



**BANK NEGARA MALAYSIA**  
CENTRAL BANK OF MALAYSIA

# ***Musyarakah***

Issued on: 20 April 2015

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## **PART A OVERVIEW**

### **1. Introduction**

- 1.1 Compliance with Shariah requirement is a prerequisite in ensuring the legitimacy and integrity of Islamic financial products and services. In meeting this expectation, it is essential for an Islamic financial institution (IFI) to establish the necessary operational framework and infrastructure to ensure that the conduct of Islamic financial transactions is consistent with Shariah.
- 1.2 The Shariah contract-based regulatory policy is intended to promote transparency and consistency of Shariah contract application which would enhance the contracts' certainty and strengthen Shariah compliance by IFIs.
- 1.3 The Shariah contract-based regulatory policy consists of two components, namely the Shariah and the operational requirements. The Shariah requirements highlight the salient features and essential conditions of a specific contract. The latter outlines the core principles underpinning good governance and oversight, proper product structuring, effective risk management, sound financial disclosure and fair business and market conduct. The operational requirements aim to complement and promote sound application of the Shariah principle.
- 1.4 *Musyarakah* is a partnership between two or more parties, whereby all contracting parties contribute capital to the *musyarakah* venture and share the profit and loss from the partnership.

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## **2. Policy objectives**

2.1 This policy document aims to:

- (a) provide reference on the Shariah rulings associated with *musyarakah*;
- (b) set out key operational requirements with regard to the implementation of *musyarakah*; and
- (c) promote end-to-end compliance with Shariah requirements which include adherence to sound banking practices and safeguarding customers' interest.

## **3. Scope of policy document**

3.1 Part B provides mandatory Shariah requirements to ensure the validity of *musyarakah* and its optional practices.

3.2 Parts C and D provide operational requirements on governance and oversight, structuring, risk management, financial reporting and business and market conduct. Part C provides the operational requirements for *musyarakah* venture, while Part D is on *musyarakah* financing.

## **4. Applicability**

4.1 This policy document is applicable to:

- (a) all IFIs as defined in paragraph 7.2. Notwithstanding this, licensed takaful operator under the Islamic Financial Services Act 2013 (IFSA) shall only apply part B of this policy document;
- (b) all financial products and services structured on *musyarakah*, except for:
  - (i) sukuk, collective investment schemes and equities; and
  - (ii) interbank investments, which are excluded from Part C and D.

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## 5. Legal provisions

5.1 The requirements in this policy document are:

- (a) specified pursuant to sections 29(1) and (2), 57(1), 135(1) and 277 of the Islamic Financial Services Act 2013 (IFSA) ; and
- (b) specified pursuant to sections 41(1) and 126 and issued as a direction pursuant to section 129(3) of the Development Financial Institutions Act 2002 (DFIA).

## 6. Effective date

6.1 This policy document comes into effect on 1 June 2016.

## 7. Interpretation

7.1 The terms and expressions used in this policy document shall have the same meanings as assigned under the Financial Services Act 2013 (FSA), IFSA and DFIA, as the case may be, unless otherwise defined in this policy document.

7.2 For the purpose 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;

**“G”** denotes guidance which consist information, advice or recommendation intended to promote common understanding and adoption of sound industry practices which are encouraged to be adopted;

**“Islamic financial institution” or “IFI”** means:

- (a) a licensed Islamic bank under the IFSA;
- (b) a licensed takaful operator under the IFSA;
- (c) a licensed bank and licensed investment bank under the FSA approved under section 15(1)(a) of the FSA to carry on Islamic banking business; and

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- (d) a prescribed institution under the DFIA approved under section 129(1) of the DFIA to carry on Islamic banking business or Islamic financial business.

7.3 A glossary of terms used in this policy document is set out in Appendix 2.

## **8. Related Shariah rulings and policy documents**

8.1 This policy document must be read together with but not limited to such Shariah rulings and policy documents as specified in Appendix 3.

## **9. Policy document superseded**

9.1 This policy document supersedes the requirements for *musyarakah* in the Guidelines on *Musharakah* and *Mudarabah* contracts for Islamic Banking Institutions issued on 15 September 2007 as at the effective date of this policy document.

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## PART B SHARIAH REQUIREMENTS AND OPTIONAL PRACTICES

### 10. Definition

S 10.1 *Musyarakah*<sup>1</sup> refers to a partnership between two or more parties, whereby all parties will share the profit and bear the loss from the partnership.

### 11. Nature

S 11.1 Generally, there are two types of *musyarakah (shirkah)*, namely:

(a) *Shirkah al-Milk* (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*, each partner's ownership is mutually exclusive. In this regard, one partner cannot deal with the other partner's asset without the latter's consent.

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

Refers to a contract executed between two or more partners to venture into business activities to generate profit.<sup>2</sup> Under *shirkah al-`aqd*, a partner is an agent for the other partners. In this regard, the conduct of one partner in the ordinary course of business represents the partnership.

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<sup>1</sup> The terms of *shirkah, sharikah* and *sharkah* are synonymous to *musyarakah*.

<sup>2</sup> *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 an asset or assets 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 *MUSYARAKAH*

### 12. Contracting parties

- S 12.1 Each party to a *musyarakah* contract (partner) must be a natural person or a legal entity who shall have the legal capacity<sup>3</sup> to enter into the *musyarakah* contract.
- G 12.2 A partner to a *musyarakah* contract may enter into the contract through an agent.
- S 12.3 Any terms or conditions in the *musyarakah* contract that has been mutually agreed between the partners and does not contravene the Shariah shall be binding on the partners.

### 13. Offer (*ijab*) and acceptance (*qabul*)

- S 13.1 A *musyarakah* contract shall be entered into by an offer and acceptance between the partners.
- G 13.2 The offer and acceptance may be expressed verbally, in writing or any other methods which could be evidenced by appropriate documentation or record.

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<sup>3</sup> *The legal capacity of a person, from Shariah perspective, is defined as capacity to assume rights and responsibilities; and capacity to give 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. In Malaysia, the legal capacity is governed under the Contracts Act 1950 and the Age of Majority Act 1971.*

#### **14. Management**

- G 14.1 A *musyarakah* venture may be managed by:
- (a) a single partner, certain partners or all partners in the *musyarakah* contract (managing partner); or
  - (b) a third party appointed by the *musyarakah* (third party manager).
- S 14.2 The appointment of a third party as the manager shall be executed in a separate contract.
- G 14.3 The appointment of a manager may be executed based on agency (*wakalah*), employment contract (*ijarah al-ashkhas*) or profit sharing (*mudarabah*).
- G 14.4 A managing partner may be entitled to an agreed remuneration and/or any incentive as agreed by the partners for his services as manager. This is in addition to his share in profit as a partner provided that the appointment of the manager is executed in a separate contract.
- S 14.5 A managing partner shall be liable for any loss incurred by the *musyarakah* as a result of his misconduct (*ta`addi*), negligence (*taqsir*) or breach of specified terms (*mukhalafah al-shurut*).
- G 14.6 Amendments and variations to the *musyarakah* contract may take effect at any time throughout the tenure of the contract.
- S 14.7 Pursuant to paragraph 14.6, any changes must be mutually agreed upon by the partners and in compliance with Shariah.
- G 14.8 The *musyarakah* contract may provide that any amendment to the contract is valid through a specified and agreed approval process such as a majority vote.

## 15. Capital

- S 15.1 The capital of a *musyarakah* (capital) shall be identifiable, readily available and accessible.
- G 15.2 The capital may be in the form of cash or in-kind, including intangible assets.
- S 15.3 Where the capital is in-kind, it shall be valued in monetary terms either by agreement between the partner or by a third party, which may include experts, valuers, or any other qualified person, at the time of entering into the *musyarakah* contract.
- S 15.4 Where the capital is denominated in a different currency, it shall be valued based on a specific currency as agreed by the partners at the time of entering into the *musyarakah* contract.
- S 15.5 All forms of debts shall not qualify as capital, including all account receivables and payments due from other partners or third parties.
- G 15.6 An asset with an integral financial liability<sup>4</sup> attached to it may be contributed as a *musyarakah* capital and the liability associated in such capital may be assumed by the *musyarakah*.
- S 15.7 Where an asset is contributed as capital, the risk associated with the asset shall be assumed by the *musyarakah*.
- S 15.8 The total amount of capital to be contributed by each partner shall be known and determined at the time of entering into the *musyarakah* contract.
- S 15.9 The partners' rights and liabilities with regard to the *musyarakah* shall be established upon the contribution of their capital.

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<sup>4</sup> *Integral financial liability of an asset refers to any financial liability which is necessary for the asset such as the maintenance cost and maintenance fees.*

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- G 15.10 The capital may be fully or partially contributed as per the terms of the contract.
- G 15.11 Additional capital may be contributed to the *musyarakah* subject to mutual agreement of all partners and the partners may vary or revise the profit sharing ratio.
- G 15.12 Where a partner fails to provide capital as agreed under the *musyarakah* contract (defaulting partner) –
- (a) in the case where the defaulting partner has not paid the capital within the time stipulated in the *musyarakah* contract, the non-defaulting partners may terminate the *musyarakah* contract with the defaulting partner and require the defaulting partner to indemnify the *musyarakah* for any expenses incurred as a result of his default;
  - (b) in the case of a *musyarakah* contract involving a staggered capital payment in which the defaulting partner has made partial capital payment, the non-defaulting partners may, subject to the terms of the *musyarakah* contract, –
    - (i) revise the *musyarakah* contract based on the actual capital paid by the defaulting partner;
    - (ii) terminate the *musyarakah* contract with the defaulting partner and consequently:
      - (a) pay the defaulting partner's fair share of investment in the *musyarakah*; or
      - (b) require the defaulting partner to sell his interest to the other partners or a third party; and
    - (iii) require the defaulting partner to indemnify the *musyarakah* for any expenses incurred as a result of his default.
- S 15.13 The capital either in cash or in-kind shall form a common and undivided interest of all partners.

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- S 15.14 The capital invested shall not be guaranteed by any of the partners and/or the managers.
- S 15.15 Any partner, whether a managing partner or a non-managing partner acting as an agent for *musyarakah*, who has caused the loss of capital due to his misconduct (*ta`addi*), negligence (*taqsir*) or breach of specified terms (*mukhalafah al-shurut*) shall indemnify the *musyarakah* for the loss of the capital.
- G 15.16 The share of the capital may be transferred to existing partners or a third party subject to the terms of the *musyarakah* contract.
- G 15.17 A *musyarakah* contract may impose a condition that a partner is compelled to offer his share of the capital to existing partners subject to the terms of the *musyarakah* contract.
- S 15.18 Any gain or loss in the value of the capital arising from the transfer of share capital shall be enjoyed or borne, as the case may be, by the partner who disposes the share.
- G 15.19 The *musyarakah* contract may provide for the withdrawal of capital by a partner during the tenure of the *musyarakah* contract unless stated otherwise.
- S 15.20 Where the *musyarakah* contract provides for the withdrawal of capital, the loss sharing ratio of the *musyarakah* shall be revised accordingly consequent to such capital withdrawal.
- G 15.21 In a *musyarakah* that is project-specific, 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 the capital.

## **16. Profit**

- G 16.1 A *musyarakah* profit (profit) is the value created over and above the *musyarakah* capital which is determined based on a methodology

acceptable by market conventions or practices.

- S 16.2 The profit sharing ratio (PSR) in the *musyarakah* shall be proportionate to the capital contribution of each partner unless mutually agreed otherwise at the time of entering into the *musyarakah* contract.
- G 16.3 The PSR may be revised during the tenure of the *musyarakah* contract, subject to the mutual agreement of the partners or based on a certain benchmark agreed by the partners at the time of entering into the *musyarakah* contract, as the case may be.
- G 16.4 The partners may agree on a PSR based on a specified profit threshold. In the event that:
- (a) the actual profit is equivalent or below the threshold, the profit shall be shared based on the agreed PSR.
  - (b) the actual profit exceeds the threshold, the excess amount may be:
    - (i) distributed based on a different PSR agreed by the partners;
    - or
    - (ii) paid to any of the partners as agreed.
- S 16.5 The *Musyarakah* 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 16.6 The expected return in the form of a percentage which is attributed to the capital amount is only permissible in the form of indicative profit rate.
- G 16.7 The PSR may be varied to correspond with different periods of investment, different amount of capital or pre-mature withdrawal of capital provided that the conditions for the variation have been agreed upon by the partners at the time of entering into the *musyarakah* contract.

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- S 16.8 Profit shall be recognised based on the following methodology:
- (a) Realised basis by actual liquidation of assets of *musyarakah* partnership (*al-tandid al-haqiqi*); or
  - (b) Constructive basis according to an 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*).
- G 16.9 In the case of profit recognised based on constructive basis, a profit reserve may be created.
- S 16.10 In the case of profit recognised based on constructive basis, a final consolidation and adjustment shall be undertaken to determine the actual profit, either:
- (a) at the end of a certain period; or
  - (b) at the point of actual profit realisation.
- S 16.11 It is permissible to distribute a sum of money prior to valuation provided that any amount paid which exceeds the actual profit must be adjusted.
- G 16.12 The partners may agree to set aside the recognised profit as a reserve or for any other purpose.
- S 16.13 In relation to paragraph 16.12, where the partners agree to distribute the profit in the reserve fund, the distribution shall be based on the PSR unless mutually agreed otherwise by the partners.

## **17. Loss**

- S 17.1 Any loss<sup>5</sup> incurred by the *musyarakah* shall be borne by the partners proportionate to their capital contribution to the *musyarakah*.
- G 17.2 Notwithstanding paragraph 17.1, the partners may agree that the liability of the partnership is limited to the value of capital contributed.

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<sup>5</sup> A loss is depletion from the value of capital.

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S 17.3 Any loss incurred by the *musyarakah* 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 *MUSYARAKAH* WITH OTHER CONTRACTS OR CONCEPTS

### 18. Arrangement for guarantee

S 18.1 Partners in *musyarakah* shall not guarantee the capital and/or profit.

G 18.2 Notwithstanding paragraph 18.1, the following measures may be exercised:

- (a) each partner may be required under the *musyarakah* contract to provide collateral under the terms that it shall only be liquidated in the event of a misconduct (*ta`addi*) or negligence (*taqsir*) or breach of specified terms (*mukhalafah al-shurut*) of a contract by the partner(s); or
- (b) the *musyarakah* contract may require for the arrangement of an independent third party guarantee.

S 18.3 Pursuant to paragraph 18.2(b), the following requirements shall be observed:

- (a) the guarantee shall be executed in a separate contract;
- (b) the guarantee shall be utilised to cover any loss or depletion of the capital; and
- (c) the third party guarantor shall be independent of the *musyarakah* venture such that it shall not be a related party, where:
  - (i) the partner(s) has majority ownership and/or has control over the third party; or
  - (ii) the third party owns or has control over the *musyarakah* venture.



**19. Arrangement of *musyarakah* with promise (*wa`d*)**

G 19.1 A *musyarakah* contract may be arranged with a *wa`d* (promise) where:

- (a) a partner undertakes to purchase from, or sell his share to, other partners upon the occurrence of a specified event as stipulated in the *musyarakah* contract; or
- (b) an agent (*wakil*) appointed by the *musyarakah* undertakes to purchase or sell the underlying asset of the *musyarakah* upon the occurrence of a specified event as stipulated in the *musyarakah* contract.

**20. Arrangement of *musyarakah* with agency (*wakalah*)**

G 20.1 A *musyarakah* may be arranged with agency (*wakalah*), either with or without fee, where:

- (a) the *musyarakah* appoints one of the partner as the agent (*wakil*) to act on behalf of the *musyarakah*; or
- (b) the *musyarakah* appoints a third party as the agent (*wakil*) to act on behalf of the *musyarakah*.

**21. *Musyarakah mutanaqisah***

G 21.1 A *musyarakah* 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 *musyarakah* contract. Such arrangement is commonly referred to as *musyarakah mutanaqisah* (diminishing partnership).

S 21.2 *Musyarakah mutanaqisah* with an asset acquisition objective must be governed by the principle of *shirkah al-milk* and therefore must have the effect of *shirkah al-milk* as defined in paragraph 11.1(a).

S 21.3 *Musyarakah 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

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defined in paragraph 11.1(b).

## **22. *Musyarakah mutanaqisah* for the purpose of asset acquisition <sup>6</sup>**

- G 22.1 *Musyarakah mutanaqisah* for the purpose of asset acquisition may be arranged with other contracts such as leasing (*ijarah*), advance lease (*ijarah mawsufah fi zimmah*), selling (*bai` musawamah*) and manufacturing (*istisna`*).
- G 22.2 *Musyarakah mutanaqisah* for the purpose of acquiring completed assets may be arranged whereby the partners jointly purchase an asset from a third party. Subsequently, one of the partners will lease his share of the asset ownership to the other partner based on *ijarah*. Simultaneously, the partner who is the lessee will purchase the share of the other partner on a gradual basis and ultimately become the sole owner of the asset.
- G 22.3 *Musyarakah mutanaqisah* for the purpose of acquiring asset under construction may be arranged with *istisna`* whereby the partners enter into an *istisna`* contract with a third party. Subsequently, one of the partners will lease his share of the asset 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 a gradual basis and ultimately become the sole owner of the asset.
- G 22.4 A partner under *musyarakah mutanaqisah* may lease his share of the *musyarakah* asset to other partners.
- G 22.5 A partner may, at the time of entering into the contract, request other partner to give a 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.
- G 22.6 Partners may agree on a specific method of price calculation in the case

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<sup>6</sup> Provisions under this section are based on *shirkah al-milk*.

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where total shares are acquired prior to the stipulated tenure.

- S 22.7 Pursuant to paragraph 22.6, the lease between the partners is dissolved.
- G 22.8 A partner may pledge his ownership share of the completed asset as collateral to the other partners.
- G 22.9 Partners may agree at the time of entering into the *musyarakah* contract that, in the event a partner (promisor) breaches his promise to acquire the *musyarakah* asset as agreed or fails to pay his rental, the other partner (promisee) may sell the asset to that partner or to a third party subject to the terms of the *musyarakah* contract.
- G 22.10 Pursuant to paragraph 22.9, in the case of breach of promise to acquire the asset, 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 the following options:
- (i) allocation to all partners is made after deducting all costs related to asset liquidation from the proceeds of the sale; or
- (ii) allocation to all partners is made 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)

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and the realised proceeds portion allocated for the promisee.

- (e) In the event that 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.
- (f) In the event that the promisee's share of the proceeds is equivalent to or higher than the promised purchase price, the provisions on compensation under paragraph (d) and (e) shall not be applicable.
- (g) In the event that the promisee's portion of proceeds exceeds 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. Where the promisor fails to perform the promise, the promisee may sell his remaining ownership share to the promisor on credit based on a price agreed 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 event that 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 that 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.
  - (iii) 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 the promisor.

G 22.11 In *musyarakah mutanaqisah* for acquisition of asset under construction which is arranged based on the terms in paragraph 22.3, if a partner (promisor) breaches his promise to acquire the ownership share of the

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asset as agreed or fails to pay his rental, and where the construction of the asset has been completed, the provisions of paragraph 22.9 shall apply.

G 22.12 In *musyarakah mutanaqisah* for acquisition of asset under construction which is arranged based on the terms in paragraph 22.3, 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 the asset(s) has yet to be completed:

- (a) the promisee may invoke the promise and compel the promisor to purchase the promisee's interest in the *musyarakah* based on the price agreed in the promise.
- (b) the rental paid by the promisor under *ijarah mawsufah fi zimmah* may be set off against the purchase price of the promisee's interest of the asset.

**23. *Musyarakah mutanaqisah* for the purpose of venturing in profit-generating business activities**

S 23.1 *Musyarakah mutanaqisah* for the purpose of venturing in profit-generating business activities must take into consideration the requirements specified in this policy document except the following:

- (a) Paragraph 11.1(a); and
- (b) Paragraph 22.

G 23.2 A partner may request the other partner(s) to give a promise (*wa`d*) to gradually purchase his shares of the *musyarakah* venture over an agreed period of time at market value, fair value or at an agreed price by the parties at the time of purchase.

S 23.3 Pursuant to paragraph 23.2, gradual acquisition of shares by one partner of the other partners' shares shall not result in a guarantee of capital.

S 23.4 Pursuant to paragraph 23.2, in the event that the share acquisition is accelerated, the price determination shall be based on the market value,

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fair value or an agreed price by the parties at the time of purchase.

- G 23.5 *Where* a partner (promisor) breaches his promise to acquire the shares in a *musyarakah* 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 from the promisor.

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## DISSOLUTION

### 24. Dissolution of *musyarakah*

- S 24.1 A *musyarakah* contract is 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;
  - (d) loss of legal capacity;
  - (e) the total acquisition by one partner of the other partners' share of *musyarakah*; or
  - (f) Invalidity of *musyarakah*.
- G 24.2 Notwithstanding paragraph 24.1(c) and (d), the remaining partners may agree to continue with the contract according to the terms in the *musyarakah* contract.
- G 24.3 Upon the termination of the *musyarakah* contract, *musyarakah* assets may be subjected to the liquidation process.
- G 24.4 *Musyarakah* assets may be liquidated where the assets are disposed of in the market.
- S 24.5 Pursuant to paragraph 24.4, 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.

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## **PART C OPERATIONAL REQUIREMENTS FOR *MUSYARAKAH* VENTURE**

### **25. Background**

25.1 Part C outlines the expectations for the establishments of policies and procedures for *musyarakah* ventures. It covers requirements to enable effective governance and oversight function, proper structuring, sound risk management and appropriate financial disclosure for *musyarakah* venture. It also highlights expectations on IFI's business and market conduct. The policy intent of these operational requirements is to provide adequate safeguards for stakeholders' interests, promote effective implementation of business and risk management strategies and drive the development and establishment of necessary systems, processes and control measures.

S 25.2 A *musyarakah* venture takes place in the following situations:

- (a) **Provision of capital via acquisition of ordinary shares**; where IFI enters into a *musyarakah* contract to acquire ordinary shares from a separate legal entity (e.g. Special purpose vehicle (SPV)) that undertakes Shariah-compliant activities; or
- (b) **Provision of capital other than via acquisition of ordinary shares**

Please refer to Appendix 4 on illustrations of a *musyarakah* venture.

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## 26. Governance and oversight

**Principle 1: The IFI shall establish sound governance and oversight structure to ensure that a *musyarakah* is conducted based on sound practices and comply with Shariah requirements**

- S 26.1 This policy document complements the *Guidelines on Corporate Governance for Licensed Islamic Banks* and *Guidelines on Corporate Governance for Development Financial Institutions*.
- S 26.2 Sound governance and oversight function requirements for the *musyarakah* venture reside within both the IFI and the venture.
- S 26.3 While the broad governance and oversight principles can be applied, specific requirements are needed to manage the distinct risks and the unique nature of a *musyarakah* venture. An IFI shall have sufficient understanding of its risk profile and availability of resources with the appropriate knowledge and skill set.

### IFI's level

- S 26.4 An IFI shall identify areas for further enhancements which include the establishment of additional roles of the board of directors, board committee, Shariah committee, senior management and the dedicated function or unit<sup>7</sup>.

### *Board of Directors*

- S 26.5 The board of directors (the Board) shall establish a sound governance structure to facilitate an effective oversight function on the management of the *musyarakah* venture. The adequacy of the governance structure shall commensurate with the nature, complexity and risk profile of the *musyarakah* venture.

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<sup>7</sup> Dedicated function or unit as per paragraph 26.11.

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S 26.6 The roles and responsibilities of the Board with respect to a *musyarakah* venture shall include the following:

- (a) setting the IFI's business strategy and risk appetite with regard to the *musyarakah* venture;
- (b) approving and overseeing policies and procedures for effective risk management to ensure compliance with the relevant law and regulations;
- (c) ensuring that a comprehensive and effective Shariah governance framework is in place;
- (d) ensuring that the IFI has adequate and qualified personnel with sufficient knowledge and competency on the concept, application and risks associated with the *musyarakah* venture; and
- (e) ensuring that independent reviews are conducted regularly to assess compliance with the policy documents issued by the Bank and internal policies established by the IFI.

#### *Board Committee*

S 26.7 Key responsibilities of the board committee shall include conducting oversight to ensure that the *musyarakah* venture is managed effectively, assisting the Board in performing its oversight function and providing recommendations in respect of the management, operations and performance of the *musyarakah* venture.

S 26.8 The board committee shall consist of members who are qualified with sufficient knowledge, competency and understanding of the risks associated with the *musyarakah* venture.

#### *Shariah Committee*

S 26.9 The Shariah committee shall perform the following to ensure that all activities associated with a *musyarakah* venture undertaken by the IFI are conducted in line with Shariah requirements:

- (a) endorse that the Shariah requirements are appropriately applied in the relevant policies and procedures governing the *musyarakah*

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- venture;
- (b) deliberate and endorse that the terms and conditions stipulated in legal documentation and other documents<sup>8</sup> are in compliance with Shariah;
- (c) ensure Shariah review and Shariah audit are conducted, identify issues and propose appropriate corrective measures; and
- (d) advise and provide clarification on relevant Shariah rulings, decisions or guidelines on Shariah matters issued by the Bank and, if relevant, any other authorities.

### *Senior Management*

S 26.10 The roles and responsibilities of the senior management with regards to a *musyarakah* venture shall include the following:

- (a) developing and implementing business strategies, internal control and risk management requirements in line with IFI's business objectives;
- (b) establishing policies, processes and procedures with regard to proper management of the *musyarakah* venture;
- (c) implementing relevant internal systems, infrastructure and adequate mechanisms to identify, measure, control and monitor risk inherent in the *musyarakah* venture;
- (d) ensuring that the IFI monitors and has proper and adequate reporting of the *musyarakah* venture's operations and performance;
- (e) identifying, assigning and training key personnel with the appropriate skill set for the *musyarakah* venture and ensuring that the roles and responsibilities are properly delegated to the relevant functions within the IFI;
- (f) undertaking regular reviews and monitoring of compliance with the approved policies; and
- (g) ensuring timely disclosure of relevant information to the Board and the Shariah committee.

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<sup>8</sup> Such as information published in promotional materials, product manuals or other publications.

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*Dedicated function or unit at operational level*

- S 26.11 An IFI shall set up a dedicated function or unit specifically for *musyarakah* ventures within the IFI with the relevant skills and expertise to provide an oversight on the *musyarakah* ventures.
- S 26.12 The roles and responsibilities of the dedicated function or unit include:
- (a) conducting appraisal of proposals received from potential customers and recommending the *musyarakah* venture to the relevant management committee if deemed viable;
  - (b) monitoring the progress of the *musyarakah* venture, regular on-site<sup>9</sup> visits, on-going collection of relevant information and conducting analyses on impact to the *musyarakah* venture;
  - (c) ensuring that risk management policies and internal control to manage exposures are adhered to; and
  - (d) promptly alerting the senior management if abnormalities are detected and preparing progress reports to the management on a periodical basis.
- S 26.13 The dedicated function or unit shall consist of personnel with the appropriate expertise, knowledge and competencies in a *musyarakah* venture.
- G 26.14 An IFI may appoint an external party to complement the operations of the dedicated function or unit<sup>10</sup> in areas or business activities where the IFI does not possess such expertise.
- S 26.15 For such appointment under paragraph 26.14, the IFI must ensure that:
- (a) the external party has the credibility, capacity, sufficient knowledge and expertise in the areas or business activities involved;
  - (b) there is no conflict of interest between the external party and the IFI;
  - (c) there is no conflict of interest between the external party and the

<sup>9</sup> Includes on-site visit for Shariah compliance purposes.

<sup>10</sup> Includes advisory, assessment, monitoring, review or any other processes necessary in managing the *musyarakah* venture.

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- parties involved in the *musyarakah*; and
- (d) appropriate legal documentation governing the transactions between the IFI and the external party to ensure enforceability of provisions such as liabilities, roles and responsibilities and confidentiality.

*Dedicated Structure at Board and Senior Management level*

S 26.16 Where the exposure<sup>11</sup> to *musyarakah* ventures reaches 25% of the total capital<sup>12</sup>, an IFI shall establish dedicated oversight committee to enable higher level of focus and in-depth deliberation:

- (a) Board Investment Risk Committee (BIRC) at board level; and
- (b) Investment Committee (IC) at management level.

S 26.17 The BIRC shall oversee the senior management's activities in managing risks related to *musyarakah* ventures and to ensure that the risk management processes are in place and functioning effectively. The roles and responsibilities of the BIRC includes:

- (a) reviewing and ensuring effectiveness of policies and risk management framework;
- (b) recommending to the Board for new or change in investment strategy;
- (c) setting authorisation limit for investments; and
- (d) overseeing the IC.

S 26.18 The IC shall be responsible to oversee the performance and ensure effective management of *musyarakah* ventures. The roles and responsibilities of the IC includes:

- (a) oversight on progress of investment activities;
- (b) approval of investment application;
- (c) provide recommendation relating to investment proposal and strategy to BIRC; and

<sup>11</sup> Includes non-sale based contracts where IFIs may be exposed to capital loss e.g. *mudarabah*.

<sup>12</sup> As defined under the Capital Adequacy Framework for Islamic Banks (Capital Components).

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- (d) oversight function and approval of investment to ensure it is within the IFI's limit or strategy set.

The dedicated structure and details of the respective roles and responsibilities are given in Appendix 5.

S 26.19 The membership of the BIRC is limited to non-executive directors with at least three members and chaired by an independent director.

S 26.20 An IFI shall ensure that at least one member in the BIRC and the IC has the expertise and experience<sup>13</sup> in the main business segments<sup>14</sup> relating to *musyarakah* ventures.

G 26.21 Notwithstanding the requirements to establish a BIRC under subparagraph 26.16(a), the IFI may leverage on the existing board committee such as Board Risk Management Committee (BRMC) to undertake the functions of the BIRC.

S 26.22 If the approach under paragraph 26.21 is adopted, the IFI shall ensure that:

- (a) mechanisms are in place to enhance the competency and credibility of the board committee members, which includes ensuring that at least one member in the existing board committee has the expertise and knowledge in the main business segments relating to the *musyarakah* venture; and
- (b) the amount of losses or impairment of the *musyarakah* venture is low or insignificant<sup>15</sup> at all times.

<sup>13</sup> 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.

<sup>14</sup> 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.

<sup>15</sup> For example, losses or impairment is not more than 5% of total *musyarakah* venture exposure.

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## ***Musyarakah* Venture's Level**

### *Representative*

- S 26.23 An IFI shall ensure that effective mechanisms are in place to monitor and assess whether the managing partner or third party manager of the *musyarakah* venture is executing his duties effectively, diligently and in accordance with the stipulated terms and conditions of the *musyarakah* contract.
- S 26.24 An IFI shall establish appropriate safeguard measures to ensure effective governance and oversight at the venture level.
- G 26.25 The safeguard measures may include the appointment of suitable representative with the necessary skills and experience at the *musyarakah* venture's board, management or project level. This is to ensure that the IFI has access to timely information, enhanced understanding of issues and is able to closely monitor the managing partner's or third party manager's conduct in executing fiduciary duties both at the highest as well as at the working level in the *musyarakah* venture.
- S 26.26 Where a representative is appointed for a complex structure such as a *musyarakah* venture involving multi-tiered SPV or indirect exposures, such appointment shall be made at the entity that conducts the actual business activity and/or the entity which has control over the actual business activity. Illustration of a complex structure is given in Appendix 6.
- S 26.27 An IFI shall establish policies and procedures on the appointment of the representatives, which includes the eligibility criteria, conduct, roles and responsibilities and the review mechanism to enable the representative to discharge its duties effectively.
- S 26.28 The appointed representative shall:
- (a) possess skill and in-depth knowledge of the nature of business of the *musyarakah* venture;
  - (b) possess the necessary qualifications, experience and qualities that

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enable him to discharge his duties effectively;

- (c) possess the maturity to understand the deliberations carried on in the *musyarakah* venture, especially those appointed at the board level;
- (d) must be “fit and proper” to hold the post which encompass:
  - (i) his probity, diligence, competence and soundness of judgement;
  - (ii) his 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 or improper business practices or any practices which would discredit him.

G 26.29 The appointed representative may be an employee of the IFI, an employee of an entity within the IFI’s group of companies or an external party as the subject matter expert from the relevant industry.

S 26.30 The appointment of the representative shall be subject to the following conditions:

- (a) no conflict of interest between the representative and the IFI that may jeopardize the IFI’s interest. In particular, the IFI is not allowed to appoint its Board member as a board representative in the *musyarakah* venture;
- (b) no conflict of interest between the representative and the managing partner or third party manager which may cause the oversight function to be ineffective;
- (c) the appointment terms shall define the rights and responsibilities of the representative including duties to the IFI, the prohibited conduct and the disclosure requirements;
- (d) if the representative is an external party to the IFI:
  - (i) the IFI must have in place an assessment process in appointing an external party as a representative to ensure that he has the credibility, knowledge and expertise in the areas or



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business activities involved; and

- (ii) the external party shall provide a written undertaking to the IFI on the obligation to comply with the secrecy provision stipulated in section 145 of IFSA or section 133 of FSA or section 119 of DFIA, as the case may be.

S 26.31 The roles and responsibilities of the representative shall include the following:

- (a) reporting the progress and performance of the *musyarakah* venture to the IFI in a timely manner;
- (b) safeguarding the IFI's interest;
- (c) obtaining necessary information in order to validate any issues faced by the managing partner or third party manager; and
- (d) maintaining a high level of integrity and avoiding any transactions with the managing partner or third party manager or any other parties for personal benefit or gain.

S 26.32 An IFI shall have the following policy in place to ensure the effectiveness of the representative's function:

- (a) the *musyarakah* venture is recognised as one of his core job functions;
- (b) establish an internal limit on the number of invested entities for which each individual is allowed to be a representative e.g. each representative is limited to only two ventures at any time;
- (c) any assignment of an alternate representative shall be limited to only one other specified<sup>16</sup> person, who shall also be subject to the terms and conditions of the appointment of a representative; and
- (d) any fees or remuneration payable to the representative for conducting this function cannot be sourced from the managing partner or third party manager.

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<sup>16</sup> Specified means an alternate representative who shall be made permanent throughout the assignment and not be replaced by any other person.

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- S 26.33 An IFI shall immediately relinquish the representative's function upon disposal of the IFI's interest in the *musyarakah* venture.
- S 26.34 An IFI shall ensure the independence of all functions at the IFI and venture level are preserved at all times to enable checks and balances e.g. the board and project representative shall not be the same person and the head of the dedicated unit or function shall not be the board representative.

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## 27. Structuring

**Principle 2: The IFI shall ensure that the structuring and implementation of *musyarakah* are supported by comprehensive policies and procedures, processes, adequate infrastructure and robust documentation.**

**Principle 3: The IFI shall ensure a sound structuring of *musyarakah* which includes conducting end-to-end process to match the risk and reward profile between sources and usage of funds.**

### Shariah Compliance

S 27.1 An IFI shall be responsible for ensuring:

- (a) the overall operations of *musyarakah* venture are in compliance with Shariah requirements;
- (b) the product structure, strategies, terms of agreement and type of business involved<sup>17</sup> are endorsed by the Shariah committee; and
- (c) the opinion of the Shariah Advisory Council (SAC) of the Bank is sought to resolve issues pertaining to Shariah matters as outlined in the *Shariah Governance Framework for Islamic Financial Institutions*.

S 27.2 An IFI shall establish an effective management system that is supported by adequate policies and procedures and competent personnel to ensure that the *musyarakah* ventures continue to adhere to Shariah requirements.

### Sources of funds

S 27.3 An IFI's capital contribution under a *musyarakah* venture shall be subjected to the following requirements:

- (a) funding from Unrestricted Investment Account (UA)<sup>18</sup> and Restricted Investment Account (RA) are allowed provided that the

<sup>17</sup> Such as the business or services conducted by the managing partner in a *musyarakah* financing.

<sup>18</sup> For the purpose of funding real estate business, UA is eligible as source of fund subject to conditions specified in paragraph 7.6 of Guidelines on Property Development and Property Investment Activities by Islamic Banks.

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requirements as per the policy document on Investment Account<sup>19</sup> are adhered to. In addition, any utilization of UA fund shall be subject to conditions that would significantly mitigate<sup>20</sup> liquidity risk;

- (b) shareholders' funds are allowed subject to:
- (i) the IFI maintaining adequate capital as required under the *Capital Adequacy Framework for Islamic Banks (Capital Components)*;
  - (ii) the IFI clearly establishes its risk appetite for *musyarakah* venture and establishes an internal limit on the use of shareholders' funds which commensurate with its risk appetite; and
- (c) sources from deposits are not allowed.

S 27.4 An IFI shall observe the applicable prudential limits and requirements based on the type of funds used in a *musyarakah* venture as specified in the relevant policy documents as per Appendix 7.

S 27.5 Where the mechanism of matching tenure under subparagraph 27.3(a) is used to significantly mitigate liquidity risk, any extension to the tenure of the *musyarakah* venture must be supported by an extension of redemption period for the UA and RA funds.

### **Usage of funds**

S 27.6 In utilising funds for purposes of a *musyarakah* venture, an IFI shall assess the business venture viability and risk profile i.e. cash flow, risk and reward, in line with the IFI's risk appetite and sources of funds.

S 27.7 To avoid perpetual holdings of *musyarakah* venture via acquisition of shares, the extension of holdings of shares is limited of up to five years from the point of original maturity.

<sup>19</sup> UA and RA refers to URIA and RIA respectively in the policy document on Investment Account.

<sup>20</sup> 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.

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### **Contracting parties<sup>21</sup>**

- S 27.8 An IFI shall undertake an assessment on the suitability of the contracting parties before entering into the *musyarakah* venture.
- S 27.9 The contracting parties' roles and responsibilities shall be stipulated clearly in the legal documentations.
- S 27.10 The terms and conditions for the appointment of a managing partner shall include clarification of the:
- (a) remuneration and/or incentive in addition to their share in profit sharing; and
  - (b) liabilities to be borne by the managing partner(s).
- S 27.11 Appointment of a third party manager, as per paragraph 14.2, to manage a *musyarakah* venture shall be executed in a separate contract and the terms to be stipulated in the contract shall at minimum include the following:
- (a) roles and responsibilities in managing the venture including reporting obligation, frequency and furnishing detailed reports on any occurrence of loss;
  - (b) remuneration and/or incentive; and
  - (c) liabilities to be borne by third party manager.

### **Management of *musyarakah***

- S 27.12 Notwithstanding paragraph 14.8, amendments of PSR or any other terms that may significantly dilute the rights of any contracting parties shall be mutually agreed upon.
- G 27.13 Decisions in relation to the management of a *musyarakah* venture may be determined by the partners via:
- (a) a simple majority; and/or
  - (b) a minimum of one representative from each party needs to agree.

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<sup>21</sup> Including partners and/or third party manager.

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G 27.14 With regards to financial matters, an IFI may wish to exercise veto power to safeguard its interest.

S 27.15 An IFI shall have the mechanisms in place to ensure that there are no conflicts of interest between the managing partner or third party manager and any party appointed for business dealings.

### **Capital**

S 27.16 An IFI shall ascertain the value of the capital contributed by each partner to the *musyarakah* venture upon the execution of the contract.

S 27.17 The capital shall be in the form of cash or in-kind including intangible assets. In this regard, intangible assets shall be defined in accordance with the relevant Malaysian Financial Reporting Standards (MFRS).

S 27.18 The capital shall be identifiable, readily available and accessible at the date of commencement of the *musyarakah* venture. The capital shall not be in the following forms:

- (a) debt or receivables owing to the partner; and
- (b) encumbered assets<sup>22</sup>.

G 27.19 In respect of capital in-kind e.g. land, property and machinery, an IFI may assign a third party with relevant expertise such as a professional valuer or quantity surveyor to determine its value in monetary terms.

G 27.20 The capital may be fully or partially disbursed as per the terms of contract and additional capital injection is allowed within the tenure of the venture, subject to mutual agreement amongst the partners.

S 27.21 Upon disbursement of the capital, an IFI shall assume its rights and liabilities as a partner of the *musyarakah* up to the limit of the amount of capital disbursed or contributed.

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<sup>22</sup> E.g. Assets pledged as collateral.

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S 27.22 In the event where there is commingling of funds by a managing partner or third party manager, an IFI shall ensure that the following are imposed on the managing partner or third party manager in the relevant terms and conditions:

- (a) identification of funding purpose and assets is clearly stated in the terms and conditions;
- (b) proper tagging of assets (either dedicated or proportionate) at all times using appropriate mechanisms by the managing partner or third party manager such as separate record keeping;
- (c) proper valuation of underlying assets under the *musyarakah* venture is carried out periodically; and
- (d) the IFI has the rights<sup>23</sup> on the underlying assets funded by the IFI at all times, including upon exit and upon the managing partner's or third party manager's winding-up.

S 27.23 In addition to the requirements in paragraph 27.22, when there is commingling of the *musyarakah* capital with the managing partner's or third party manager's other funds, an IFI shall ensure that the terms and conditions as well as any other measures taken are legally enforceable and effective in ensuring the IFI's rights on the underlying assets under the *musyarakah* venture.

### **Profit**

S 27.24 The PSR shall be mutually agreed between the contracting parties and stipulated clearly in the *musyarakah* contract at the time of entering into the contract.

G 27.25 In determining the appropriate PSR, an IFI may consider the following factors:

- (a) estimated return on the *musyarakah* venture;
- (b) benchmark rate of return of equivalent product, underlying asset or business segment; and

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<sup>23</sup> Rights as stipulated in the legal documentations.

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(c) estimated management or operational costs incurred by the managing partner in managing the *musyarakah* venture.

S 27.26 Notwithstanding the requirements in paragraph 16.8, the profit shall be recognized and measured based on the applicable MFRS.

S 27.27 As required under paragraph 27.26, the contracting parties shall conduct an assessment at the end of a certain period or upon actual realisation of profit to arrive at the actual amount of profit. A final adjustment in accordance with MFRS shall be undertaken on the amounts already recognized, to reflect the actual profit of the *musyarakah* venture.

S 27.28 Methodology used for determining profit distribution shall be objective, transparent and acceptable to all contracting parties. Where one or more of the partner(s) is involved in multiple projects, direct expenses under a *musyarakah* venture shall be identified and tagged to avoid commingling of the *musyarakah* venture's capital with other non-*musyarakah* ventures' capital.

S 27.29 The contracting parties shall determine the time period or date for profit distribution of a *musyarakah* venture.

### **Loss**

S 27.30 Pursuant to paragraph 17.1, any loss shall be recognized and measured based on the applicable MFRS.

S 27.31 Expectations and requirements on the managing partner or third party manager shall be sufficiently provided in the terms and conditions to ensure proper conduct of the managing partner or third party manager and to protect the interests of the IFI in the event of a loss.

S 27.32 An IFI shall have effective processes in place to ensure that the managing partner or third party manager provides justification and detailed report on any occurrence of loss, underperformance against projected returns or derailment from expected performance in a timely



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manner to other partners.

- G 27.33 An IFI may set criteria<sup>24</sup> on misconduct and negligence in the *musyarakah* venture terms and conditions to provide clarity, encourage proper conduct of managing partner or third party manager as well as to protect the interests of the IFI in the event of loss.
- S 27.34 A managing partner or third party manager shall be fully liable if it is proven that the loss is due to his misconduct (*ta'addi*), negligence (*taqsir*) or breach of specified terms (*mukhalafah al-shurut*).
- S 27.35 If the loss is not attributed to misconduct, negligence or breach of specified terms of the managing partner or third party manager, all partners shall bear the loss proportionate to their capital contribution ratio and limited to the amount of capital contributed.
- S 27.36 Application of any mechanism which will effectively cause a partner to guarantee the principal amount upfront<sup>25</sup> is prohibited.
- S 27.37 A *musyarakah* venture shall be separated from the managing partner's other businesses. The venture shall be structured via a separate entity, e.g. an SPV if the business falls under the following circumstances:
- (a) existence of high-risk activities; where the managing partner has other high-risk business activities which may affect the *musyarakah* venture. Example of ventures that are considered as high-risk are:
    - (i) products that are still at the exploratory or prototype stage e.g. pharmaceuticals; or
    - (ii) industries with high a rate of obsolescence e.g. technology sector;
  - (b) inability to practise effective management; where the IFI is unable to appoint representative(s) or unable to operationalise the use of

<sup>24</sup> Such as setting expectations on maintaining proper books and records, transparency, disclosure of information.

<sup>25</sup> E.g. upfront waiver on loss absorption or *wa'd* to purchase assets or rights at price equivalent to capital provided.

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the designated account<sup>26</sup> under the non-SPV set-up.

S 27.38 An IFI shall assess whether the *musyarakah* venture should be segregated from the IFI and structured under a separate entity such as an SPV. The factors to be considered include:

- (a) activities and level of risk involved such as the examples in subparagraph 27.37(a); and
- (b) the need to limit risks or claims on the IFI or potential legal impact to the IFI.

S 27.39 If a *musyarakah* venture is structured in the form of a separate entity, it shall be:

- (a) a limited liability entity (e.g. established under the Companies Act 1965); and
- (b) for single-purpose only, which shall be determined by the IFI.

### **Tenure**

S 27.40 An IFI shall determine a fixed tenure<sup>27</sup> for the *musyarakah* venture. Any decision to extend the tenure of the *musyarakah* venture shall be supported by justifiable reasons such as delay in construction or significant change in market conditions and after conducting appropriate renegotiation and reassessment such as the cost benefit analysis.

S 27.41 Notwithstanding paragraph 27.40, *musyarakah* ventures that are perpetual in nature shall be subject to approval and assessment by the Bank on a case-by-case basis.

### **Guarantee or Collateral**

S 27.42 For the purpose of paragraph 18.2(b), the independent third party guarantee shall exclude the following parties:

- (a) for corporate guarantors:

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<sup>26</sup> As per paragraph 28.11.

<sup>27</sup> Takes into consideration the appropriate tenure to maximise returns.

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- (i) entities<sup>28</sup> with control over the managing partner or third party manager; and
- (ii) entities<sup>29</sup> controlled by the managing partner or third party manager

as defined by MFRS<sup>30</sup>.

- (b) for individual guarantors:
  - (i) employee (and his close relatives) of the managing partner or third party manager; or
  - (ii) controlling shareholder (and his close relatives) of the managing partner or third party manager.

S 27.43 For the purpose of meeting the requirement in paragraph 18.3, an IFI shall conduct assessment on:

- (a) the need for collateral or guarantee and its intended purpose<sup>31</sup>;
- (b) the value of assets acceptable as collateral;
- (c) acceptability of collateral and eligibility of guarantors, which includes:
  - (i) existing legal impediments on the collateral such as encumbered assets;
  - (ii) financial strength of guarantors; and
  - (iii) third parties' eligibility as guarantors as per paragraph 27.42.

S 27.44 An IFI shall ensure legal enforceability of any collateral or guarantee documentation.

### **Exit<sup>32</sup> from venture**

S 27.45 An IFI shall clearly stipulate the terms and conditions of an exit of the *musyarakah* venture, which includes:

- (a) tenure of the *musyarakah* venture;
- (b) time or intervals allowed for the purpose of withdrawal or

<sup>28</sup> E.g. parent company.

<sup>29</sup> E.g. subsidiary.

<sup>30</sup> Namely, MFRS 127 Separate Financial Statements.

<sup>31</sup> To cover losses due to misconduct, breach of contract or negligence or to cover losses due to any other reasons.

<sup>32</sup> May be in the form of dissolution, termination, withdrawal or redemption of the *musyarakah* capital.

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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 the exit including submission of relevant documents, notice period, number of days taken to process the transaction and settlement period.

S 27.46 As part of the measures to mitigate risks, an IFI shall identify potential exit options in order to immediately cut loss, taking into consideration the overall impact to the IFI which may include potential compensation or damages payable to partners.

#### **Documentation**

S 27.47 An IFI shall develop comprehensive and legally enforceable documentation for the *musyarakah* venture which are in compliance with Shariah and regulatory requirements.

S 27.48 At minimum, the legal documentations must clearly stipulate the following:

- (a) the purpose of the *musyarakah* venture;
- (b) the contractual relationship between the various parties;
- (c) the rights, roles and responsibilities of parties to the *musyarakah* venture
- (d) the amount of capital contributed by the partners;
- (e) the PSR;
- (f) the loss that shall be borne by the relevant contracting parties;
- (g) the calculation methodologies and timing for profit distribution;
- (h) the tenure of *musyarakah* venture;
- (i) the pricing or valuation method of underlying assets or shares;
- (j) requirements on the reporting of the *musyarakah* venture's

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performance which includes the frequency and the information to be reported;

- (k) details on the collateral and guarantees including rights over assets, if any;
- (l) the terms and mechanism of exit; and
- (m) the terms, fees and charges to be borne by the relevant contracting parties, where applicable.

S 27.49 The use of Arabic terminology in the documents shall be sufficiently clarified or translated to facilitate understanding of the contracting parties.

S 27.50 Where there is an arrangement of *musyarakah* with other Shariah contracts, the IFI shall ensure that the documentation involved is separated and executed in a sequence that is consistent with Shariah requirements.

G 27.51 An IFI may identify negative covenants necessary to protect the IFI's interest, which includes imposing conditions on any dilution of rights or shareholding e.g. rights issuance and any transactions that may be detrimental to the IFI's interest.

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## 28. Risk management

**Principle 4: The IFI shall institute and implement sound and integrated risk management system to effectively manage risks throughout the life cycle of the *musyarakah*.**

G 28.1 A *musyarakah* venture may expose an IFI to various types of risks, such as equity, market, liquidity, credit and operational risks. These risks, which appear at various stages of transactions, may change in nature and may necessitate a comprehensive and sound risk management infrastructure, reporting and control framework.

S 28.2 An effective risk management framework shall consist of three main stages prevalent in a *musyarakah* venture:

- (a) the pre-contractual stage;
- (b) the during or on-going stage; and
- (c) the exit stage.

### **Pre-contractual stage**

G 28.3 At the pre-contractual stage, the risk management objective is to enable sufficiency of information for decision making purposes before embarking on a *musyarakah* venture.

### *Policies and procedures*

S 28.4 An IFI shall establish comprehensive risk management policies and procedures, systems and internal control to address risks in line with its risk appetite, throughout the life cycle of a *musyarakah* venture and shall include the following;

- (a) the identification and monitoring of risks;
- (b) the appropriate valuation and calculation methodology for underlying assets and distribution of profit;
- (c) the risk exposure limits;
- (d) the risk mitigation techniques; and
- (e) the monitoring and reporting mechanism.

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S 28.5 Internally, an IFI shall clearly specify and communicate the policies and procedures and limits to all its relevant functions.

S 28.6 An IFI shall establish a systematic process to review and update its policies, procedures, internal limits and shall ensure consistency with the risk appetite of the IFI and any material changes within the industry.

*Feasibility assessment*

S 28.7 An IFI shall ensure that the objectives and criteria of potential *musyarakah* ventures are in line with the IFI's investment strategy.

S 28.8 An IFI shall ensure that a comprehensive and robust feasibility and due-diligence framework is in place to facilitate effective decision making, which includes the following:

- (a) the assessment methodologies employed are suitable for the type of products, services and business segments under the *musyarakah* venture e.g. the use of an assessment framework under a similar business segment for sale-based financing<sup>33</sup> may not be exactly suitable for a *musyarakah* venture due to differences in the nature of funding;
- (b) the assessment shall be based on empirical evidence based on both quantitative and qualitative analysis. Should there be any data limitations, the IFI shall identify other means to support the assessment such as using relevant data as proxies. Where judgment is significantly involved, an IFI shall have in place the parameters for the application of judgment in the assessment process, e.g. identifying appropriate personnel or committee that can exercise such judgment;
- (c) salient risks and important features affecting the prospects of the *musyarakah* venture have been taken into consideration. Salient risks such as investment, market, operational (which includes legal risk and Shariah non-compliance risk), liquidity and credit risks shall

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<sup>33</sup> Such as *Murabahah* financing.

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be assessed appropriately. All relevant factors affecting these risks shall be identified and assessed, including:

- (i) the credibility, capability, track record<sup>34</sup> and experience of the managing partner or third party manager including any other contracting parties involved in a *musyarakah* venture such as agents, contractors and suppliers. This also includes assessment of potential conflict of interest amongst the contracting parties;
  - (ii) the transaction or venture characteristics such as marketability of products or services which are influenced by several factors including the type and design of the products or services, consumer demand, location, promotional strategies and competition;
  - (iii) the expected selling price, costs involved, expected cash-flow and any potential changes affecting the *musyarakah* venture; and
  - (iv) the enforceability of legal requirements, Shariah-compliance of the business activities as well as economic and regulatory changes;
- (d) robust methodologies are applied in assessing 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, increase in labour costs or delay in delivery. For this purpose, an IFI shall ensure that sound assumptions based on objective evidence are used in arriving at the projections. In addition, an IFI shall 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) the information used for assessment purposes are current, relevant

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<sup>34</sup> Such as performance and financial track record.



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and obtained from reliable sources; and

- (f) the assessment process is conducted by parties<sup>35</sup> with appropriate knowledge and expertise in the relevant business activity and no conflict of interest with the potential managing partner or third party manager. Where external parties are involved, an IFI shall also have in place the policies and procedures which include the criteria on the selection of suitable external parties.

- G 28.9 In addition to the assessment usually applied for sale-based financing, an IFI may wish to apply an appropriate business courtship<sup>36</sup> arrangement with its potential partner before embarking on a *musyarakah* venture. This will involve arrangements for getting to know the partner(s) more thoroughly over a certain period of time, which involves close monitoring, information collection and a familiarisation process before entering into a *musyarakah* venture.
- S 28.10 An IFI shall ensure that the rights to fully access the books and records of the managing partner or third party manager and any information that would potentially affect a *musyarakah* venture shall be clearly stipulated in the terms and conditions.
- S 28.11 An IFI shall establish designated account(s) for a *musyarakah* venture where all financial transactions shall be maintained to enable close monitoring and supervision of transactions made by the *musyarakah* venture.
- S 28.12 Any credit facilities, other than the capital contributions made under *musyarakah* venture, extended by the IFI shall be made on an arm's length basis whereby the terms and conditions for these facilities should not be more favourable than those granted to other obligors with similar background and creditworthiness.

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<sup>35</sup> The party conducting the assessment may be internal or external party.

<sup>36</sup> A period of time where an IFI engage and seek for more information to better understand the business e.g. request for periodic performance overtime without any obligation.

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- S 28.13 An IFI shall assess potential exit strategies for a proposed *musyarakah* venture and potential compensation or damages of all contracting parties.
- S 28.14 The legal mechanism on exit strategies shall be specifically and appropriately documented in the *musyarakah* contracts to ensure a smooth exit<sup>37</sup>.
- S 28.15 An IFI shall classify a *musyarakah* venture as impaired or loss-making in accordance with the applicable MFRS.
- G 28.16 For purposes of internal assessment, the IFI may use relevant indicators<sup>38</sup> to monitor and classify a *musyarakah* venture according to its level of performance.

### **During or on-going stage**

#### *Active monitoring and continued assessment*

- G 28.17 The risk management objectives at this stage are intended to ensure continuous monitoring in achieving long term strategy and value creation.
- S 28.18 An IFI shall ensure continuous monitoring of the *musyarakah* ventures through adequate and robust risk reporting, risk monitoring and risk control framework with the aim to reduce the IFI's overall risk exposure and safeguard the IFI's investment portfolio. Any gaps or inappropriate risk exposures must be reported immediately.
- S 28.19 An IFI shall have in place an early-warning mechanism, with pre-identified trigger events, to facilitate prompt decision making upon any alarming performance of the *musyarakah* ventures.
- S 28.20 In respect of the *musyarakah* venture's performance reporting, an IFI shall conduct the following:
- (a) identify the information required from the managing partner or third party manager or other contracting parties, if any, including:

<sup>37</sup> E.g. voting power by other partners must not restrict execution of exit.

<sup>38</sup> E.g. specified series of reduction or significant percentage reduction in returns projection.

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- (i) periodical management and financial accounts;
- (ii) key performance indicators;
- (iii) risk management practices;
- (iv) minutes of board of director's meetings; and
- (v) significant activities or changes<sup>39</sup> that have material effect on the performance of the venture.

- (b) managing partner or third party manager to provide periodical reports in a timely manner; and
- (c) validate the reports received to mitigate the risk of potential manipulation of the performance results leading to understatements of *musyarakah* earnings. This may include validation of the reported earnings or losses, calculation of profits as well as valuation of underlying assets.

S 28.21 An IFI shall have in place a rigorous stress testing framework on the *musyarakah* venture.

S 28.22 An IFI shall conduct assessment periodically on the projected returns of a *musyarakah* venture or upon the occurrence of material changes affecting a *musyarakah* venture. The frequency for such periodic assessments shall commensurate with the level of risk and complexity of the *musyarakah* venture.

S 28.23 An IFI shall have in place a sound valuation methodology that provides the possible loss estimates for the *musyarakah* ventures.

S 28.24 An IFI shall establish a process to collect and analyse data and information on the *musyarakah* ventures.

S 28.25 If a third party is appointed to conduct any activity for the *musyarakah* venture, the IFI shall ensure that the managing partner or third party

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<sup>39</sup> Such as change in management (e.g. resignation or election of new board of directors), change in key contractual parties (e.g. change of agent, contractor, supplier or other outsourcing party), and regulatory changes in business requirements (e.g. health and safety regulations and product bans).

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manager conduct the following:

- (a) undertake proper selection process;
- (b) monitor effectiveness of functions and conduct of the third party;
- (c) discloses information<sup>40</sup> about the third party; and
- (d) ensure an exit mechanism is in place<sup>41</sup>.

G 28.26 Legal documentation may contain clauses that will enable an IFI to take actions against the managing partner's or third party manager's failure to prepare timely periodical reports within a reasonable period.

S 28.27 An effective asset-liability management shall be established to manage mismatch in returns and cash flows of the *musyarakah* venture and the IFI's source of funding.

G 28.28 The partners may appoint an independent third party to carry out valuations on the *musyarakah* venture to ensure transparency and objectivity in the valuation and distribution of profits.

#### *Underperforming musyarakah venture*

S 28.29 If a *musyarakah* venture is or is expected to be underperforming, the IFI shall conduct a detailed assessment on whether the *musyarakah* venture would continue to be viable.

S 28.30 The viability assessment shall take into consideration the following:

- (a) the possibilities for improvement on the issues and factors that lead to the underperformance;
- (b) the feasibility of improvement plans proposed by the managing partner or third party manager, such as change in management, operational processes and period for turnaround;
- (c) the appropriateness of the revised projection of returns and assumptions used to support such projection;
- (d) the additional funding required; and

<sup>40</sup> E.g. performance history, financial strength and company reputation.

<sup>41</sup> E.g. able to replace third party should the arrangement fail to deliver results.

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(e) whether the *musyarakah* venture's level of risk and reward are still within the IFI's risk appetite.

S 28.31 After conducting the viability assessment of *musyarakah* venture, any decision not to exit shall 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 or third party manager to turnaround the *musyarakah* venture; and
- (c) followed by the identification of clear strategies, measures and action plans<sup>42</sup> by the IFI.

S 28.32 Risk monitoring, assessment and control functions shall be strengthened<sup>43</sup> if an underperforming *musyarakah* venture is to be continued.

### **Exit Stage**

S 28.33 Processes and procedures on the exit mechanism shall be clearly stipulated and communicated to the relevant functions or departments in an IFI in order to ensure effective and efficient execution of exit.

S 28.34 An assessment on the impact of each exit options shall be conducted by the IFI to determine the best value realisation.

S 28.35 An IFI shall obtain legal opinion that the exit mechanism can be executed without any legal impediments.

S 28.36 In the event an IFI exits from the *musyarakah* venture, an assessment on any potential damages payable to the partner or any other parties involved shall be conducted.

<sup>42</sup> Which may include renegotiating the terms of the *musyarakah* venture.

<sup>43</sup> An example of a turnaround process flow for a *musyarakah* venture is stipulated in Appendix 8.

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## 29. Financial disclosure

**Principle 5: The IFI shall provide adequate disclosure and transparency to facilitate stakeholders understanding and assessment of *musyarakah*.**

- S 29.1 An IFI shall maintain accounting records and other records in a timely manner which will sufficiently enable the preparation and reporting of financial statements that give a true and fair view.
- S 29.2 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 shall be observed by the IFI.
- S 29.3 Specific governance and oversight function<sup>44</sup> in place for the *musyarakah* ventures, if any, shall be disclosed.
- S 29.4 The financial disclosure<sup>45</sup> for the *musyarakah* ventures shall include the following:
- (a) the value of the *musyarakah* ventures:
    - (i) the initial capital contribution;
    - (ii) the outstanding or recoverable value<sup>46</sup> by sector including any losses incurred or provisions made during the period; and
  - (b) the composition of aggregate sources of funds.
- S 29.5 Any potential consolidation<sup>47</sup> in the financial statements of the IFI arising from the *musyarakah* ventures shall be notified to the Bank in advance.

<sup>44</sup> E.g. board representative in the respective *musyarakah* venture and their roles.

<sup>45</sup> Illustration of the disclosure requirements is given in Appendix 9.

<sup>46</sup> Exposure value as per MFRS.

<sup>47</sup> Refers to line-by-line consolidation.

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### 30. Business and market conduct

**Principle 6: The IFI shall undertake *musyarakah* in a fair and transparent manner in line with Shariah to protect stakeholders' interest.**

S 30.1 The IFI shall give due regard to the interests of consumers in its policies and procedures to ensure that the *musyarakah* ventures is conducted in a fair, transparent, responsible and professional manner.

#### **Fair dealings**

S 30.2 The internal policies and procedures of an IFI on business and market conduct for a *musyarakah* venture shall reflect fair dealing practices to the partners, including:

- (a) the suitability assessment;
- (b) the information provided which shall be accurate, clear and not misleading;
- (c) the fees and charges (if any); and
- (d) reasonable care is taken to ensure suitability of advice and recommendations, if any.

S 30.3 An IFI shall not disclose any material information, for example trade secrets, of the *musyarakah* venture to a third party without authorisation from the partners.

S 30.4 All conflicts of interest including those that will potentially occur under a *musyarakah* venture shall be disclosed to the partners by the IFI.

S 30.5 An IFI shall ensure fairness in the terms of the *musyarakah* contract including in any amendments to the *musyarakah* contract during renegotiation or extension of tenure.

#### **Disclosure of information**

S 30.6 At the pre-contractual stage, an IFI shall provide adequate and relevant information to the potential partners in the marketing or promotional materials, product disclosure sheet and any other relevant materials with

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regard to a *musyarakah* venture. The information shall include:

- (a) comprehensive description of the *musyarakah* venture, which includes;
  - (i) the contractual relationship between the partners;
  - (ii) the concept of profit sharing and loss sharing;
- (b) the overview of the transaction's structure;
- (c) the roles, responsibilities, rights and obligations of the partners;
- (d) the key terms and conditions of the *musyarakah* contract; and
- (e) the requirements, if any, for guarantee and/or collateral (including the rights and obligations of the partners on the collateral pledged).

S 30.7 In relation to the product disclosure sheet, an IFI is also required to observe the minimum information to be disclosed in the product disclosure sheet as prescribed in the *Guidelines on Product Transparency and Disclosure*.

S 30.8 An IFI shall facilitate the contracting parties' understanding of the concept of a *musyarakah* contract.

S 30.9 At the time of entering into the contract, an IFI shall disclose the salient features of a *musyarakah* venture in the legal documentation to facilitate the partners understanding of the terms and conditions of the *musyarakah* contract.

S 30.10 An IFI shall provide appropriate disclosure to the partner during the tenure of a *musyarakah* venture such as providing timely notice of changes to the terms and conditions, features, rights and obligations as well as fees and charges (if applicable).

S 30.11 Where the IFI is the managing partner, the IFI shall disclose the performance of the *musyarakah* venture to other partners and shall bear the liability as a managing partner in accordance with the conditions stipulated in the *musyarakah* contract.



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## **PART D OPERATIONAL REQUIREMENTS FOR *MUSYARAKAH* FINANCING**

### **31. Background**

- S 31.1 *Musyarakah* financing refers to a financing using a *musyarakah* contract structured to reflect a debt-based financing risk profile which is in line with the Shariah concept of *shirkah al-milk*.
- S 31.2 The operational requirements for *musyarakah* financing shall be similar to the requirements and expectations for debt-based financing. While the overarching principles<sup>48</sup> as outlined in Part C are similarly applicable to Part D, specific requirements on *musyarakah* financing are imperative to address the peculiarities arising from the usage of additional contracts or concepts that transform the inherent risk-sharing element into credit risk.

### **32. Structuring**

- G 32.1 *Musyarakah* financing may be structured based on the combination of a *musyarakah* contract and other Shariah contracts or concepts such as *ijarah* (leasing), *ijarah mausufah fi-zimmah* (advanced leasing), *bai' musawamah* (sale contract<sup>49</sup>), or *wa'ad* (promise). A common example of *musyarakah* financing is *musyarakah mutanaqisah*.
- S 32.2 For the purpose of the *musyarakah* financing, there shall be no restrictions on the sources of funds.
- S 32.3 Where asset is acquired pursuant to paragraphs 22.2 and 22.3, the price of such asset under the *musyarakah* financing shall be fixed<sup>50</sup> at the time of entering into the *musyarakah* contract.
- S 32.4 For gradual redemption<sup>51</sup> under the *musyarakah mutanaqisah* financing, an IFI shall specify a specific formula in the legal documentation on the calculation and determination of the redemption amount.

<sup>48</sup> Principles 1 to 6 under *musyarakah* venture.

<sup>49</sup> Without the disclosure of asset cost price and profit margin to the buyer.

<sup>50</sup> Based on purchase price during inception and not based on future market price at the point of redemption.

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- G 32.5 In determining the formula for calculation of profit, an IFI may use a relevant pricing benchmark<sup>52</sup> or an Islamic reference rate<sup>53</sup>.
- S 32.6 The costs and expenses of a *musyarakah* financing shall either be:
- (a) agreed by the partners at the pre-contractual stage;
  - (b) shared proportionately among the partners throughout the life cycle of the *musyarakah* financing; or
  - (c) in accordance with the requirements made in the relevant Shariah contracts e.g. *ijarah*.
- S 32.7 Legal documentation relating to a *musyarakah* financing shall clearly stipulate all costs and expenses agreed and borne by each party.
- S 32.8 Where a *musyarakah* contract is arranged with *wa'd*, the IFI shall:
- (a) determine the purpose of *wa'd* at the time of entering into the *musyarakah* contract;
  - (b) assess the appropriate terms under *wa'd* and the potential recoverable amount; and
  - (c) specify the trigger event and actions that can be taken when a party breaches the *wa'd*.
- S 32.9 In the event of default of a *musyarakah* financing, the IFI shall ensure the following:
- (a) the customer, as a partner or joint-owner shall have the first right of refusal to purchase the asset;
  - (b) the sale of such asset to a third party must be in accordance with Shariah requirements;
  - (c) in the case of any shortfall from the customer, the IFI shall not redeem such shortfall from the customer until the loss is realised; and
  - (d) in the case of the *musyarakah mutanaqisah* arranged with *ijarah*,

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<sup>51</sup> Also known as gradual share acquisition during the tenure of the *musyarakah mutanaqisah* financing.

<sup>52</sup> Such as current rental rate.

<sup>53</sup> For example, Kuala Lumpur Islamic Reference Rate (KLIRR).

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the IFI shall only claim rental accrued if the customer is still enjoying the usufruct.

S 32.10 An IFI shall ensure that all legal documentation relating to the *musyarakah* financing:

- (a) are legally enforceable;
- (b) clearly describes the terms and conditions of the *musyarakah* financing; and
- (c) where it is arranged with another Shariah contract or concept, the salient features of such Shariah contract or concept are clearly stipulated.

S 32.11 An IFI shall ensure that all legal documentation relating to the *musyarakah* financing stipulates the rights, obligations and expectations on all parties including:

- (a) the nature of relationship or the Shariah principles used;
- (b) the lease (*ijarah*) of the IFI's shares in the asset, if applicable;
- (c) the gradual acquisition or diminishing of shares in the asset, if applicable;
- (d) the events of default;
- (e) the rights of the IFI in the event of partner's default; and
- (f) the responsibility of each party with respect to the asset.

S 32.12 Where a *musyarakah* financing is arranged with another Shariah contract, the IFI shall ensure that the execution and sequencing of the Shariah contracts are consistent with Shariah requirements.

### **33. Risk management**

S 33.1 An IFI shall establish comprehensive risk management policies and procedures to effectively manage risks arising from *musyarakah* financing.

S 33.2 In the case of *musyarakah mutanaqisah* financing, an IFI shall ensure

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any changes in the ownership ratio is recorded and updated regularly.

- S 33.3 An IFI shall ensure that the requirements relating to the transfer of ownership in the *musyarakah mutanaqisah* financing is reflected in the legal documents.
- S 33.4 In the case of acquiring an asset under construction using *musyarakah mutanaqisah* financing:
- (a) an IFI shall undertake due diligence to assess the capacity of the developer or manufacturer to fulfil its contractual obligations; and
  - (b) an IFI shall identify trigger events for construction risk<sup>54</sup> and establish a replacement procedure for a new developer to replace the non-performing developer, where applicable<sup>55</sup>.
- S 33.5 An IFI shall monitor<sup>56</sup> the progress of the asset construction up to its completion in order to facilitate timely delivery of the asset by the developer or manufacturer.

#### **34. Business and market conduct**

- S 34.1 Where the customer wishes to make an early settlement of the *musyarakah* financing, the amount to be paid to the IFI shall be the outstanding amount (principal plus accrued profit).
- S 34.2 An IFI shall not claim any penalty charges or impose any other charges on the customer unless the charges represent the costs incurred by the IFI due to early settlement by the customer. The reasonable estimation of costs to be incurred must be in line with the *Guidelines on Ibra' (Rebate) for Sale-based Financing*.
- S 34.3 For purposes of paragraph 34.2, the Shariah Committee of the IFI shall perform an effective oversight over the implementation of requirements

<sup>54</sup> Such as the developer is behind the work schedule.

<sup>55</sup> Such as in *Istisna'* contract.

<sup>56</sup> To inculcate strong risk management culture, IFI will still be responsible and accountable even if IFI appoints customer as *wakil* or agent under *wakalah* contract.

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on early settlement and in determining the reasonable estimate of the costs incurred.

- S 34.4 An IFI shall implement and enforce clear policies and procedures to ensure that any defaulting customer with genuine<sup>57</sup> financial difficulties are given due consideration in determining late payment charges<sup>58</sup>.
- S 34.5 Where an asset under construction is acquired using *musyarakah mutanaqisah* financing, failure of the developer or manufacturer to deliver the asset at the agreed time shall not be a trigger event for the IFI to invoke a *wa'd*<sup>59</sup>.
- S 34.6 The minimum losses to be borne by the IFI arising from the incompleteness of asset under construction shall be based on the capital contribution ratio between the partners.

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<sup>57</sup> Such as mitigating circumstances which includes abandoned projects, unemployment, loss of property due to disaster & unavoidable distress situation such as deceased of a sole bread winner of family.

<sup>58</sup> In line with Guidelines on Late Payment Charges for Islamic Financial Institutions.

<sup>59</sup> In line with SAC resolution 64<sup>th</sup> and 65<sup>th</sup> meeting dated 18<sup>th</sup> January 2007 and 30<sup>th</sup> January 2007 respectively which states that application of *wa'd* shall be applied fairly without denying the profit and loss sharing element amongst the contracting parties.

## APPENDICES

### Appendix 1 Legitimacy of *musyarakah*

1. The legitimacy of the *musyarakah* 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 *Musyarakah*.

(a) فَإِنْ كَانُوا أَكْثَرَ مِنْ تِلْكَ فَهُمْ شُرَكَاءُ فِي التُّرْثِ مِنْ بَعْدِ وَصِيَّةٍ يُوصَىٰ 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)."*<sup>60</sup>

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 مِنَ الْخُلَطَاءِ لَيَبْغِي بَعْضُهُمْ عَلَىٰ بَعْضٍ إِلَّا الَّذِينَ آمَنُوا وَعَمِلُوا الصَّالِحَاتِ وَقَلِيلٌ مَا هُمْ

*"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."*<sup>61</sup>

The verse reminds the partners to bind themselves to ethical value dealing with each other. This indirectly indicates the acknowledgement of the *Qur'an* in partnership.

<sup>60</sup> *Surah an-Nisaa', verse 12.*

<sup>61</sup> *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 s.w.t, 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."<sup>62</sup>

4. عن عثمان يعني ابن الأسود قال أخبرني سليمان بن أبي مسلم قال سألت أبا المنهال عن الصرف يدا بيد فقال اشتريت أنا وشريك لي شيئاً يدا بيد ونسيئة فجاءنا البراء بن عازب فسألناه فقال فعلت أنا وشريكي زيد بن أرقم وسألنا النبي صلى الله عليه وسلم عن ذلك فقال: " ما كان يدا بيد فخذوه وما كان نسيئة فذروه".

Narrated by Usman who is meant Ibn Al-Aswad said: 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."<sup>63</sup>

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 يداري ولا يماري".

Narrated by As-Saaib bin Abi As-Saaib, who had been a business partner of

<sup>62</sup> Abu Daud, Sunan Abi Daud, hadith no. 2936.

<sup>63</sup> Al-Bukhary, Sahih Al-Bukhary, hadith no. 2317.

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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."<sup>64</sup>

### **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 will 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."<sup>65</sup>

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<sup>64</sup> *Al-Hakim, al-Mustadrak, hadith no. 2317.*

<sup>65</sup> *Ibn al-Munzir, al-Ijma', Maktabah al-Furqan, 1999, p. 137.*



## Appendix 2 Glossary

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

<b>Terms</b>	<b>Definition</b>
Actual liquidation	The act of realising the worth or value of the assets or venture through a liquidation process based on market value.
<i>Musyarakah Mutanaqisah</i>	Diminishing partnership. Also known as <i>Musyarakah Muntahiyah Bittamlik</i> .
Fair value	A valuation, in accordance with a standard methodology that is reasonable to all parties involved in a transaction in light of all pre-existing conditions and circumstances.
Market value	The value of an asset if it was to be sold on the open market at its current market price.
<i>Al-tandid al-haqiqi</i>	Actual valuation which is a valuation based on actual value of assets.
<i>Al-tandid al-hukmi</i>	Constructive valuation which is a valuation based on the fair value of assets.

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### Appendix 3 Related Shariah rulings and and policy documents

1. Shariah Advisory Council (SAC) rulings published by the Bank<sup>66</sup>;
2. Shariah Governance Framework for Islamic Financial Institutions;
3. Guidelines on Corporate Governance for Licensed Islamic Bank;
4. Guidelines on Corporate Governance for Development Financial Institutions;
5. Capital Adequacy Framework for Islamic Banks (Capital Components);
6. Investment Account;
7. Guidelines on Property Development and Property Investment Activities by Islamic Banks;
8. Guidelines on Investment in Shares, Interest-in- Shares and Collective Investment Schemes for Islamic Banks;
9. Single Counterparty Exposure Limit for Islamic Banking Institutions;
10. Guidelines on Product Transparency and Disclosure;
11. Guidelines on Ibra' (Rebate) for Sale-based Financing;
12. Guidelines on Late Payment Charges for Islamic Financial Institutions;
13. Guidelines on Financial Reporting for Islamic Banking Institutions;
14. Guidelines on Financial Reporting for Development Financial Institutions;
15. Capital Adequacy Framework for Islamic Banks – Disclosure Requirements (Pillar 3); and
16. Applicable Malaysian Financial Reporting Standards (MFRS).

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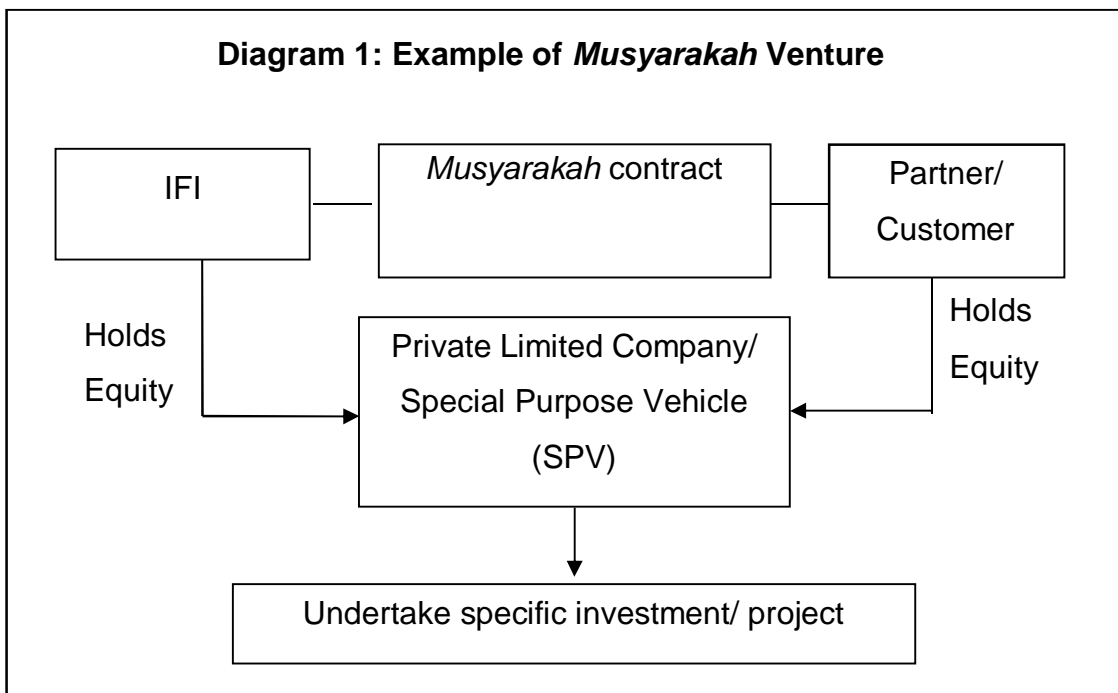
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<sup>66</sup> Including Shariah resolutions in Islamic Finance, standards, circulars or any directive pertaining to Shariah matters issued by the Bank.

#### Appendix 4 Structures of *musyarakah* venture & financing

This appendix provides examples of the structures of *musyarakah* contracts. The examples are non-exhaustive and should not be construed as the only structures available.

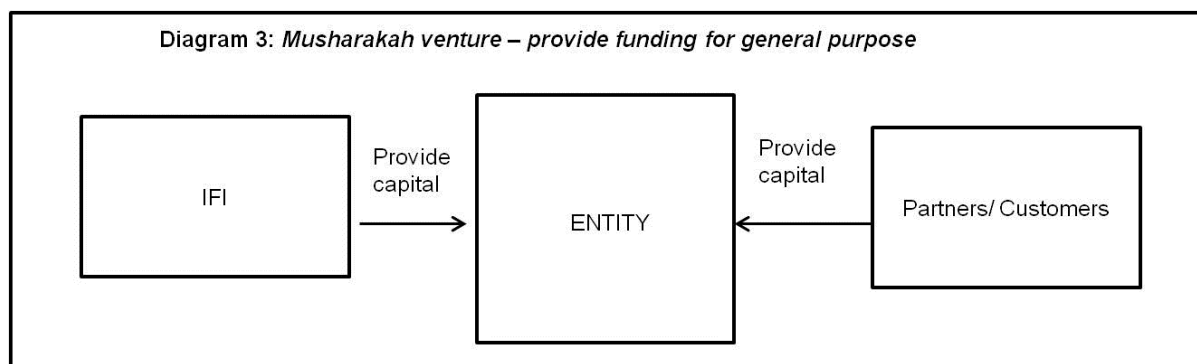
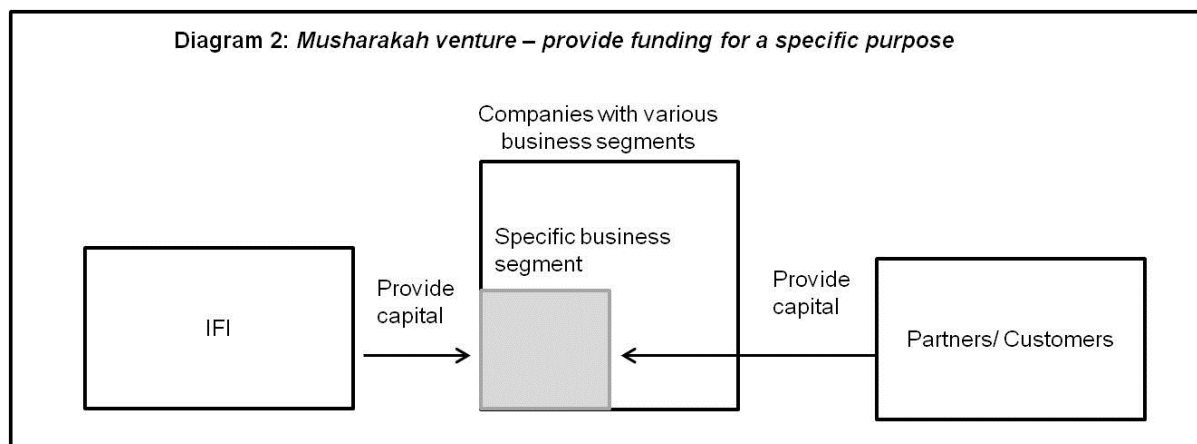
##### ***Musyarakah* venture (Provision of capital via acquisition of ordinary shares)**



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### **Musyarakah venture (Provision of capital other than via acquisition of ordinary shares)**

1. The structure of the *musyarakah* venture (by providing capital via cash) are exemplified by the following diagram:

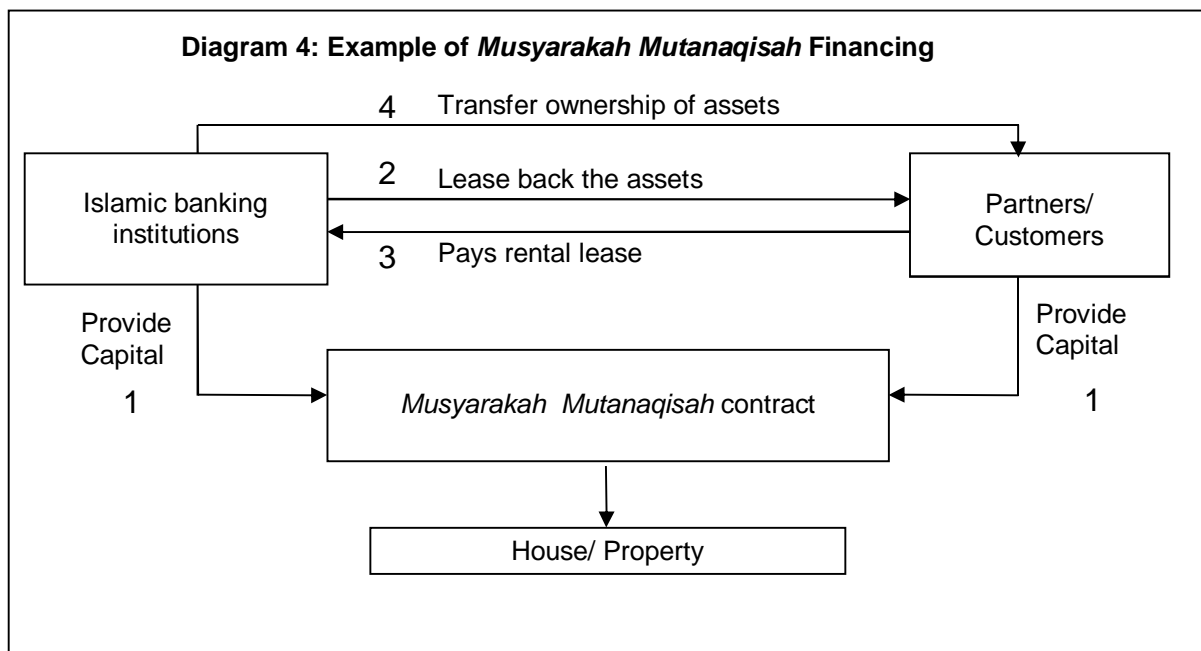


### **Musyarakah Financing**

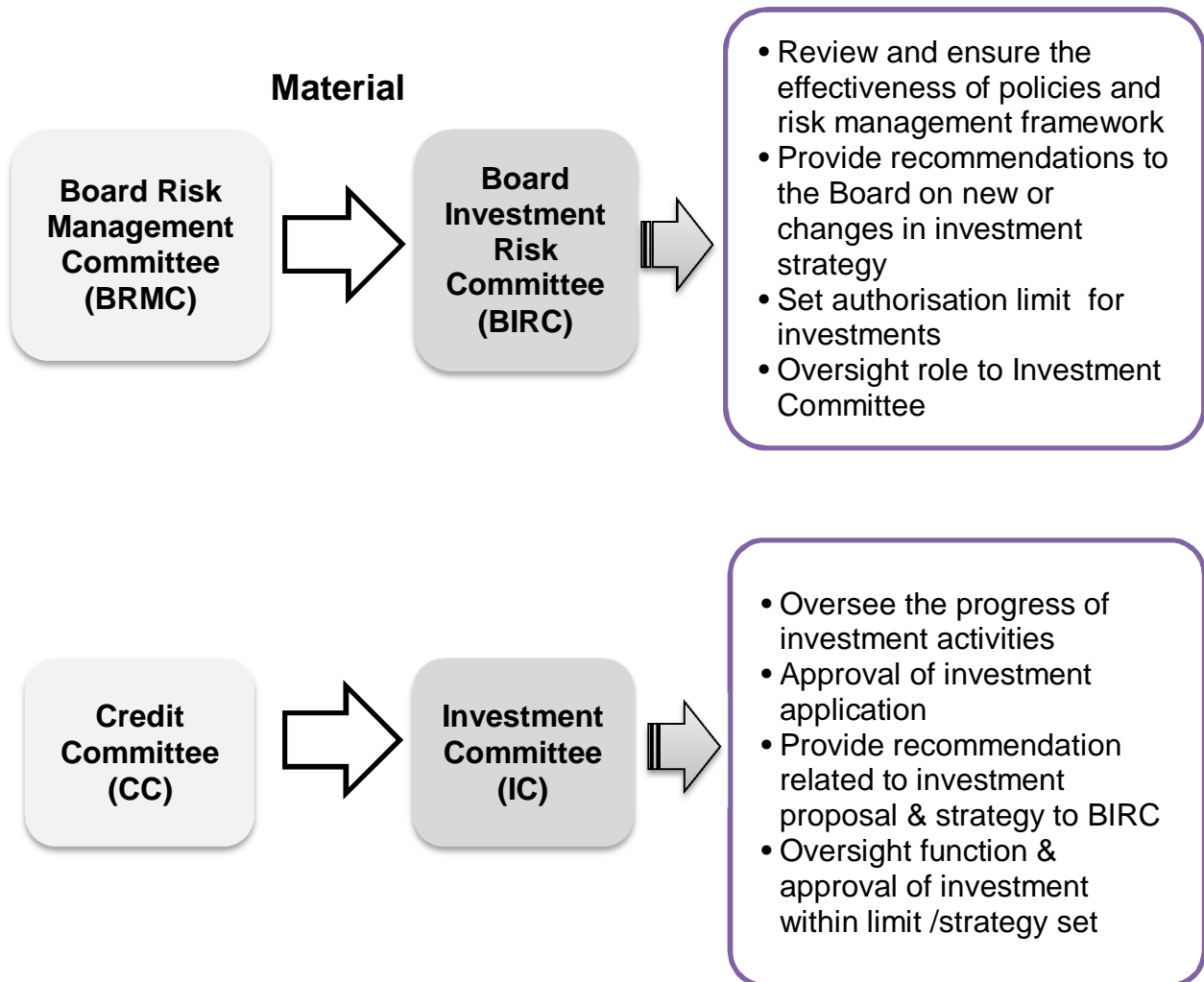
2. One of the prevalent *musyarakah* financing in the market is through *Musyarakah Mutanaqisah*<sup>67</sup>, where the customer and the IFI jointly acquire and own the asset. The customer, as a partner/joint-owner/lessee, promises to gradually acquire the IFI's ownership in the property. The IFI shall 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 been completed.

<sup>67</sup> Also known as *diminishing partnership*.

3. In *musyarakah mutanaqisah* home or property financing, the customer and the IFI jointly acquire and own the property. The IFI then leases its share of the property to the customer on the basis of *ijarah* (lease). The customer, as an owner-tenant, promises to acquire gradually 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 rental 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* term and upon payment of all lease rentals, the customer would have acquired all the IFI's share in the property and the partnership will come to an end with the customer being the sole owner of the house.
4. The following diagram illustrates an example of home or property financing under *musyarakah mutanaqisah* financing:

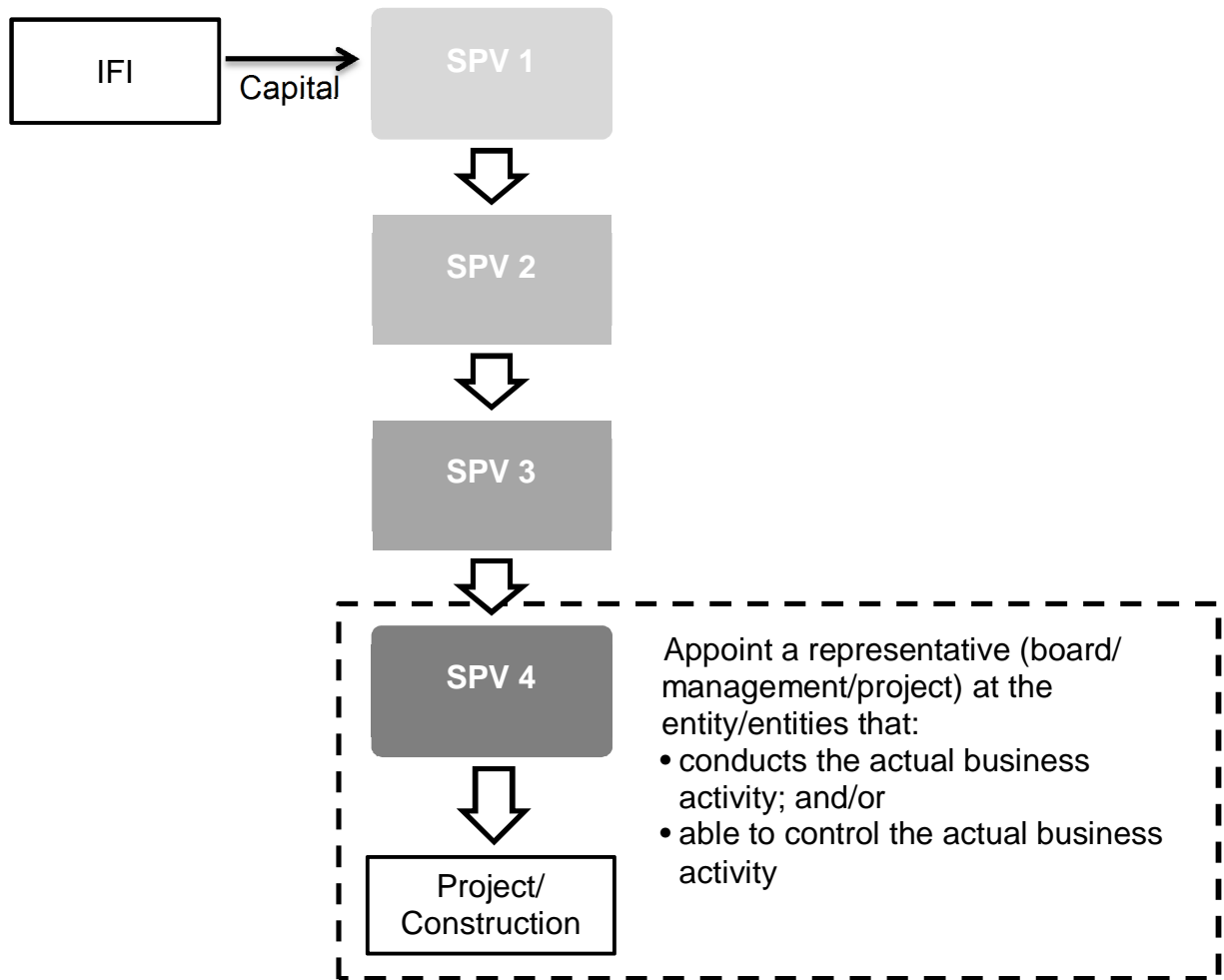


## Appendix 5 Dedicated structure



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### Appendix 6 An example of a complex structure in *musyarakah* venture



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## Appendix 7 Prudential limits and requirements<sup>68</sup> based on sources of funds

Sources of Funds	Policy Document	Guidelines on Property Development and Property Investment Activities by Islamic Banks		Guidelines on Investment in Shares, Interest-in- Shares and Collective Investment Schemes for Islamic Banks	Single Counterparty Exposure Limit (SCEL) for Islamic Banking Institutions
	Requirements	Use of General Investment Account (GIA) is limited up to 15% of total GIA fund of IFI for funding real estate business	Permissible structure to conduct <i>musyarakah</i> venture in Appendix 1 <ul style="list-style-type: none"> <li>• Must be &lt;50% ownership of venture or equity participation with reputable property development company</li> </ul>	Investment in each real estate business shall not exceed 25% of IFI's total capital <sup>69</sup>	<ul style="list-style-type: none"> <li>• Aggregate book value of investment in shares, interest-in-shares, CIS and immovable properties shall not exceed 50% of IFI's total capital<sup>69</sup></li> <li>• Aggregate book value of investment in shares &amp; interest-in-shares shall not exceed 25% of IFI's total capital<sup>69</sup></li> </ul>
RA	Not applicable	Exempted <sup>70</sup>	Exempted	Exempted	Excluded from SCEL
UA	Applicable	Applicable	Applicable	Exempted	Excluded from SCEL
Shareholders' fund	Not applicable	Applicable	Applicable	Applicable	Included in SCEL

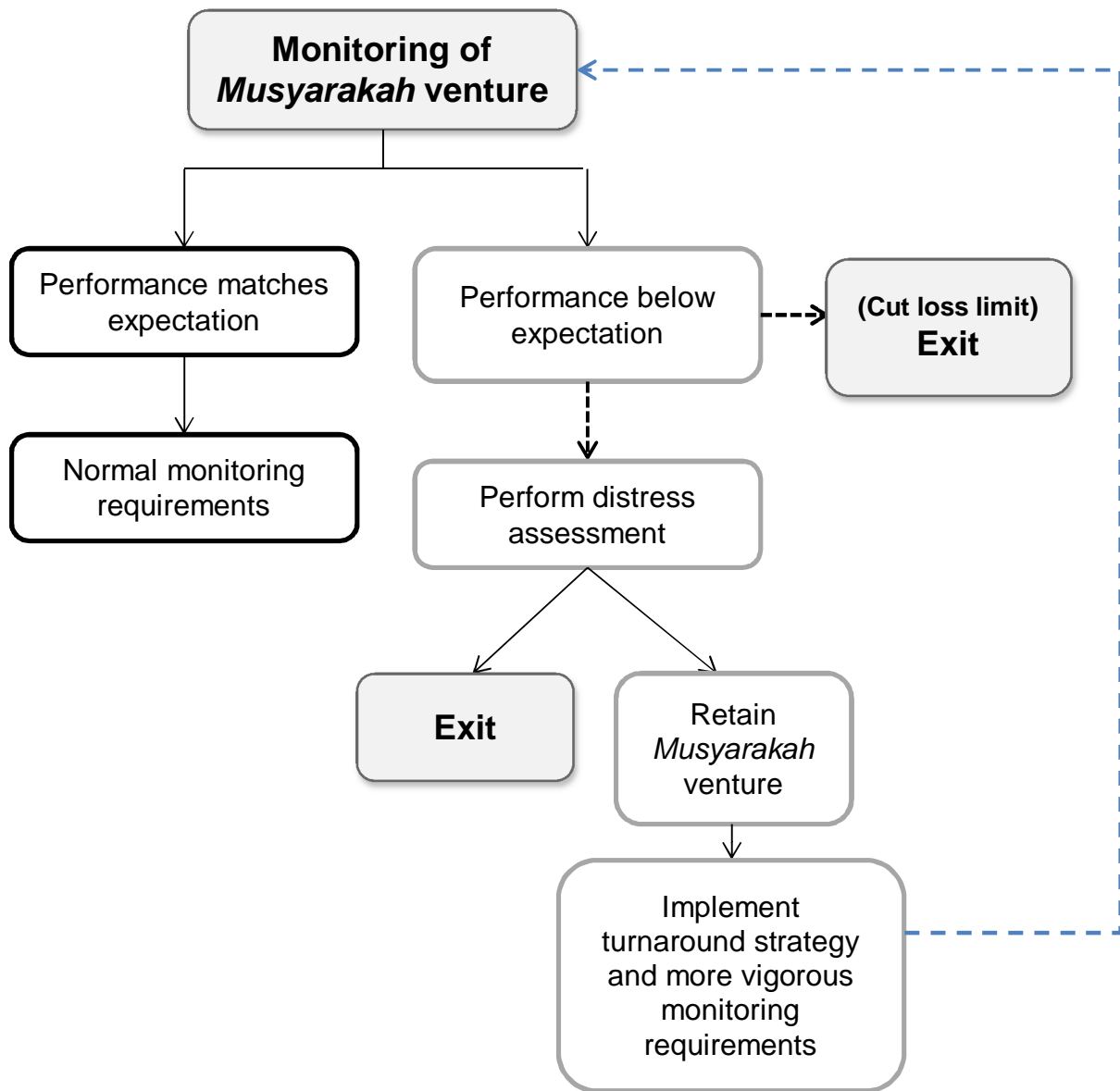
<sup>68</sup> Subject to changes in respective policy documents.

<sup>69</sup> Total capital as per defined in the Capital Adequacy Framework for Islamic Banks (Capital Components).

<sup>70</sup> RA funds which are off-balance sheet.



### Appendix 8 Distress assessment process flow



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**Appendix 9 Illustration of additional financial disclosure for *musyarakah* venture**

**Notes to Account**

**Amount funded by:**

Unrestricted Investment Accounts (UA)	x
Restricted Investment Accounts (RA)	x
Shareholders' Fund	x
	xxx
	xxx

**Musyarakah**

<b>Sector</b>	<b>Initial capital (RM'000)</b>	<b>Losses/Impairment Provisions (RM'000)</b>	<b>Amount as at 31 Dec 20XX (RM'000)</b>
Property	xxx	xxx	xxx
Manufacturing	xxx	xxx	xxx
<b>Total</b>	xxx	xxx	xxx

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