



BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

**DRAFT OF SHARIAH PARAMETER
REFERENCE 4: MUSHARAKAH CONTRACT**

(SPR4)

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SECTION ONE: BACKGROUND AND PREAMBLE

1. *Musharakah* is a form of partnership which is based on profit and loss sharing. In early literature of Islamic jurisprudence, the term *Musharakah* was referred to as *Shirkah* or partnership.
2. *Musharakah* has been practised before the Prophet Muhammad's *Sallallahu `Alaihi Wasallam* (SAW) first revelation and since then, the practice of *Musharakah* has been assimilated as part of Islamic jurisprudence by virtue of *Sunnah* of the Prophet Muhammad (SAW).
3. *Shirkah* primarily comprises *Shirkah al-Aqad* (commercial partnership) and *Shirkah al-Milk* (joint-ownership). *Shirkah al-Aqad* refers to partnership with commercial objective, whereas, *Shirkah al-Milk* refers to joint-ownership in a particular asset.
4. Modern application of *Musharakah* may take the form of *Musharakah* investment or *Musharakah* financing, as the case may be.
5. Examples of *Musharakah* financing are structuring project financing, syndicated financing, asset financing, working capital financing, contract financing, trade financing and structured products based on securitization such as sukuk. One of the common *Musharakah* applications in asset financing is *Musharakah Mutanaqisah* (diminishing partnership).
6. *Musharakah* may also be applied to acquire a stake in another entity in the form of *Musharakah* investment.

Shirkah is the origin of Musharakah and it is applicable in both Musharakah financing and Musharakah investment.

SECTION TWO: PURPOSE AND SCOPE

7. The purpose of this Shariah parameter for *Musharakah* is to provide a reference on the nature and features of the contract to the Islamic financial services industry, for the various financial instruments including *Musharakah* financing, *Musharakah* investment and *Musharakah Mutanaqisah*. This parameter is endorsed by the Shariah Advisory Council of Bank Negara Malaysia (Central Bank of Malaysia). Specific definition and guidelines on the basis of legitimacy in adopting the *Musharakah* contract are described to facilitate the understanding of the Shariah contract requirements. The features identified in this parameter shall serve to assist the Islamic financial services industry to identify, understand, apply and distinguish the contract from other contracts prevalent in the industry.
8. The features identified and described in this parameter are extracted from the text of fatwas opined by Shariah boards or committees of financial authorities and financial institutions. For each of the *fatwa*, on a particular conditionality, activity, situation or context relating to the contract, the underlying concepts and principles were deduced and synthesized to guide the development of the Shariah parameter.
9. The features outlined in this parameter may serve as general guidance for the application of *Musharakah* contract. Any practice by the Islamic financial institutions (IFIs) which are not specified in the parameter may be conducted as long as it does not contradict the features outlined in the parameter.
10. This parameter also takes into consideration pertinent mechanisms and contracts such as *Ijarah*, *Wa'd*, *Wakalah*, *Kafalah* and *Rahn* where relevant. These are identified as secondary features mentioned in this parameter.
11. The scope of the parameter is confined to the *Musharakah* contract as endorsed by the Shariah Advisory Council of Bank Negara Malaysia

and adopted by the Islamic financial institutions under the purview of Bank Negara Malaysia.

SECTION THREE: DEFINITION

12. '*Musharakah*' is an Arabic word which literally means sharing. The origin of *Musharakah* is *Shirkah* which connotes engagement of two or more parties who have a common interest to form a partnership.
13. Technically, *Musharakah* is a contract between the partners to contribute capital to an enterprise or a venture, whether existing or new, or to owner of a real estate or moveable asset, either on a temporary or permanent basis. Profits generated by that venture or real estate or asset are shared in accordance with the terms of the *Musharakah* agreement, while losses are shared in proportion to each partner's share of capital.

Musharakah is a joint capital contribution by a number of parties to share in the profit and loss

SECTION FOUR: LEGITIMACY OF *MUSHARAKAH* CONTRACT

14. The legitimacy of the *Musharakah* contract is based on the *Qur'an*, the *Sunnah* of the Prophet Muhammad (SAW) and the consensus of Muslim jurists

Basis of legitimacy

4.1 THE QUR'AN

15. The following *Qur'anic* verses generally indicate the validity of *Musharakah*.

The concept of partnership in the Quran

- i. "...but if more than two, they share in a third..." (Al-Nisa':12)

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.

- ii. "Verily many are the partners (in business) who wrong each

other except those who believe and work deeds of righteousness and how few of them....” (Al-Sad: 24)

4.2 THE SUNNAH OF THE PROPHET MUHAMMAD (SAW)

The Narration of Abu Hurayrah

16. Abu Hurayrah said that: The Prophet SAW said: Allah says: I am the third [partner] of the two partners as long as they do not betray each other. When one of them betrays the other, I depart from them”. (Sunan Abu Daud)

The concept of partnership in the Sunnah

The Narration of Abu al-Minhal

17. Abu al-Minhal narrated that Zayd Ibn Arqam and al-Barra’ Ibn ‘Azib were partners, and they bought silver in cash and credit. Their practices were brought to the Prophet SAW, and the Prophet SAW pronounced that what was bought on cash then they could benefit from it and what was bought on credit then they should reject it.” (Musnad Ahmad)

It is learned from the narration that Prophet Muhammad SAW approved the partnership formed between Zayd Ibn Arqam and al-Barra’ Ibn ‘Azib but disapproved their venture into business activity of purchasing silver on credit.

4.3 THE CONSENSUS OF THE MUSLIM JURISTS

18. This type of partnership has been practised throughout the history of Muslims without objection from the jurists.
19. 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 co-mingles the

Permissibility of partnership by consensus of muslim jurist

two capitals to form a single property which is indistinguishable, and they would sell and buy what they see as (beneficial) for the business, and the surplus will be distributed between them whilst the deficit will be borne together by them, and when they really carry out [as prescribed], the partnership is valid.”

SECTION FIVE: FEATURES OF MUSHARAKAH CONTRACT

20. The essential features attributable to a *Musharakah* contract are capital, management, profit sharing, loss sharing and a joint venture.

5.1 CAPITAL CONTRIBUTION BY ALL PARTNERS

21. The essential conditions of a valid *Musharakah* capital are as follows:-

Joint contribution of capital

- i. *Musharakah* capital shall be readily available;
- ii. *Musharakah* capital shall be contributed by all partners; and
- iii. The capital may be in the form of monetary asset such as cash or non-monetary assets that includes tangible and intangible assets.

Monetary and non-monetary assets as capital

Illustration 1: Equity Claim in the Form of Project Net Assets

A corporation seeks to obtain financing from an IFI for an expansion of its existing project. Currently, the project value is RM10 million and is partly funded by a 40% debt. The 40% debt arose from the purchase of equipment for the project. The net asset value (NAV) of the equipment is RM6 million. The corporation requested additional financing of RM6 million from the IFI. The IFI granted the request and financed the cooperation through musharakah financing. Thus, a 50% equity claim is financed by the IFI and the remaining 50% by the corporation represented by the net assets.

22. Monetary assets denominated in different currencies shall be valued based on the currency agreed by the partnership upon conclusion of the contract.

Conversion of capital in multiple currencies into a single currency

Illustration 2: Determination of Capital

An IFI has agreed to finance a project of a customer that is undertaken in a country different from the domicile of the Islamic financial institution. The customer has contributed Euro 1 million. The Islamic financial institution which is based in Malaysia has agreed to contribute RM20 million. It has been agreed that the currency of the partnership is in Euros. Therefore, RM20 million must be converted into its Euro equivalent based on the currency exchange rate on the day when the *Musharakah* contract was signed.

23. Capital in the form of non-monetary assets shall be valued based on the valuation determined by a third party which may include authoritative bodies, experts or valuers, or as agreed upon by the contracting parties at the time of conclusion of the contract.

Valuation of non-monetary capital

Illustration 3: Valuation of Non-Monetary Assets as Capital

A partner provided specialized machineries and equipment as capital. These items do not have any available market price and hence, are subject to fair value by third party experts based on objective methods of valuation, such as prospective cash flows from use and disposal of these assets. For example, If the specialized machineries can be used for the next 5 years (economic life) with lease payments of RM50,000 per annum with zero disposal value, the maximum value at zero discount rate would be RM250,000. Any discount factor added will reduce the amount further. This machinery may be accepted as capital valued at RM250,000.

24. All forms of debts shall not qualify as *Musharakah* capital. All account receivables and payment due from other partner or third parties are considered as debt.

Receivables as capital

25. Notwithstanding paragraph 24, a non-monetary asset with an integral debt component to the asset may be contributed as a *Musharakah* capital provided that the integral debt is less than 50% of the asset value.

Illustration 4: Assets Including Debt as Musharakah Capital

A partner whose building and land is part funded by 30% debt may be contributed as capital to the Musharakah partnership although debt cannot be contributed as capital. In this case, the debt is an integral component and not separable part of the asset. Hence the non-monetary asset with an associated debt may be contributed as capital.

26. Funds placed with the IFI in the form of deposits may be invested as capital in a *Musharakah* contract. *Deposit as capital*
27. The total amount of capital to be contributed by each partner shall be determined up front. The agreed capital may be contributed in one lump sum or on staggered basis. *Delivery of capital*
28. Notwithstanding paragraph 27, additional capital may be injected upon mutual agreement of all partners. In this regard, the partners may agree to vary or revise the proportion of capital contribution, the profit sharing ratio or change of partners.
29. Failure to contribute capital by the capital provider as per the agreed schedule shall constitute a breach of promise according to specified terms and conditions of the contract. The partners have an option to terminate the agreement or may agree to revise the agreement based on actual capital contribution. *Failure to contribute committed capital*
30. *Musharakah* capital comprising of monetary and non-monetary assets invested by each partner should be commingled representing the collective rights of each partner. *Mixture or commingling of capital*

31. Once contributed as capital, the rights, obligation and liabilities of all assets contributed to the *Musharakah* venture shall be jointly and severally assumed by partners. *Total mixture and no identification of capital*
32. The capital invested shall not be guaranteed by any of the partners. *Capital guarantee by the partner*
33. Any of the partners acting as agents of each other shall be liable for misconduct or negligence to the partnership as a whole. *Liability of the partner(s)*
34. Any partner acting on his own or as agent who has caused the loss of capital due to misconduct or negligence shall be liable to refund the loss of capital to the other partners. *Partner's liability due to negligence*
35. Any loss of capital in the course of the venture shall be recognized as capital impairment. *Capital impairment*

Illustration 5: Impact of Capital Impairment

An Islamic financial institution invested in a two year project valued at RM100,000 by providing 70% of the capital based on the *Musharakah* contract. At the end of the first year, the project value declined by 20% resulting in capital loss of RM20,000. The impairment loss of the project investment incurred by IFI is RM14,000 ($0.2 \times \text{RM}70,000$). Since the project remains viable, the loss is carried forward to the next period at net asset value of RM80,000. In subsequent period, performance is measured based on the outstanding capital. On the other hand, if the project is abandoned leading to the termination of the *Musharakah* contract, the IFI claims should be only RM56,000 ($0.7 \times \text{RM}80,000$).

36. Upon termination of the partnership, capital impairment loss shall be borne by the partners proportionate to capital contribution. *Capital Impairment loss*
37. A share of a *Musharakah* capital may be transferred to existing partners or a third party according to the existing terms and conditions of the *Musharakah* contract. *Transfer of share to other investors (Takharuj)*

38. The *Musharakah* agreement may impose a condition that compels a partner to offer the redemption of the partner's share of capital to existing partners based on certain agreed terms and conditions. *Right of Pre-emption*

Illustration 6: Right of Pre-Emption of Partner to Maintain Shareholding

Two *Musharakah* partners involving an IFI and a customer contributed 50% capital respectively and the ratio is maintained throughout the investment period. It is provided in the agreement that either party may exit or invite new partners subject to the consent of both parties. In either case the remaining partner will have the right of pre-emption to increase or maintain the share. During the period, the IFI decides to reduce its share to 20% and the customer has the right to increase to 80% or allow a third party to acquire the remaining 30% share.

39. New partners may enter the *Musharakah* during the tenure of the existing contract subject to the agreement of existing partners. *Admission of new partner*
40. Any gain or loss in the value of capital from the transfer of share capital shall be enjoyed or borne by the partner that disposes of the shares. *Capital gain or capital loss*
41. Any realized losses arising from the conduct of *Musharakah* during the period shall be borne by each partner proportionate to equity share of each partner. *Loss proportionate to a partner's capital contribution at the time of loss*

5.2 MANAGEMENT OF MUSHARAKAH VENTURE

42. *Musharakah* venture may be managed in the following manner:- *Management of the partnership*
- i. Management by all partners; or
 - ii. Management by certain partners or single partner; or
 - iii. Management by a third party.

In the case of 42 (ii) and 42(iii), the non-managing partners shall not act on behalf of the partnership.

43. A managing partner(s) may be entitled to an agreed remuneration for their services as the manager in addition to their share in profit sharing as a partner. Alternatively, the agreed remuneration may also be in the form of a greater profit sharing ratio.

Entitlement to management fees

Illustration 7: Appointment of Partner as Manager

An IFI and a customer jointly finance 80:20 capital contribution in a project based on *Musharakah* contract. In addition the IFI appoints the customer/partner as professional manager on a fee based arrangement to manage the project. Profits to be shared are after deducting the fees paid to the customer/partner who provides management services.

44. Pursuant to paragraph 42 (iii), the *Musharakah* venture may appoint a third party to manage the venture based on relevant contract such as *Wakalah*, *Ujrah* or *Mudarabah* contract.

Illustration 8: Engagement of Professional Manager at a fee

An IFI and a customer of the bank jointly finance 80:20 capital contribution in a project based on *Musharakah* contract. The partners then engage a professional manager on a fee based arrangement to manage the project. Profits to be shared are after deducting the fees paid to the professional manager.

45. Non-managing partners may waive their voting rights relating to the management of *Musharakah* and this shall be specified in the contract.
46. The managing partner(s) as an agent shall be liable for any loss caused by his negligence or misconduct or breach of management contract.

Waiver of executive and voting rights

Liability of the managing partner in the case of negligence and misconduct

5.3 PROFIT SHARING RIGHTS

47. Profit shall be measured as an amount exceeding capital after deducting the cost and expenses attributable to *Musharakah* venture. *Profit measurement*
48. In cases where the *Musharakah* is specified and meant for a specified project or activities, only expenses that can be identified by the partners or deemed direct expenses to the project may be deductible. *Deductions of direct expenses in specified Musharakah*
49. The profit sharing ratio may either be proportionate to the capital contribution or be based on a ratio or percentage which is agreed upon by all partners irrespective of their capital contribution.

Illustration 9: Profit Sharing Ratio Basis

'A' and 'B' contributed RM20,000 and RM80,000 respectively to form a *Musharakah* partnership. While B has decided not to take part in the management of the business venture, A has committed to managing the business of the partnership. According to the first provision, the profit sharing ratio between A and B should be 20:80 or 1/5 and 4/5 respectively. The ratio could be of any ratio such as 80:20 or 50:50 or any other arrangement as agreed upon by both parties.

50. It is not permissible to include a condition in *Musharakah* contract that stipulates a pre-determined fixed amount of profit to one partner which deprives the profit share of the other partner. *Fixed amount profit not permissible*

Illustration 10: Fixed payment to Musharakah Partner

A partner who contributed RM1 million of capital to an RM5 million *Musharakah* venture specifies that RM100,000 per annum or 10% returns on capital shall be distributed to the partner. Such a pre-determined fixed payment will disadvantage the other partner as it does not conform to the profit distribution principle. It may also deprive another partner his profit share if the total profit does not exceed RM100,000 or 10% of capital.

51. Notwithstanding paragraph 50 and subject to certain conditions, a lump sum amount or fixed amount of profit may be permissible if it does not deprive the other partner from benefiting from, and sharing the profit.

Profit in the form of lump sum

Illustration 11: Target Performance for Musharakah Partner

A and B have agreed that the profit sharing ratio between them is 50:50 in all cases except where the profit realized is more than a certain agreed upon benchmark. For example, it was agreed that if the profit exceed RM500,000, which is the benchmark, A will have the first RM200,000 and the remaining, will be shared according to profit sharing ratio. Effectively, both partners could share in the profit with this arrangement. If the profit is below the agreed benchmark, then a profit-sharing ratio of 50:50 will apply.

52. The profit sharing ratio may be revised either subject to the mutual consent of the partners or subject to a certain benchmark agreed upon by the partners as the case may be.
53. The profit expressed in the form of a certain percentage should not be linked to the capital amount. However, a profit sharing ratio may be ultimately translated into a fixed percentage based on the capital investment amount once profit is realized.

Revision of the profit sharing ratio

Profit pegged to capital investment

Illustration 12 : Profit Percentage as per Capital Contribution Ratio

A *Musharakah* partnership estimates a net profit of RM100,000 per year to be generated. The capital investment contributed by both partners was based on a ratio of 50:50 amounting to RM1 million. The profit sharing ratio is 50:50. The expected annual profit distribution to both partners is RM50,000 or 5% of capital. The expression of profit in a form of percentage (in this case 5% of capital) is permissible because the 5% profit expressed is a reflection of the 50:50 profit sharing ratio given that expected profit is RM100,000 annually. Any profit that varies from RM100,000 is to be shared at 50:50. However the percentage as return on capital will vary accordingly. It is not permissible to express profit in a *musharakah*, in a form of percentage of capital only, that connotes a payment of fixed profit regardless of the actual profit realized.

54. A partner who has agreed to a certain profit sharing ratio may waive the rights to profits to be given to another partner on the basis of *Tanazul* (waiver) at the time of profit realization and distribution as well as at the time of the contract. However, a waiver of profit that takes place at the time of contract shall be by way of unilateral promise (*wa'd*). *Waiver of profit*
55. The mechanism for estimating profit on *Musharakah* capital employed may be benchmarked to conventional benchmarks, such as but not limited to Base Lending Rate (BLR) in order to determine the indicative profit rate. *Profit estimation may be benchmarked to conventional benchmarks*
56. Profit may be distributed from actual or realized profits through the sale of assets of the *Musharakah* partnership (*al-tandhid al-haqiqi / al-fi'li*).
57. Profit distribution may also be on the basis of constructive valuation (*al-tandhid al-hukmi*) on the assets including accounts receivables.

58. In the case of constructive valuation based on market valuation or a third party verification, the unrealized profit shall be recorded as a reserve. *Treatment of unrealised profit as reserve*

Illustration 13: Revaluation Reserve for Unrealized Profit

Assets of a *Musharakah* partnership are re-valued at fair value. Any increase in the net asset value is recorded as a revaluation reserve to be realized upon the sale of the business. A trade asset of the *Musharakah* partnership with a recorded net book value of RM100,000 is re-valued at fair value for RM120,000. Hence, the RM20,000 increase in value is recorded as a revaluation reserve to be realized upon the sale of the business.

59. Any allocation of funds to any partner prior to actual profit realisation shall be rationalized at a later stage. The partners shall then reimburse the amount they have received in excess of the rationalised profit, if applicable. *Rationalisation of allocation of funds to partners prior to actual profit realisation*
60. During the *Musharakah* contract period, the partners may mutually agree to set aside a portion of the profit as a reserve or for any other purpose specified and mutually agreed by the partners. *Profit set aside as reserves*
61. If the reserve fund is distributable to the partners, equitable claims by the partners shall be specified.

Illustration 14: Distributable Reserve as Per Profit Sharing Ratio

An IFI set aside 20% of distributable profit of RM500,000 earned from mobilization *Musharakah* funds in a reserve according to the profit distribution ratio of 60:40 between the investor and IFI. At the end of the period, the distributable profit considered as reserves for the investors and IFI are RM60,000 and RM40,000 respectively.

62. Partner(s) in *Musharakah*, shall not fully or partially guarantee the principal and profit of another partner(s). *Profit guarantee*

63. A third party who is not related to any party in the *Musharakah* in terms of equity ownership and management control may guarantee the profit to the *Musharakah* venture subject to certain conditions.

Illustration 15: Guaranteed Rental Income for Profit Distribution

A *Musharakah* financing agreement is signed between an IFI and property developer to build and rent a property to an identified tenant. Both partners obtained an undertaking from the prospective tenant that upon completion of the property and its availability for occupancy, the tenant will lease the property for a specified period at an agreed rental rate. Profit to be shared between the partners is based on the guaranteed rental income by the lessee for the lease agreement. This guaranteed rental by a third party is permissible.

64. Pursuant to the principle of *Tanazul* (waiver), some partners may give some preferential treatment to other partners with regard to profit distribution.
65. Any unusual investment income from Shariah prohibited activities of a *Musharakah* venture due to extenuating circumstances may be distributed to charity.

Accidental non-compliant profit

Illustration 16: Non-Compliant Activities and Disposal of Shares

Investors, through *Musharakah* participation, subscribe to an investment fund that invests in a portfolio of several large companies. During the investment period one of the companies shifted its core business to non-Shariah compliant activities. The fund manager responded by disposing of the share investments in the company. Gains from the disposal of the share for the period of non-compliant activities are to be identified and distributed to charity.

5.4 LOSS SHARING

66. Capital loss incurs when a capital asset (investment or real estate) decreases in value. The loss is not realized until the asset is sold for a lower price than the purchase price. *Capital loss due to capital impairment, non performance or negligence*
67. Loss shall be shared on the basis of *pari-passu* among the partners and proportionate to the capital contribution. *Losses proportionate to capital contribution*
68. Preferential treatment to a particular partner over the others in the same *Musharakah* venture in absorbing the loss shall not be permissible. *No preferential treatment of losses*
69. The loss to the partners shall be limited to the capital contribution of each partner. *Losses limited to capital contributed*
70. Upon realization of loss, a partner may agree, without any prior condition, to bear the loss of another partner at the time such a loss is realized. *Agreement of a partner to bear the loss of another partner*
71. A third party may undertake to bear the loss of a partner subject to provision in paragraph 105. *Losses may be undertaken by a third party*
72. The loss due to misconduct, negligence and breach of terms and conditions by a managing partner shall be borne entirely by that partner. *Liability of losses due to negligence*

5.5 PARTNERSHIP VENTURE

73. Business ventures of *Musharakah* shall be Shariah compliant and may be conducted in various sectors such as trading, plantation, construction, manufacturing, investment and services. *Business venture must be Shariah compliant*
74. A *Musharakah* contract may be adopted for non-commercial activities which are non-profit oriented. *Musharakah for non-profit ventures*

75. Pre-contracting costs incurred to conclude *Musharakah* contract such as the conduct of technical and feasibility studies of the financial viability of the *Musharakah* venture by the IFI may be charged to the customer subject to the latter's consent. *Feasibility study fee for Musharakah business venture*

5.6 SPECIFIC FEATURES OF MUSHARAKAH MUTANAQISAH

76. *Musharakah Mutanaqisah* (Diminishing *Musharakah*) technically is a partnership contract between two or more parties on a particular asset or venture which allows one of the partners to gradually acquire the shareholding of the other partner through an agreed redemption method during the tenure of the contract.
77. An IFI may request its customer to give a binding promise (*wa'd*) to the IFI to purchase the *Musharakah* asset or IFI's share either on a lump sum basis or gradually over an agreed period of time at market value or at a fair value or at any price to be agreed by the parties.
78. The execution of the promise shall not violate the element of profit and loss sharing in the *Musharakah Mutanaqisah* contract. *No- violation of profit and loss sharing features through Wa'd*

Illustration 17: Profit and Loss Sharing

ABC Islamic Bank has entered into a *Musharakah* agreement with Customer Y to purchase a shophouse leased to a textile company. ABC Islamic Bank will provide 90% of the funds to purchase the *Musharakah* asset, while Customer Y will contribute the balance 10%. Both parties have agreed that profits and losses will be shared according to the capital contributed. Customer Y has also promised to gradually buy over ABC Islamic Bank's share in the *Musharakah* partnership at market value, at 10% per year commencing from the first anniversary of the *Musharakah* agreement, over a period of 10 years. Should the lease income for the third year amounts to RM100,000, Customer Y's share of the lease income is RM30,000.

79. The transfer of *Musharakah* asset or share to the other party in a diminishing *Musharakah* may be executed in a single payment or on staggered basis. *Transfer of ownership right (share) between two partners*
80. Transfer of *Musharakah* asset may be made by way of conditional gift upon the full payment of the rental obligation.
81. In the event of a customer's default to acquire the *Musharakah* asset or IFI's share as stipulated in paragraph 80, the IFI may terminate the *Musharakah* contract and proceed with recovery action. *Termination of a Musharakah contract due to a customer's failure to redeem IFI's share*
82. In relation to paragraph 82, the IFI may recover its capital from the proceeds of disposal of the jointly owned asset to a third party. *Recovery from the proceeds of the disposal of the partnership asset*
83. Should the proceeds from the disposal be insufficient to cover the capital loss, the IFI may have recourse to the customer for the outstanding balance. In the case where the customer is insolvent, the IFI shall bear the loss of capital.
84. In the event of a surplus from the disposal of the proceeds, the surplus shall be distributed between the partners according to their respective ownership share. *Sharing in surplus of the disposal proceeds*

5.7 ENHANCED FEATURES OF MUSHARAKAH CONTRACT

Origination and Execution of Musharakah Agreement

85. A valid *Musharakah* contract shall be concluded by an offer and acceptance between the partners and may be expressed by way of suitable documentation. *Conclusion of contract by offer and acceptance*
86. A party to a *Musharakah* contract shall conclude the contract personally or through an agent. *Conclusion of Musharakah contract by a trustee*

87. A party to a *Musharakah* contract shall have the legal capacity to enter into a contract and provided that he is not restricted by any law. *Legal capacity to enter into a Musharakah contract*
88. Upon the disbursement of the capital by the *Musharakah* partners, all partners' rights to the profit and liability to losses are established. *Establishment of right to profit and loss*

Illustration 18: Drawdown of Musharakah Facility

A customer applies for *Musharakah* financing and the IFI reviews the application for approval. Upon meeting the relevant assessment criteria, the IFI issues a letter of approval for the *Musharakah* financing facility or *Musharakah* investment as the case may be. The facility is a drawdown facility with a defined period of financing. At the point of granting the facility, the agreement is concluded between the IFI and the customer. When the first disbursement is made, the agreement is effected and risk exposure of IFI capital commences.

89. Any term or condition mutually agreed upon which does not contravene Shariah shall be binding on the partners. *Binding terms*

Termination and Dissolution of *Musharakah* Agreement

90. Partners may mutually agree to terminate the contract at any time unless stated otherwise in the *Musharakah* agreement. *Mutual agreement for termination*
91. Upon termination of *Musharakah* agreement, a partner may elect to acquire the entire asset of the *Musharakah* partnership. *Outstanding capital as debt upon liquidation*
92. The acquisition by one partner of the other partner's entire asset may be satisfied as a debt due to the other partner, after taking into consideration the liabilities and determining profit and loss.

Illustration 19: Outstanding Capital and Profit Due from Partner

Musharakah financing is provided by IFI for a specific project which is identified by the customer for a period of three years. During the first year losses incurred are carried forward to the second year. At the end of the second year the project reported net profit. The partners mutually agreed to terminate the contract where the customer agreed to purchase the IFI share. Subsequently, due to poor cash flow management, the value of IFI's share and profit after fulfilment of liabilities became debt due from customer/partner.

93. A *Musharakah* contract shall be terminated upon expiration of specified tenure of the contract, even though the venture is still in progress unless the partners mutually agree to extend the partnership. *Termination due to expiry of tenor*
94. Parties to a *Musharakah* contract may agree to end the partnership upon completion of business venture. *Termination due to completion of business venture*
95. A *Musharakah* contract may be terminated if a considerable portion of the capital is impaired, subject to terms and conditions. Such impairment may arise from losses due to extenuating circumstances that hinder the partnership to continue for the remaining period or from being on going concern. *Termination due to impairment of capital may lead to termination*
96. The demise or bankruptcy of one of the partners shall terminate the *Musharakah* contract. However, the partners may agree to continue with the contract according to the terms in the *Musharakah* deed or agreement. *Termination due to death*

Illustration 20: Conditions for Termination of Musharakah Agreement

A *Musharakah* financing agreement between an IFI and a customer specifies that the agreement is terminated if any of the following conditions occurs:

- (a) Both partners mutually agree to terminate after determining the liabilities of each partner;
- (b) Upon demise of the customer;
- (c) Court order to terminate the *Musharakah* is obtained by IFI;
- (d) Significant loss of capital that incapacitates the partnership;
- (e) Insolvency or bankruptcy of the customer; and
- (f) Violation of conditions in the agreement by any partner.

In the event that any of these conditions are met, both partners need to settle any outstanding liabilities at the date of termination.

97. Upon the termination of the *Musharakah* contract, *Musharakah* assets shall be subjected to the liquidation process. *Liquidation of assets post termination*
98. *Musharakah* assets may be liquidated through actual liquidation in which the assets are disposed to the markets or third parties. The proceeds of the disposal shall then be measured against the capital to recover the capital and to distribute the profit or to record a loss accordingly. *Actual liquidation of Musharakah asset*
99. In the case of an actual liquidation, the assets shall be sold at market value and the proceeds of the sale shall be used as follows:- *Market value for actual liquidation*
- i. Payment of liquidation expenses;
 - ii. Payment of financial liabilities that are owing to the partnership; and
 - iii. Distribution of the remaining assets, if any, among the partners in proportion to their capital contribution.
100. A constructive liquidation of the partnership asset may be effected in the case where the partners agree to dissolve existing partnership and venture into another new partnership by investing the initial asset as capital in kind. *Constructive liquidation of Musharakah asset*

Illustration 21: Market value on Termination & Disposable Proceeds

Both IFI and the customer have agreed to terminate and dissolve the partnership with initial investment value at RM200,000 and market value of assets at RM1 million upon termination. Outstanding liabilities of RM600,000 to external parties need to be settled. Upon liquidation, RM400,000 is available for distribution among the partners (RM1,000,000 – RM600,000).

In the case where the outstanding liability exceeds market value of investment, for example, the liability is RM1,100,000. The loss on dissolution of the partnership is (RM1,000,000 - RM1,100,000) = (- RM100,000). Each partner shall bear the loss of RM50,000.

Amendment and Variation of Musharakah Agreement

- | | |
|---|---|
| 101. Amendments and variations to the <i>Musharakah</i> agreement may take effect at any time throughout the tenure of the contract on all issues provided such amendments and variations are mutually agreed upon by the partners. | <i>Amendment of conditions by mutual agreement</i> |
| 102. Any amendment to the loss sharing ratio which differs from the capital contribution ratio is not permissible under all circumstances. | <i>Amendment of agreement via a specified procedure.</i> |
| 103. The <i>Musharakah</i> agreement may provide that any amendment to the agreement is valid by a specified approval process such as a majority vote or a decision by the management. | <i>No amendment to loss sharing ratio proportionate to capital contribution ratio</i> |
| 104. The <i>Musharakah</i> contract may enable the partner to withdraw capital throughout the agreed period unless stated otherwise in the <i>Musharakah</i> agreement. | <i>Withdrawal of capital during the partnership tenor</i> |

Third Party Guarantee of Musharakah Capital

105. Specific conditions on third party guarantee of the capital are as follows:-

Conditions for third party guarantee

- i. The legal capacity and financial soundness of such a third party as a guarantor shall be independent from the *Musharakah* contract and partners;
- ii. The guarantee shall neither be provided in consideration for nor linked in any manner to the *Musharakah* contract;
- iii. The third party guarantor shall not hold the majority ownership of the guaranteed party; and
- iv. The guaranteed party shall not hold the majority ownership of the third party guarantor.

Illustration 22 : Separate Legal Entity

The government provides a guarantee on the capital of a *Musharakah* venture which is led and managed by XYZ in order to encourage public participation in the *Musharakah* investment. XYZ is neither a subsidiary nor a quasi-government entity. This type of guarantee is permissible and valid as the government is an independent party to XYZ entity.

SECTION SIX: GLOSSARY

Terms	Definition
Actual liquidation	The act of realizing the worth or value of the assets/venture through liquidation process based on market value
Capital impairment	Depreciation of value of capital.
Constructive liquidation	Liquidation of the asset/venture based on appraisal value system e.g. third party valuation.
<i>Musharakah</i> financing	Financing facility provided by IFIs, which is structured based on <i>Musharakah</i> contract.
<i>Musharakah</i> investment	Investment made by IFIs which fulfils the characteristics of <i>Musharakah</i> contract, whereby the IFIs participate in a business venture/company with other party(s) through share/equity holding.
Fair value	A valuation, in accordance with standard methodology, that is reasonable to all parties involved in a transaction in light of all pre-existing conditions and circumstances.
Intangible asset	An asset that can neither be seen nor touched. The most common of these are competencies, ie: market power, goodwill, patents, trademarks and copyright.
Market value	The value of an asset if it were to be sold on the open market at its current market price.
Monetary asset	Cash and cash equivalent.
<i>Pari passu</i>	Ranking equally. Eg: when a new issue of shares is said to rank <i>pari passu</i> with existing shares, the new shares carry the same dividend rights and winding-up rights as the existing shares. A <i>pari passu</i> bank loan is a new loan that ranks on level par with older loans.
<i>Takharuj</i>	Exit from partnership by selling the shares to another party at a value determined by the market forces.
<i>Tanazul</i>	Full or partial cessation of right to claim of any right.
<i>Al-tandhid al-haqiqi/fi'li</i>	Actual valuation i.e valuation based on actual value of assets.
<i>Al-tandhid al- hukmi</i>	Constructive valuation i.e valuation based on fair value of assets.

