement in property development companies. In this regard, experience merely as a banker in real estate or mortgage financing may not be adequate.

\(^{11}\) If the IFI is involved in more than one business segment at a time, the IFI shall apply judgment in identifying the main business segments that require the existence of a specific committee member with the relevant expertise.

\(^{12}\) Includes advisory, assessment, monitoring, review or any other processes necessary in managing the *musharakah* venture.
22.19 In the event the IFI appoints an external party as per paragraph 22.18, the following measures shall be undertaken to ensure:

(a) the external party has credibility as well as considerable knowledge and expertise in the areas or business activities involved;

(b) there is no conflict of interest between the external party with the parties involved in the musharakah; and

(c) robustness in legal documentation governing the transaction with the external party to ensure enforceability of provisions such as liabilities, roles and responsibilities as well as confidentiality.

22.20 The dedicated function/unit shall execute its roles and responsibilities effectively and efficiently, which includes:

(a) conduct appraisal on received proposal from potential customers and recommend the project to the relevant management committee if viable;

(b) monitor the progress of musharakah venture, regular on-site visits, on-going collection of relevant information and conducting analysis on impact to the musharakah venture;

(c) ensure risk management policies and internal control to manage exposures are adhered to; and

(d) promptly alert the management if abnormalities are detected and prepare progress report to relevant management committee on a periodical basis.

\[13\] Includes on-site visit for Shariah compliant purposes.
Venture's Level

**S 22.21** The fulfilment of managing partner’s fiduciary duties is an integral element to the success and sustainability of the *musharakah* venture. Therefore, it is important for IFI to ensure that effective mechanisms are in place to monitor and assess whether the managing partner is executing his/her duties effectively, diligently and in accordance with the stipulated terms and conditions of the *musharakah* contract.

**S 22.22** IFI shall establish appropriate safeguard measures to ensure effective governance and oversight at the venture level.

**G 22.23** IFI may appoint representative at both the *musharakah* venture’s board and the management or project level. This is to ensure that IFI has access to information of issues relating to the venture and monitor conduct of managing partner’s fiduciary duties both at the highest as well as at the working level in the *musharakah* venture.

**G 22.24** For avoidance of doubt, where the *musharakah* structure is a complex structure such as involving multi-tiered SPV or indirect exposures, IFI shall appoint representative as per paragraph 22.23 at the entity that conducts the actual business activity and/or be able to control the actual business activity. Illustration of complex structure is given in Appendix 6.

**S 22.25** If a representative is appointed, IFI shall establish policies and procedures on the representative function, which includes eligibility criteria, conduct, roles and responsibilities as well as review mechanism to ensure its effectiveness.
The appointed representative shall satisfy the following criteria:

(a) have skill and possess in-depth knowledge of the nature of business involved under the *musharakah* venture;

(b) possess necessary qualification, experience and qualities that enable them to perform their duties effectively;

(c) for board representative, the personnel must possess the maturity and in-depth knowledge to understand the deliberations carried out at the *musharakah* venture and at the board level;

(d) the representative is limited to employees of IFI and its related companies; and

(e) the personnel must be “fit and proper” to hold the post. Criteria for consideration includes:

(i) his/her probity, diligence, competence and soundness of judgement

(ii) his/her reputation, character, integrity and honesty, and

(iii) any history of offence(s) involving fraud, dishonesty, violence, incompetence or malpractice, including any engagement in deceitful, oppressive/improper business practices or any practices which would discredit him/her.

**Question 2:** With reference to paragraph 22.26 (d) should the representative be limited to only the personnel of the IFI and its related companies? If not, what are the safety measures and conditions that may be required to ensure effectiveness of the third party representative?
S 22.27 The roles and responsibilities of the representative shall include:

(a) duly report the progress and performance of the *musharakah* venture to the IFI in a timely manner;

(b) safeguard IFIs’ interest by carrying out his/her duties in the best possible way;

(c) obtain necessary information in order to validate any issues faced by the managing partner; and

(d) maintain high level of integrity and avoid any transactions with the managing partner or other related entities of the musharakah for personal benefits or gains.

S 22.28 The IFI must take into account the following to ensure effectiveness of the representative’s function:

(a) IFI shall ensure that the representative is able to focus on the venture as one of their core job functions;

(b) IFIs are required to establish internal limit on the number of invested entities for each individual who is allowed to be a representative e.g. IFI may wish to ensure each representative is limited to only two ventures at all times;

(c) if the appointed representative is an external party to the IFI, he/she must provide a written undertaking on the obligation to comply with the secrecy provision stipulated in Section 145 of IFSA or Section 133 of FSA and Section 119 of DFIA;
(d) any assignment of alternate representative shall be limited to only one other specified\textsuperscript{14} personnel, who shall also be subject to the terms and conditions of the appointment of a representative; and

(e) fees or remuneration payable to the representative for conducting this function cannot be sourced from the managing partner.

22.29 IFI shall immediately relinquish the representative’s function upon disposal of the IFI’s interest in the \textit{musharakah} venture.

22.30 IFI shall ensure that independence of all functions at the IFI and venture level are preserved at all time to enable check and balance e.g. the board and project representative shall not be the same person, head of the dedicated unit/ function should not be the board representative.

23. \textbf{Structuring}

\textbf{Principle 2:} IFI must ensure the implementation of \textit{musharakah} is supported with comprehensive processes and procedures, adequate systems and robust documentations.

\textbf{Principle 3:} IFI shall ensure sound structuring of \textit{musharakah} which includes conducting the end-to-end process to match the risk & reward profile between sources and usage of funds.

\textbf{Shariah Compliance}

23.1 The IFI is responsible to ensure that the overall operations of \textit{musharakah} venture are in compliance with Shariah requirements. The product structure, strategies, terms of agreement, asset portfolio and type of business involved\textsuperscript{15} must be endorsed by the Shariah committee. The

\textsuperscript{14} Specified means an alternate representative who shall be made permanent throughout the assignment and not be replaced by any other person.

\textsuperscript{15} Such as the business or services conducted by the managing partner in a \textit{musharakah} financing
opinion of the Shariah Advisory Council (SAC) of the Bank shall be sought to resolve issues pertaining to Shariah matters as outlined in the *Shariah Governance Framework for Islamic Financial Institutions*.

**S 23.2** The IFI must establish a holistic and effective management system that is supported by adequate policies and procedures and competent personnel to ensure that the *musharakah* venture continue to adhere with Shariah requirements.

**Sources of funds**

**S 23.3** IFI’s capital contribution under *musharakah* venture are subject to the following requirements based on sources of funding:

(a) funding from Unrestricted Investment Account (URIA) and Restricted Investment Account (RIA)\(^{16}\) are allowed subject to ensuring that matching principles are in place which includes conditions that significantly mitigate\(^{17}\) liquidity risks;

(b) shareholder funds are allowed subject to:

(i) IFI maintaining adequate capital as required under *Capital Adequacy Framework for Islamic Banks and Capital Adequacy Framework (Capital Components)*; and

(ii) IFI clearly establish its risk appetite for *musharakah* venture and establish an internal limit on the use of shareholders fund which commensurate with this risk appetite.

(c) funds from deposits are not allowed.

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\(^{16}\) As defined under the Investment Account Framework.

\(^{17}\) This may include mechanisms such as matching of tenure between source and usage of funds, redemptions only upon liquidation of underlying assets or replacement of investors other than the IFI.
23.4 For avoidance of doubt, pursuant to paragraph 23.3 (a), when the mechanism of matching tenure is used, any extension to the tenure of the *musharakah* venture must also be supported by an extension of redemption period for the URIA and RIA funds.

**Question 3:**

a) Are you agreeable to the proposal on sources of funding? Please provide justification and detail out any other appropriate alternatives (if any);

b) What are the sources of funds allowed for *musharakah* venture at your institution and what are the conditions or internal limits imposed, if any?

**Usage of funds**

23.5 In utilizing funds for purposes of *musharakah* venture, IFI shall assess business venture viability in line with IFI’s risk appetite and strategy as well as ensuring understanding the business profile i.e. cash flow, risk and reward.

23.6 To avoid ever greenining of *musharakah* venture via acquisition of shares, IFI shall limit the extension of holdings of shares up to 5 years from the point of original maturity.

23.7 IFI shall report to the Bank on potential consolidation of *musharakah* venture into IFI’s balance sheet.

**Question 4:**

a) Are you agreeable with requirements on paragraph 23.6? Please provide justification and detail out any other appropriate alternatives.

b) Do you foresee any potential consolidation of *musharakah* venture in your balance sheet?
**Contracting Parties**

S 23.8 Legal capacity shall be consistent with Contracts Act 1950. However, IFI shall undertake suitability assessment to ensure suitability of contracting parties in entering into *musharakah* venture.

S 23.9 The contracting parties’ roles and responsibilities shall be stipulated clearly in the legal documentations.

S 23.10 The appointed managing partner(s), if any, shall be stipulated clearly in the legal documentation, including with the terms to be applied to the managing partner, at minimum the terms shall include the following:

(a) roles and responsibilities of the managing partner in managing the venture including reporting obligation, frequency and to furnish detailed report on any occurrence of loss;

(b) remuneration and/or incentive in addition to their share in profit sharing; and

(c) liabilities to be held by the managing partner(s).

S 23.11 Appointment of third party manager to manage the *musharakah* shall be executed in a separate contract, the terms to be stipulated in the contract shall at minimum include the following:

(a) roles and responsibility in managing the venture including reporting obligation, frequency and to furnish detailed report on any occurrence of loss;

(b) remuneration and/or incentive;

(c) liabilities to be held by third party manager.
Management of Musharakah

S 23.12 Notwithstanding paragraph 10.7, amendments on PSR or any other terms that may significantly dilute the rights of any contracting parties shall be mutually agreed.

G 23.13 Management decision may be determined via:

(a) simple majority; and

(b) minimum of one representative from each party needs to agree.

G 23.14 IFI may wish to exercise veto power over financial matters.

S 23.15 There shall be no conflict of interest (with the partners) for any third party appointment and transactions.

Capital

S 23.16 IFI shall determine the value of the capital contributed by each partner to the musharakah venture upon the execution of the contract.

S 23.17 Capital shall be in the form of cash or capital in-kind which may include intangible assets. In this regard, intangible assets shall be defined as per the relevant MFRS.

S 23.18 Capital shall be identifiable, readily available as well as accessible at the date of commencement of the musharakah venture. In this regard, capital shall not be in the following form:

(a) debt or receivables owing to the partner; and

(b) encumbered assets (e.g. assets pledged as collateral).

S 23.19 For capital in-kind e.g. land, property and machine, IFI shall assign a third party with relevant expertise such as professional valuer and quantity surveyor to determine the value in monetary terms of the capital in-kind.
G 23.20 *Musharakah* capital may be fully or partially disbursed as per terms of contract and additional capital injection is allowed within the tenure of the venture.

S 23.21 Upon disbursement of capital, the IFI shall assume its rights and liabilities as a partner of the *musharakah* up to the limit of the amount of capital disbursed or contributed.

S 23.22 Subject to consent from partners, the managing partner may commingle the *musharakah* capital with other funds. In the event where there is commingling of funds, the IFI shall ensure:

(a) identification of funding purpose and assets in the terms and conditions;

(b) proper tagging of assets (either actual or proportionate) at all times using appropriate mechanism by the managing partner such as separate record keeping;

(c) proper valuation of underlying assets under the *musharakah* are done periodically; and

(d) managing partner’s rights on underlying assets funded by managing partner at all times, including upon exit and managing partner’s winding-up.

S 23.23 In addition to the requirements in paragraph 23.22, when there is commingling of the *musharakah* capital with other funds, the IFI shall ensure that the rights on underlying assets funded by the *musharakah* contract are properly ring-fenced at all times, including upon exit of IFI from the *musharakah* venture and upon liquidation of the managing partner. Possible measures used to ensure rights on the underlying assets funded under *musharakah* must be legally enforceable and effective.
**Question 5:** What are your comments on the feasibility of the following methods to secure rights to the underlying assets funded by the IFI under *musharakah* venture, if the assets are recorded in the books of the managing partner (i.e. basically managing partner legally owning the underlying assets)?

a) Legal documentations to directly specify IFI’s rights on the underlying assets;

b) Creation of ‘trust concept’, whereby the assets are held on trust basis by the managing partner for the IFI; or

c) Create security on underlying asset.

What would be your choice of methodology between the ones suggested above? Do you have suggestion on any other feasible methods?

**Profit**

**S 23.24** PSR shall be mutually agreed between contracting parties and be stipulated clearly in the agreement at time of contract.

**G 23.27** PSR may be revised during the tenure of contract, provided that the revised PSR is mutually agreed between contracting parties.

**G 23.28** In determining the appropriate PSR, the IFI may consider the following factors:

(a) estimated return on *musharakah*;

(b) benchmark rate of return of equivalent product, underlying asset or business segment; and

(c) estimated management or operational costs incurred by the managing partner in managing the *musharakah*.
S 23.29 Profit shall be recognized and measured based on the applicable MFRS.

S 23.30 As required under paragraph 23.29, the contracting parties shall conduct an assessment at the end of certain period or upon actual realization of profit to arrive at the actual amount of profit. A final adjustment in accordance with MFRS shall be undertaken to the amounts already recognized, to reflect the actual profit of the *musharakah*.

S 23.31 Methodology used for determining profit distribution must be objective, transparent, and acceptable to all contracting parties. For better management of fund of a project where one or more of the partner(s) is involved in multiple projects, direct expenses under *musharakah* projects need to be identified and tagged to avoid commingling of *musharakah* capital with other non *musharakah* projects.

S 23.32 The contracting parties shall determine the time period or date for profit distribution of the *musharakah*.

Loss

S 23.33 Loss shall be recognized and measured based on the applicable MFRS.

S 23.34 IFI shall ensure expectations and requirements on managing partner is sufficiently provided in the terms and conditions. This is to ensure proper conduct of managing partner as well as to protect the interest of the IFI in event of loss.

S 23.35 IFI shall ensure that the managing partner provides justification and detailed report on any occurrence of loss, underperformance against projected returns or derailment from expected performance in a timely manner to other partners.
S 23.36 If loss is proven to be a result from misconduct, breach of specified terms or negligence of a managing partner, the managing partner shall be liable to the full sum of loss.

S 23.37 If loss is not attributed to misconduct, breach of terms and conditions or negligence, all partners shall borne the loss in proportionate to their capital contribution ratio and shall be limited to the amount of capital disbursed.

S 23.38 IFI shall not apply any mechanism that would effectively cause partner to guarantee principal amount upfront e.g. upfront waiver on loss absorption, wa’d at price equivalent to capital provided.

S 23.39 IFI shall structure the musharakah venture via a separate entity such as Special Purpose Vehicle (SPV) if:

(a) managing partner has other high-risk business activities which may affect the musharakah venture. Examples of venture that is considered high-risk are:

(i) untested new exploration or development e.g. pharmaceutical;

(ii) industry with high rate of obsolescence e.g. technology sector; or

(b) better management of musharakah venture is needed such as rights to appoint observer and use of dedicated operational accounts.
23.40 If *musharakah* is structured in the form of a separate entity, it shall be:

a) a limited liability entity (Eg. Limited Liability Partnership Act or Company’s Act); and

b) for single-purpose only.

**Question 6:** How should single purpose under paragraph 23.40(b) be defined?

**Tenure**

23.41 IFI shall determine a fixed tenure for the *musharakah*, which among others takes into consideration the appropriate tenure to maximise returns. Any decision to extend the tenure of the *musharakah* shall be done only after conducting appropriate reassessment and renegotiation. The reassessment shall be supported by justifiable reasons such as delay in construction or significant change in market conditions. Reassessment may include but not limited to cost benefit analysis.

23.42 For perpetual ventures, assessment shall be determined on a case-by-case basis.

**Guarantee/ Collateral**

23.43 Any collateral taken from the managing partner shall only be liquidated in the event of misconduct or negligence or breach of specified terms of contract by the managing partner.

23.44 To cover for any other losses, an independent third party guarantee may be arranged. This guarantee will need to be executed in a separate contract.
S 23.45 For purposes of paragraph 23.44, the independent third party guarantee must not be provided by the following parties:

(a) for corporate guarantors:

(i) entities with control on the managing partner or controlled by the managing partner as defined by MFRS 127 Separate Financial Statements e.g. parent, subsidiary.

(b) for Individual guarantors:

(i) employee of managing partner or close relatives; or

(ii) controlling shareholders of managing partner or their close relatives.

S 23.46 For purposes of requirements under paragraph 23.43, the IFI shall conduct assessment on:

(a) the need for collateral/guarantee and its intended purpose;

(b) the value of assets acceptable as collateral;

(c) ability and eligibility of collateral providers/guarantors, which includes:

(i) no legal impediments on collateral such as ensuring assets are unencumbered;

(ii) financial strength of guarantors; and

(iii) independence of parties to the managing partner eligible as guarantors as per paragraph 23.45.

S 23.47 IFI shall ensure legal enforceability of any collateral or guarantee documentations.

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18 To cover losses due to misconduct, breach of contract or negligence or to cover losses due to any other reasons.
Dissolution/ Termination/ Withdrawal (Exit)

S  23.48 IFI shall clearly stipulate the terms and conditions of exit, which include:

(a) tenure of investment or venture;

(b) time or intervals allowed for redemption;

(c) qualifying criteria for exit before maturity;

(d) methodology for valuation of underlying asset and calculation of profit and loss upon exit;

(e) potential amount payable or to be received, including compensation or damages incurred; and

(f) operational procedures for exit including submission of relevant documents, notice period, number of days taken to process the transaction and settlement period.

S  23.49 As part of the measures to mitigate risks, IFI shall have in place exit strategies, which may include ability to immediately cut loss. In addition, IFI shall take into consideration the overall impact to IFI which may include potential compensation or damages payable to partners.

Legal documentation

S  23.50 IFI must develop comprehensive and legally enforceable documentations for musharakah transaction which are in compliance with Shariah and regulatory requirements.

S  23.51 At minimum, the legal documentations must clearly stipulate the following:

(a) purpose of musharakah venture;

(b) contractual relationship between parties;
(c) rights, roles and responsibilities of parties to the *musharakah* venture

(d) capital contributed by partners;

(e) profit sharing ratio;

(f) loss shall be borne proportionate to the capital contribution;

(g) calculation methodologies and timing for profit distribution;

(h) tenure of venture;

(i) pricing or valuation method of underlying asset or shares;

(j) reporting obligation of the *musharakah* performance which include the timing and the information to be reported;

(k) collateral and guarantees including rights over assets, if any,

(l) terms on dissolution, termination, redemption or withdrawal of *musharakah* venture; and

(m) where applicable, fees and charges to be borne by the relevant contracting parties.

S 23.52 The use of Arabic terminology in the documents must be sufficiently clarified or translated to facilitate understanding of the contracting parties.

S 23.53 In the event of *musharakah* arrangement with other Shariah contracts, IFI shall ensure that documentations involved are separated and executed in proper sequence as per Shariah requirements.

G 23.54 IFI may wish to impose negative covenants such as imposing conditions for any dilution of rights or shareholding e.g. rights issuance and any transactions that may be detrimental to IFI’s interest.
24. Risk management

Principle 4: IFI must institute and implement sound and integrated risk management system to effectively manage risks throughout the life cycle of *musharakah*

24.1 The distinct risk profile of *musharakah* venture which is a form of equity participation may expose the IFI to various types of risks, such as equity risk, market risk, liquidity risk, credit risk and operational risk. These risks, which intermingle and change from one kind to another at different stages of transaction, require a proper, comprehensive and sound risk management infrastructure, risk reporting and risk control framework.

24.2 There are three main stages prevalent in *musharakah* venture consisting of pre-contractual, during and exit.

Pre-contractual stage

24.3 At the pre-contractual stage, the risk management objective is to enable optimal decision on *musharakah* venture before venturing into the *musharakah*, based on risk and rewards attained from risk identification and assessment process. Efficient risk management is essential for reducing the overall risk exposure through adequate resources devoted to perform risk identification and measurement as well as the development of risk management techniques.

Policies and procedures

24.4 IFI shall establish comprehensive risk management policies and procedures, systems and internal control which can address risks in line with IFI’s risk appetite throughout the life cycle of *musharakah* and shall cover, at minimum, the following;

(a) identification and monitoring of risks;
(b) appropriate valuation and calculation methodology for underlying assets and distribution of profit;

(c) risk exposure limits;

(d) risk mitigation techniques; and

(e) monitoring and reporting mechanism.

S 24.5 IFI shall clearly specify and communicate the policies and procedures to all relevant functions within IFI.

S 24.6 IFI shall establish a systematic process to review and update the policies, procedures and internal limits which shall be in line with the risk appetite of the IFI and take into consideration any changes in the industry.

Feasibility assessment

24.7 The assessment process is the main, and in some cases, the only effective measure for the IFI to ensure success in a musharakah venture.

S 24.8 IFI shall ensure that the objectives and criteria of potential musharakah venture are in line with IFI’s investment strategy.
24.9 IFI must ensure that a holistic and robust feasibility and due-diligence framework is in place to facilitate effective decision making in assessing the viability of the _musharakah_ venture. The IFI shall:

(a) ensure that the assessment methodologies employed are suitable for the type of products, services and business segments under the _Musharakah_ venture. For example, use of an assessment framework under a similar business segment for sale-based financing\(^\text{19}\) may not be exactly suitable for a _musharakah_ venture due to differences in the nature of funding;

(b) assessment shall be based on historical data and empirical evidence as far as possible. Given potential data limitations, IFI may identify other means to support the assessment such as using relevant data as proxies. If judgment is involved, the IFI shall have in place the policies and procedures for application of judgment in the assessment process;

(c) ensure that salient risks and important features affecting the prospects of the _musharakah_ financing have been taken into consideration. Salient risks such as investment, market, operational which includes legal and Shariah non-compliance, liquidity, as well as credit risk shall be assessed appropriately. All relevant factors affecting these risks shall be identified and assessed, including:

(i) credibility, capability, track record\(^\text{20}\) and experience of the managing partner including any other key parties involved in the _musharakah_ venture such as agents, contractors or suppliers;

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\(^{19}\) Such as _Murabahah_ financing.

\(^{20}\) Such as performance and financial track record.
(ii) transaction or venture characteristics such as marketability of products or services which among other are influenced by type and design of products/services, consumer demand, location, promotional strategies and competition;

(iii) expected selling price, costs involved, expected cash-flow and potential changes affecting them; and

(iv) enforceability of legal requirements, Shariah-compliance of business activities as well as economic and regulatory changes;

(d) have robust methodologies to assess projection of returns, costs involved and cash-flow, taking into consideration stressed conditions such as potential changes in the costs of materials, delay in sales, and increase in labour costs or delays in delivery. For this purpose, the IFI shall ensure sound assumptions based on objective evidence are used in arriving at the projections. In addition, IFIs should be more conservative in their projection of returns when the actual cash-in flow is based on bullet projection of repayments due to uncertainty in business and market conditions;

(e) ensure information used for assessment purposes are current, relevant and obtained from reliable sources; and

(f) ensure the assessment process is conducted by parties with appropriate knowledge and expertise in the relevant business activity. These parties, which may be internal or external, shall have no conflict of interest with the potential managing partner. If external parties are involved, IFI shall also have a place the policies and procedures on the selection of suitable external parties.
**Question 7:** In relation to paragraph 24.9(d) above, please provide your comments on the following:

a) What is the current assessment framework or methodology used in your institution for *musharakah*? How is this assessment conducted?

b) What is the current assessment framework or methodology used in your institution for specialised financing which uses sale-based contracts such as *istihsan* or *murabahah*? How is this assessment conducted?

c) What should be the main areas of differentiation made to the assessment framework or methodology for specialised financing using *musharakah* in comparison to specialised financing using sale-based contract?

**G 24.10** In addition to the assessment usually applied for sale-based financing, IFI may wish to apply an appropriate ‘courtship’ arrangement with potential partner before embarking in a *musharakah* venture. This will involve arrangement to more thoroughly know your partner for certain duration of time involving close monitoring, information collection and familiarisation process before entering into the *musharakah* venture.

**S 24.11** IFI shall ensure rights to full access to the books and records of the managing partner and any information relevant or affecting the *musharakah* venture is clearly stipulated in the terms and conditions.

**S 24.12** IFI shall establish Dedicated Operational Account(s) of the *musharakah* venture where all financial transactions of the venture shall be exclusively maintained in the IFI which will enable IFI to closely monitor transactions made by the *musharakah* venture.
S 24.13 Any credit facilities other than the capital under *musharakah* extended by the IFI to the partner shall be made on arm’s length basis. The terms and conditions for these facilities should not be more favourable than those granted to other obligors with similar backgrounds and creditworthiness.

S 24.14 IFIs must identify the exit strategies for the *musharakah* venture. The strategies may include the available options of exiting to ensure that IFI obtain the most profitable value realization.

S 24.15 The mechanism on exit strategies must be specifically and appropriately documented in *musharakah* contract to ensure smooth exit process without any legal impediments e.g. voting power by other partners must not restrict execution of exit.

S 24.16 IFI shall have in place investment rating framework which includes specific rating definitions, processes and criteria for assigning exposures to *musharakah* ventures to grades within a rating system:

(a) there must be sufficient details and clarity in the grade descriptions and criteria. This is to ensure those responsible for assigning ratings to consistently assign the same grade to obligors or facilities with similar risk;

(b) the criteria must also be consistent with the IFI’s internal financing standards and policies for handling troubled obligors and facilities; and

(c) rating criteria and procedures must be periodically reviewed to ensure relevance and resulting ratings are reflective of the current portfolio and reflect external conditions.

S 24.17 IFI shall classify the *musharakah* venture as Non-Performing Investment (NPI) when there is capital loss based on projected cash flow.
Question 8: Due to the inherent nature of *musharakah* venture which does not have a contractual repayment schedule, classification as NPF based on repayment conduct as practiced for sale-based contracts under *Classification and Impairment Provisions for Loans/Financing (GP3)* may be difficult.

a) Please provide the methodology for classification as NPI for *musharakah* venture in your institution;

b) The proposal in paragraph 24.17 requires classification as NPI based on projected cash flow which is done at least quarterly. Please provide your opinion on the proposed classification as NPI.

G 24.18 IFI may wish to adopt more prudent methods of classifying *musharakah* venture as NPI based on level of deterioration in projection of returns e.g. NPI classification upon a specified series of reduction or significant percentage of reduction in returns projection.

During/ On-going Stage

*Active monitoring and continued assessment*

S 24.19 The risk management objectives at this stage are to ensure continuous monitoring and enable IFI to guide management towards achieving long term strategy and value creation.

S 24.20 IFI shall ensure continuous monitoring on *musharakah* venture at all times by having an adequate and robust risk reporting, risk monitoring and risk control framework to reduce the overall risk exposure and safeguard bank’s portfolio. Any anomalies must be reported and escalated swiftly to the management for further action.
IFI shall have in place early-warning mechanism with pre-identified trigger events to facilitate prompt decision making upon any alarming performance of the musharakah.

IFI shall conduct the following with regard to partner’s performance reporting:

(a) identifying areas for monitoring and information required from partner or other parties;

(b) ensure that partner provides information including periodical reports regarding the performance of the venture to the IFI in a timely manner;

(c) regular on and off-site monitoring to assess performance; and

(d) validation of the reports received from the managing partner to mitigate the risk of potential manipulation on the performance results leading to understatements of musharakah earnings. This may include validation of the reported earnings or losses, calculation of profits as well as valuation of underlying assets.

The periodical report expected from partner shall include the following areas:

(a) venture’s business performance:
   i) periodical management and financial accounts of the venture;
   ii) Key Performance Indicators;

(b) risk management practices;

(c) minutes of Board of Director’s meeting; and

(d) significant activities or changes that have material effect on the performance of business which includes:
   i) change in management (resignation or election of new board of directors);
ii) change in key contractual parties such as change of agent, contractor, supplier or other outsourcing party; and

iii) regulatory changes on business requirements (e.g. safety and health regulation and product ban).

S 24.24 IFIs would also need to have in place rigorous stress testing framework that enables periodical assessment on the invested entities and its implication to the financial condition of IFI.

S 24.25 IFI shall conduct periodic assessment on projected returns of the mudarabah venture at least quarterly or sooner upon the occurrence of material changes affecting the musharakah. The periodic assessment shall be subject to stressed conditions and any assumptions made must be based on objective evidence.

S 24.26 IFI must have in place a sound impairment provisioning methodology that is able to detect and provide best estimates of losses and determine prudent level of provisions for the exposures to musharakah venture.

G 24.27 IFI may wish to place safeguard measures to ensure that any involvement of outsourced parties will not impose additional risk to the musharakah venture. In this regard, the IFI shall:

a) stipulate criteria or conditions to the partner in the agreement to ensure proper selection, effective management and proper conduct of the outsourcing parties; and

b) ensure that partner disclosure information about the appointed party (e.g. performance history, financial strength and company reputation).

G 24.28 IFI may impose conditions in the legal documentation to take action on partner’s failure to prepare timely periodical report (e.g. withhold/ delaying cash disbursement) if clear justification is not given within a stipulated period.
IFI must monitor the flow of transaction conducted under dedicated operational accounts at all times. Any anomalies must be reported to the senior management for further action.

IFIs shall ensure robust asset-liability management to mitigate risk in terms of mismatch in returns and cash flows between musharakah vis-à-vis IFI’s source of funding.

Subject to mutual consent, the contracting parties may appoint an independent party to carry out audit and valuations on musharakah venture to ensure transparency and objectivity in the valuation and distribution of profits.

Under-performing musharakah venture

If a musharakah venture is or expected to be under-performing, the IFI is required to conduct a detailed assessment on whether the musharakah venture would continue to be viable.

The viability assessment must consist, at minimum, consideration of following:

(a) possibilities for improvement on issues and factors that lead to the underperformance;

(b) feasibility of improvement plans proposed by managing partner, such as change in management, operational processes and period for turnaround;

(c) appropriateness of the revised projection of returns and assumptions used to support such projection;

(d) additional funding required; and

(e) whether the musharakah venture’s level of risk and reward are still within IFI’s risk appetite.
IFI may appoint third party expert to conduct assessment on feasibility of the venture.

After conducting the viability assessment and to avoid the ever-greening of *musharakah* venture, any decision not to exit must be:

(a) based on plausible grounds, such as to minimise losses or high-potential to recover profit and capital;

(b) time-barred, whereby the IFI shall identify a fixed period for the managing partner to turnaround the *musharakah* venture; and

(c) followed by identification of clear strategies, measures and action plan by the IFI, which may include renegotiating on the terms of the *musharakah* venture.

IFI shall strengthen its risk monitoring, assessment and control functions if the underperforming *musharakah* venture is continued. An example of a turnaround process flow for a *musharakah* venture is stipulated in Appendix 7.

**Exit Stage**

IFI shall have clear processes and procedures on exit mechanism which shall be clearly stipulated and communicated to the relevant functions in order to ensure effective and efficient execution of exit.

IFI must make an assessment on the impact of each exit options and determine best value realisation.

IFI shall obtain legal opinion that the exit mechanism can be executed without any legal impediments.

IFI must assess any potential damages payable to partner in the event IFI exit the venture.
In case of recoveries and/or losses due to misconduct, breach of terms or negligence by managing partner, IFI must identify measures for claims based on the risk mitigation method adopted.

25. Disclosure and Reporting Requirements

Principle 5: IFI must undertake *musharakah* in a fair and transparent manner in line with Shariah and protect stakeholder's interest.

IFI shall maintain accounting records and other records in a timely manner that will sufficiently enable the preparation and reporting of true and fair financial statements.

IFI shall also observe the requirements stipulated in the *Guidelines on Financial Reporting for Islamic Banking Institutions, Guidelines on Financial Reporting for Development Financial Institutions, Capital Adequacy Framework for Islamic Banks – Disclosure Requirements (Pillar 3)* issued by the Bank and all applicable MFRS.

Governance disclosure

IFI shall maintain and disclose the structure of governance and oversight function in place for *musharakah* venture. At minimum, the disclosure shall include:

(a) roles of Board for *musharakah* venture;

(b) BRMC or equivalent committee roles for *musharakah* venture;

(c) roles of the senior management or investment committee; and

(d) oversight mechanism at investment level e.g. board representative resides in respective *musharakah* venture and their roles.
S  Financial disclosure

25.4 Disclosure for *Musharakah* venture shall include the following:

(a) value of venture:

   (i) initial capital contribution

   (ii) outstanding or recoverable value\(^{21}\) by sector including any impairment provisions made during the period

(b) composition of aggregate sources of funds

Illustration of the disclosure requirements is given in *Appendix 8*.

**Question 9:**

a) Recognition and measurement shall be in accordance with the applicable MFRS.

   i) What is the recognition and measurement methodology and the applicable MFRS for *musharakah* venture at your institution currently?

   ii) How would the potential treatment under the impending IFRS 9 impact the recognition and measurement for *musharakah* venture at your institution?

b) Please provide us with the data as per template in Appendix 9.

26.  Consumer and Market Conduct

**Principle 5:** IFI must undertake *musharakah* in a fair and transparent manner in line with Shariah and protect stakeholder’s interest.

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\(^{21}\) Exposure value as per MFRS.
S 26.1 The IFI is required to establish policies and procedures on proper consumer and market conduct to ensure *musharakah* venture is conducted in a fair, transparent and responsible manner, in line with Shariah requirements.

**Fair dealings**

S 26.2 The internal policies and procedures on consumer and market conduct for *musharakah* should ensure fair dealing practices which include the following:

(a) suitability and affordability assessment of contracting parties;

(b) information to be disclosed provided in a timely manner to partners and shall be accurate, clear and not misleading;

(c) fees and charges (if any); and

(d) reasonable care to ensure suitability of advice and recommendation to customers.

S 26.3 IFI shall not disclose any material information e.g. trade secret, of the *musharakah* to third party without authorisation from the contracting parties.

S 26.4 IFI shall ensure all contracting parties including the IFI disclose and properly manage all conflict of interests including those that may potentially occur.

S 26.5 IFI must ensure fairness in the contract terms at all times including any amendments to the terms during renegotiation or extension of tenure.

**Information Disclosure**

S 26.6 At the pre-contractual stage, IFI shall provide adequate and relevant information in the marketing or promotional materials such as product
disclosure sheet or any other equivalent materials to potential contracting parties with regard to *musharakah*. At minimum, information to be disclosed shall include:

(a) comprehensive description of the *musharakah* transaction;
   (i) contractual relationship as partners between contracting parties; and
   (ii) concept of profit sharing and loss sharing

(b) overview of the transaction structure;

(c) roles, responsibilities, rights and obligations of contracting parties;

(d) key terms and conditions of the contract; and

(e) requirements for security deposit, guarantee and/or collateral (includes the rights and obligation of contracting parties on the collateral pledged).

S 26.7 IFI shall ensure sufficient effort have been given in facilitating the contracting parties’ understanding of the concept of *musharakah* contract.

S 26.8 At the point of entering the contract, the IFI shall disclose salient features of the *musharakah* in legal documentations to facilitate the contracting parties’ in understanding the terms and conditions of the *musharakah* contract.

S 26.9 The IFI shall also periodically disclose the relevant information to the partner during the tenure of *musharakah* e.g. changes in fees and charges (if applicable).

S 26.10 If the IFI is the managing partner, the IFI shall disclose the performance of the *musharakah* to other partners and shall bear the liability as a managing partner as per condition stipulated in the agreement.
PART D OPERATIONAL REQUIREMENTS FOR MUSHARAKAH FINANCING

27. Background

27.1 *Musharakah* financing is a financing using *musharakah* contract structured to match the risk profile of debt-based financing in line with the Shariah concept used which is Shirkah al-milk. Therefore, the operational requirements which covers governance and oversight, product structuring, risk management, disclosure and reporting and consumer and market conduct are in line with the requirements and expectations for debt-based financing. However, specifications in this Part D are the additional requirements on *musharakah* financing to address the peculiarities arising from the usage of additional contracts or concepts to inherently transform the risk sharing element to credit risk.

28. Structuring

G 28.1 *Musharakah* financing is structured based on combination of contracts which is mainly based on *musharakah* and arranged with other contracts or concepts such as *ijarah* (leasing), *ijarah mausulah fi-zimmah* (advanced leasing), *bai’ musawamah* (selling), or *wa’ad* (binding promise). A prevalent example of *musharakah* financing is *Musharakah Mutanaqisah* (MM).

S 28.2 For purposes of *musharakah* financing, there shall be no restrictions on the sources of fund.

S 28.3 Pricing of *musharakah* financing shall be fixed during inception.

S 28.4 For cost and expenses, partners shall either:

(a) pre-agree on the costs; or

(b) share proportionately; or

(c) follow requirements based on relevant contracts e.g. *ijarah*. 
S 28.5 Legal documentation shall clearly stipulate all costs and expenses agreed and borne by each party.

S 28.6 On wa’d application, IFI shall:

(a) ensure execution of wa’d does not violate the principle of profit and loss sharing in the musharakah financing contract;

(b) assess the recoverability of assets in determining application of wa’d;

(c) determine the purpose of wa’d upfront; and

(d) specify the trigger event and requirements when customer breaches the wa’d.

S 28.7 For asset under construction using MM, incompletion of asset shall not be a trigger event to invoke wa’d.

S 28.8 IFI is not allowed to claim any penalty charges from customers who make early settlement\(^{22}\) during a specified time period\(^{23}\). In addition, IFI is also not allowed to charge any other charges to the customers unless the charges represent the cost incurred by IFI due to early settlement by the customer.

S 28.9 For the purpose of 28.8, the amount to be paid must be the outstanding amount (principal plus accrued profit) and any other reasonable estimation of costs to be incurred as per Responsible Financing and Imposition on Fees & Charges guideline.

S 28.10 The Shariah Committee of the IFI is expected to perform an effective oversight over the implementation and in determining the reasonable estimate of the cost incurred.

\(^{22}\) Also known as ‘accelerated shares acquisition’

\(^{23}\) In practice known as ‘lock-in-period’.
In the event of default, IFI need to ensure the following:

(a) partner shall have the first right of refusal to purchase the asset;

(b) sale of asset to third party upon default must be in accordance to approaches allowed under Shariah;

(c) IFI not allowed to redeem shortfall from customer until loss is realized; and

(d) for MM using ijarah, IFI can only claim rental accrued if customer is still enjoying the usufruct.

On redemption method for MM, IFI shall specify specific formula in the legal documentation in calculating and determining the redemption price.

In determining the formula for redemption, IFI may use any relevant pricing benchmark to determine the redemption price.

Legal documentation must:

(a) be legally enforceable;

(b) have clarity in terms and conditions;

(c) be comprehensive by incorporating all relevant contracts and the salient features under each contract e.g. diminishing partnership agreement, ijarah or istisna’ agreement, wa’d, security documents; and

(d) outline the rights and obligations of partners.

Legal documentation shall provide clear rights, obligations and expectations of parties:

(a) nature of relationship/ Shariah principles used;

(b) lease of bank’s shares in asset, if applicable;
(c) gradual acquisition/diminishing of shares in the asset, if applicable;

(d) events of default and rights of banks on default; and

(e) responsibility with respect to asset

S 28.16 Must ensure documentations are properly separated & orderly executed, i.e. document on promise (wa’d) to purchase must be separated from diminishing partnership agreement

29. **Risk Management**

S 29.1 IFI shall have in place policies and procedures to assess *musharakah* financing application. IFI are allowed to utilise on existing policies in assessing *musharakah* financing application after assessing on the relevancy of existing policies to *musharakah* financing inherent risk.

S 29.2 For MM financing, IFI shall ensure changes in ownership ratio is recorded properly.

S 29.3 IFI shall ensure transfer of ownership in MM financing is reflected in the legal documents.

S 29.4 For asset under construction:

(a) IFI shall undertake due diligence to assess capacity of manufacturer or developer to fulfil contractual obligation; and

(b) IFI shall identify trigger events for construction risk (e.g. developer behind work schedule) and establish replacement procedure

S 29.5 During construction period, IFI shall keep track on the progress to completion of the asset & ensure timely delivery by the manufacturer or developer.
APPENDICES

Appendix 1  Definition and Interpretation

For the purpose of this policy, the following definitions shall have the following meanings.

<table>
<thead>
<tr>
<th>Terms</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Actual liquidation</td>
<td>The act of realizing the worth or value of the assets/venture through liquidation process based on market value;</td>
</tr>
<tr>
<td><em>Al-tandid al-haqiqi</em></td>
<td>Actual valuation i.e. valuation based on actual value of assets;</td>
</tr>
<tr>
<td><em>Al-tandid al-hukmi</em></td>
<td>refers to constructive valuation i.e. valuation based on fair value of assets;</td>
</tr>
<tr>
<td>Fair value</td>
<td>A valuation, in accordance with standard methodology, that is reasonable to all parties involved in a transaction in light of all pre-existing conditions and circumstances;</td>
</tr>
<tr>
<td><em>Ijarah</em></td>
<td>Lease contract that transfers ownership of a permitted usufruct or service for a specified period in exchange for a specified consideration;</td>
</tr>
<tr>
<td><em>Ijarah Mawsufah fi al-Zimmah</em></td>
<td>A lease contract that transfers ownership of a permitted usufruct at a future agreed date, as the asset is not yet available or owned by the lessor at the time of contract. In this contract, the lessor undertakes to deliver the usufruct of the asset based on agreed specifications;</td>
</tr>
<tr>
<td><em>Istisna</em></td>
<td>An agreement to sell to a purchaser a non-existent asset that is to be constructed, built or manufactured according to the agreed specifications and delivered on a specified future date at a predetermined price of the <em>istisna</em>’ asset;</td>
</tr>
<tr>
<td>Market value</td>
<td>Value of an asset if it were to be sold on the open market at its current market price;</td>
</tr>
<tr>
<td><em>Mudarabah</em></td>
<td>A contract between a <em>rabbul mal</em> (capital provider) and a <em>mudarib</em> (entrepreneur) under which the <em>rabbul mal</em> provides</td>
</tr>
<tr>
<td><strong>capital</strong></td>
<td>to be managed by the <strong>mudarib</strong> and any profit generated from the capital is shared between the <strong>rabbiul mal</strong> and <strong>mudarib</strong> whilst financial losses are borne by the <strong>rabbiul mal</strong> provided that such losses are not due to the <strong>mudarib</strong>’s misconduct, negligence or breach of specified terms;</td>
</tr>
<tr>
<td><strong>Musawamah</strong></td>
<td>A sale contract without the disclosure of the asset cost price and profit margin to the buyer;</td>
</tr>
<tr>
<td><strong>Musharakah (also known as Musyarakah)</strong></td>
<td>A partnership between two or more parties which may take effect through contractual relationship (‘aqd) or by operation of Islamic law, whereby all contracting parties will share the profit and bear loss from the partnership;</td>
</tr>
<tr>
<td><strong>Musharakah venture</strong></td>
<td>A business venture structured using <strong>Musharakah</strong> contract which reflects the concept of profit and loss sharing. It is a type of <strong>Musharakah</strong> contract where the <strong>Musharakah</strong> may be entered into by two or more parties on a particular asset or venture with entrepreneurial objective to generate profit. <strong>Musharakah</strong> investment includes both investment through ordinary shares and direct investment by providing funding to the partners.;</td>
</tr>
<tr>
<td><strong>Musharakah financing</strong></td>
<td>A financing using <strong>Musharakah</strong> contract structured to match the risk profile of debt-based financing. It is a type of <strong>Musharakah</strong> contract where the <strong>Musharakah</strong> may be entered into by two or more parties on a particular asset with the purpose for the partner(s) to own the assets. Example for <strong>Musharakah</strong> financing is <strong>Musharakah Mutanaqisah</strong> house financing which is widely used by IFIs;</td>
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</tr>
<tr>
<td><strong>Musharakah Mutanaqisah</strong></td>
<td>A type of <strong>Musharakah</strong> contract where the <strong>Musharakah</strong> may be entered into by two or more parties on a particular asset or venture which allows one of the partners to gradually acquire the shareholding of the other partner through an</td>
</tr>
<tr>
<td><strong>Tanazul</strong></td>
<td>Waiving of the entitlement to claim;</td>
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<tr>
<td><strong>the Bank</strong></td>
<td>Means Bank Negara Malaysia, a body corporate which continues to exist under the Central Bank of Malaysia Act 2009;</td>
</tr>
<tr>
<td><strong>Wa’d</strong></td>
<td>A promise or undertaking, refers to an expression of commitment given by one party to another to perform certain action(s) in the future; and</td>
</tr>
<tr>
<td><strong>Wakalah</strong></td>
<td>An agency contract in which a party (<em>muwakkil</em>) mandates another party as his agent (<em>wakil</em>) to perform a particular task in matters that may be delegated either voluntarily or with imposition of fee.</td>
</tr>
</tbody>
</table>
Appendix 2 Related legal and policy documents

This policy document must be read together with the following legal and policy documents:

(a) Shariah Advisory Council (SAC) rulings published by the Bank;

(b) Shariah Governance Framework for Islamic Financial Institutions;

(c) Guidelines on Corporate Governance for Licensed Islamic Bank;

(d) Guidelines on Corporate Governance for Development Financial Institutions;

(e) Risk Governance;

(f) Guidelines on Property Development and Property Investment Activities by Islamic Banks.

(g) Concept Paper on Investment Account Framework;

(h) Guidelines on Investment in Shares, Interest-in- Shares and Collective Investment Schemes for Islamic Banks;

(i) Guidelines on Product Transparency and Disclosure;

(j) Guidelines on Imposition of Fees and Charges on Financial Products and Services;

(k) Concept Paper on Fair Treatment of Financial Consumer;

(l) Guidelines on Financial Reporting for Islamic Banking Institutions;
(m) Guidelines on Financial Reporting for Development Financial Institutions;

(n) Guidelines on Investor Protection; and

(o) Guidelines on Responsible Financing.
Appendix 3  Legitimacy of *Musharakah*

1. The legitimacy of the *Musharakah* contract is based on the Qur’an, the Sunnah of the Prophet Muhammad (peace be upon him) and the consensus of Muslim jurists.

**The Quran**

2. The following verses from the Qur’an generally indicate the validity of *Musharakah*.

(a) 

فَإِنَّ كَانُوا أُوْلَـٰٰدًا مِّنْ ذَٰلِكَ فَهُمْ شُرَكَاءُ بِالْثَّلُثِّ مِنَ الْوَرَّاءَ وَصِيَّةَ يُوصَى بِهَا أَوْ دَيْنٍ غَيْرَ مُضَارٍّ

“If there be more (brothers and sisters of the same mother), they shall (equally) share the third of the estate, after payment of any bequest that may have been bequeathed or debt (incurred); the bequests made should not harm (the rights of the heirs).”

The verse specifically underlines the rule of Islamic inheritance. However, in general context, Muslim jurists have regarded the text as containing general permissibility of any form of partnership.

(b) 

وَإِنَّ كَثِيرًا مِّنَ الْخَلْقِ لَا يَعْبُدُونَ غَيْرَ مَنْ أَوْلُوهُمْ عَلَى بَعْضِهِمْ وَعَمِلُوا الصَّالِحَاتِ وَقَلِيلُ مَا هُمُّ

“Truly many partners (in all walks of life) are unjust to one another: but not so those who believe and do good works, and they are few.”

The verse reminds the partners to bind themselves to ethical value dealing with each other where its indirectly indicates the acknowledgement of the Qur’an in partnership.

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24 Surah an-Nisaa’, verse 12.
25 Surah as-Sod, verse 24.
The *Sunnah* of The Prophet Muhammad (peace be upon him)

3.  عن أبي هريرة رفعه قال إن الله يقول: " أنا ثالث الشريكين ما لم يخن أحدهما صاحبه. فإذا خانه خرجت من بينهما".

Narrated by Abu Hurayrah: The Apostle of Allah (peace be upon him) having said: Allah, Most High, says: "I make a third [partner] with two partners as long as one of them does not betray the other, but when one of them betrays the other, I depart from them."²⁶

4.  عن عثمان يعني ابن الأسود قال أخبرني سليمان بن أبي مسلم قال سألت أبا المنهال عن الصرف يدا بيد فقال اشترط أنا وشريك لي شيئا يدا بيد ونسبة فحاءنا الابراج بن عازب فسألناه فقالت أنا وشريكي زيد بن أرقم وسائرنا النبي صلى الله عليه وسلم عن ذلك فقال: "ما كان يدا بيد فخذوه وما كان نسبة فذروه".

Narrated by Usman who is meant Ibn Al-Aswad: reported to me Sulaiman bin Abi Muslim said that: “I asked Abu Minhal about money exchange from hand to hand.” He said, “I and a partner of mine bought something partly in cash and partly on credit. Al-Bara’ bin ‘Azib passed by us and we asked him about it.” He replied, “I and my partner Zaid bin Arqam did the same and asked the Prophet (peace be upon him) about it.” He said: “Take what was from hand to hand and leave what was on credit.”²⁷

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²⁶ Abu Daud, *Sunan Abi Daud*, hadith no. 2936.
²⁷ Al-Bukhary, *Sahih Al-Bukhary*, hadith no. 2317.
5. عن السائب بن أبي السائب، أنه كان شريك النبي صلى الله عليه وسلم في أول الإسلام.

في التجارة، فلما كان يوم الفتح قال: "مرحبا بأخي وشريكي لا يذاري ولا يبماري".

Narrated by As-Sa'ib bin Abi As-Sa'ib, who had been a business partner of Prophet Muhammad (peace be upon him) in the early days of Islam, related that on the Day of the Muslim conquest of Makkah, the Prophet (peace be upon him) said to him, “Welcome to my brother and partner, [who] does not wrangle or dispute.”

Consensus of The Muslim Jurists (ijma’)

6. This type of partnership has been practised throughout the history of Muslims without objection from the jurists.

7. Imam Ibn Al-Munzir states in his book al-ijma`: “And they (Muslim jurists) agree on the validity of partnership where each of the two partners contributes capital in dinar or dirham, and commingles 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.”

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28 Al-Hakim, al-Mustadrak, hadith no. 2317.
Appendix 4 Possible structure for Musharakah venture & financing

1. This appendix provides examples on the structures of musharakah contracts. The examples are non-exhaustive and should not be construed as the only structures available in Islamic finance.

*Musharakah Venture (via acquisition of ordinary shares)*

2. The structure of the musharakah venture (via acquisition of ordinary shares) are exemplified by the following diagram:

![Diagram 1: Example of Musharakah Venture](image)
Musharakah venture (By providing capital via cash)

3. The structure of the musharakah venture (by providing capital via cash) are exemplified by the following diagram:

![Diagram 2: Musharakah venture – provide funding for a specific purpose]

![Diagram 3: Musharakah venture – provide funding for general purpose]

Musharakah Financing

4. One of the prevalent musharakah financing in the market is Musharakah Mutanaqisah (diminishing Musharakah). In Musharakah Mutanaqisah financing, the customer and IFI jointly acquire and own the asset. The partner, as an owner/lessor, promises to acquire periodically the IFI’s ownership in the property. The IFI shall determine the redemption method in determining the price for the other partner/owner to acquire the share owned by IFI. The partnership ends when transfer of the asset ownership has completed.
5. In *Musharakah Mutanaqisah* (diminishing *Musharakah*) home or property financing, the customer and IFI jointly acquire and own the property. The IFI then leases its share of property to the customer on the basis of *ijarah* (lease). The customer, as an owner-tenant, promises to acquire periodically the IFI’s ownership in the property. The customer pays rental to the IFI under *ijarah*, which partially contributes towards increasing their share in the property. In other words, the portion of the payment proceeds or monthly instalments received from the customer shall be used towards the gradual acquisition of the IFI’s share in the jointly owned property. At the end of the *ijarah* (lease) term and upon payment of all lease rentals, the customer would have acquired all the financier’s shares and the partnership will come to an end with the customer being the sole owner of the house.

6. The following diagram illustrates an example of home or property financing under *Musharakah Mutanaqisah* contract:

![Diagram 4: Example of Musharakah Mutanaqisah Financing](image-url)
Appendix 5  Governance Structure

**Board Risk Management Committee (BRMC)**

**Board Investment & Risk Committee (BIRC)**

- Review and ensure effectiveness of policies & risk management framework
- Provide recommendation to the Board for new or change in investment strategy
- Set authorisation limit for investments
- Oversight role to Investment Committee

**Credit Committee (CC)**

**Investment Committee (IC)**

- Oversight on progress of investment activities
- Approval of investment application
- Provide recommendation related to investment proposal & strategy to BIRC
- Oversight function & approval of investment within limit /strategy set
Appendix 6  An Example of Complex Structure in Musharakah

IFI

Capital

→

SPV 1

→

SPV 2

→

SPV 3

→

SPV 4

→

Project/Construction

Shall appoint representative (board and management/project) at the entity/entities that:

• Conducts the actual business activity; and/or
• Able to control the actual business activity
Appendix 7  Distress Assessment Process Flow

Monitoring of *Musharakah* venture

- Performance matches expectation
  - Normal monitoring requirements

- Performance below expectation
  - Perform distress assessment
    - Exit
    - Retain *Musharakah* venture
      - Turnaround strategy & more vigorous monitoring requirements

=cut loss limit) Exit
Appendix 8  Illustration of Additional Financial Disclosure for Musharakah Venture

Notes to Account

Amount funded by:

Unrestricted Investment Accounts (URIA)   x
Restricted Investment Accounts (RIA)      x
Shareholders’ fund                       x

XXX

Musharakah

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<th>Sector</th>
<th>Initial capital (RM’000)</th>
<th>Impairment Provisions (RM’000)</th>
<th>Amount as at 31 Dec 20XX (RM’000)</th>
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<tr>
<td>Manufacturing</td>
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<tr>
<td><strong>Total</strong></td>
<td><strong>xxx</strong></td>
<td><strong>xxx</strong></td>
<td><strong>xxx</strong></td>
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</table>
Appendix 9  Exposures on Musharakah Venture

**Question:** Do you have any exposure?  Yes (proceed to template below)/ No

**Template:**

For *Musharakah* venture – shares acquisition

<table>
<thead>
<tr>
<th>Sector</th>
<th>Initial capital</th>
<th>Impairment provisions</th>
<th>Amount as at 30 Nov 2013</th>
<th>Classification</th>
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<tbody>
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For *Musharakah* venture – provide capital via cash

<table>
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<th>Initial capital</th>
<th>Impairment provisions</th>
<th>Amount as at 30 Nov 2013</th>
<th>Classification</th>
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30 Should be based on IFI’s internal definitions and classifications.
For Musharakah Mutanaqisah

<table>
<thead>
<tr>
<th>Purpose e.g. car, house, machinery</th>
<th>Outstanding amount as at 30 Nov 2013</th>
<th>Impairment provisions</th>
<th>Classification$^{31}$</th>
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$^{31}$ As per GP3.