Chapter 70
Musharakah Financing as Addressed in IFSB Standard: A Regulatory Perspective

Abdussalam Ismail Onagun

Abstract Islamic finance has continued to expand and demonstrate its resilience in the current more challenging international financial environment. However, this expansion has been confined in terms of debt-based contracts, rather than employing equity-based contracts such as a Musharakah contract. Principally Islamic finance promotes transactions that are based on profit and risk sharing through Mudarabah (partnership of work and capital) and Musharakah (joint venture) contracts, thus encouraging participatory finance and promoting participation in the risk-reward and financial results. However, statistics suggests that the industry has put more weight on the debt-financing instruments. There are several reasons and rationales put forward by the Islamic banks for the non-existence of the Musharakah contract. The majority of Islamic banks have limited themselves to low-risky trade-financing assets. This research paper analyse the Musharakah financing and reasons why Islamic banks tend to avoid such financing models from mainly two facets: Shari'ah perspective and regulatory perspective. Shari'ah perspective will highlight the main Shari'ah issues and minimum Shari'ah requirements that need to be observed while employing Musharakah contract in Islamic banks, while the regulatory perspective will underscore the significance of risk management dimension, minimum capital adequacy and Shari'ah-compliant securitisation related to Musharakah exposures. Finally the chapter concludes on the role of implementing IFSB standard in solving the risk exposure in Musharakah financing and the role of regulatory authority in implementing equity-based contract (Musharakah financing).

Keywords Regulatory authority • Trade-financing • Islamic banks • Musharakah financing • Securitisation

A.I. Onagun (✉)
University of Modern Sciences, Dubai, UAE
e-mail: i.abdussalam@ums.ae; abdussalam3@yahoo.com

R. Benlamri, M. Sparer (eds.), *Leadership, Innovation and Entrepreneurship as Driving Forces of the Global Economy*, Springer Proceedings in Business and Economics, DOI 10.1007/978-3-319-43434-6_70

Introduction

Musharakah contract is the second form of equity-based financing. Unlike Mudarabah, Musharakah requires the contribution of funds of all parties involved in the business. In modern Islamic banking practices, Musharakah is used as a mode of financing. When a client requests financing from an Islamic bank for a particular project, the bank signs a Musharakah contract with the client after studying the project. By this way, the bank becomes a partner with the client and they share the profits or losses occurred by the project. The aims and objectives of this research paper are to address the reasons why Islamic financial institutions tend to avoid profit- and loss-sharing products (*Musharakah* financing) and how the implementation of equity-based contract (*Musharakah* financing) by regulatory authority can offer solutions for this problem.

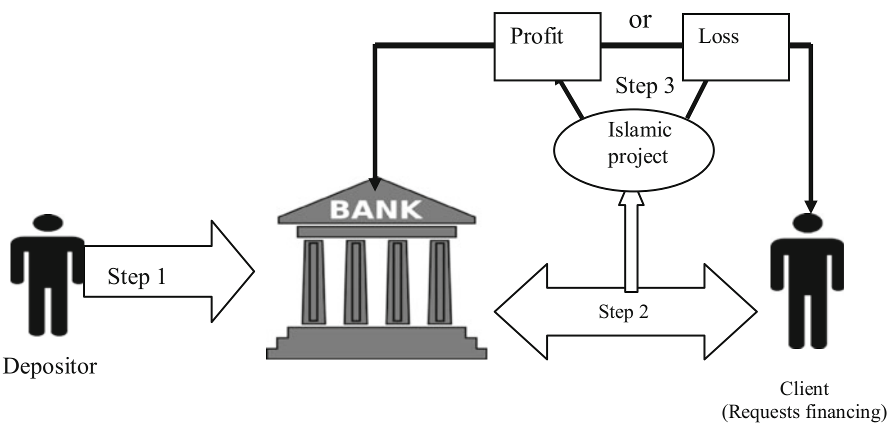
Literature Review

Definition of Musharakah

Musharakah financing which is equity-based participation is executed by Islamic banks to their clients in the form of partnership contracts where both parties share profits and losses in comparison with the conventional banks' system which are interest-based banking. Musharakah literally means sharing which is originated from an Arabic word "shirkah".

However, it technically means a form of partnership agreement between two or more parties which are the Islamic bank and its clients where they contribute their capital to a specific venture in which the profits generated are shared based on the pre-agreed terms in the Musharakah contract while the losses are shared in regard to the capital contribution ratio of each party.

The ventures that the parties contribute their capital in must be Shari'ah compliant such as trading, investments and construction. In addition, "Islamic banks use this contract on the liability side to attract deposits through investment accounts" (Ibrahim, 2012). Furthermore, the below diagram explains the process of a *Musharakah* financing in Islamic financial institutions (Tahani, 2014).



Step 1: Depositors deposit funds in the bank.

Step 2: By using Musharakah contract, the Islamic bank and its client, who requested financing for an Islamic project, mix their funds together in order to finance an agreed-upon Islamic project for a certain period of time. Both of them have the right to contribute to the management of the project.

Step 3: The Musharakah project might generate profit or suffer loss. If it generates profit, then it will belong to both parties according to the agreed-upon ratio in the Musharakah contract. But, if it suffers a loss, it will be shared in proportion to the capital contribution of each party (Tahani, 2014).

Legality of Musharakah Financing

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

The legality of Musharakah financing in the Sunnah is based on several narrations such as the narration by Abu Hurayrah that the Prophet SAW said: "I am the third (partner) of the two partners as long as they do not betray each other. When one of them betrays the other, I depart from them" (Bukhari, 1989). This Hadith is an evidence of avoiding betrayal in Musharakah financing among the partners.

Concerning the consensus of Muslim jurists, the consensus of the legality of Musharakah contract is mentioned by one of the Muslim jurists Imam Ibn al-Munzir in his book which is "And they (Muslim jurists) agree on the validity of partnership where each of the two partners contributes capital in dinar or dirham, and co-mingles the two capitals to form a single property which is indistinguishable, and they would sell and buy what they see as (beneficial) for the business, and the surplus will be distributed between them whilst the deficit will be borne together by them, and when they really carry out [as prescribed], the partnership is valid" (Tahani, 2014).

Types of Musharakah

For the purpose of determining the minimum capital adequacy requirement, IFSB-2 makes distinctions between the three main categories of *Musharakah* and provides guidance for how to apply appropriate risk weight for such investments to calculate minimum capital requirements for *Musharakah* exposure under three categories (IFSB, 2005a, 2005b) explained below:

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

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

(c) Joint ownership of real estate or movable assets (such as cars) is divided into two subcategories.

- ***Musharakah* with *Ijārah* sub-contract**: Ownership of such assets can produce rental income for the partnership, through leasing the assets to third parties by means of *Ijārah* contracts. In this case, the risk of the *Musharakah* investment is essentially that of the underlying *Ijārah* contracts, i.e. credit risk mitigated by the collateral represented by the leased assets. However, in some cases the lessee is not a third party but the IIFS's partner as customer. The existence of such an *Ijārah* sub-contract in addition to a *Musharakah* exposes the IIFS to credit risk in respect of the partner's obligation to service the lease rentals.
- ***Musharakah* with *Murābahah* sub-contract**: The Islamic bank is entitled to its share of revenue generated from selling the assets to third parties by means of *Murābahah* contracts that expose the Islamic banks to credit risk in respect of the *Murābahah* receivables from the buyer/counterparty.

Discussion and Analysis

Shari'ah *Requirements of Musharakah Financing*

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

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

- All forms of debts shall not qualify as *Musharakah* capital. All account receivables and payment due from other partner or third parties are considered as debt.
- A non-monetary asset with an integral debt component to the asset may be contributed as a *Musharakah* capital provided that the integral debt is less than 50 % of the asset value.
- The issue of funds placed with the Islamic financial institutions in the form of deposits may be invested as capital in a *Musharakah* contract.
- The rights, obligation and liabilities of all assets contributed to the Musharakah venture shall be jointly and severally assumed by partners.
- The issue of any loss of capital in the course of the venture shall be recognised as capital impairment.
- The capital of the IIFS is to be invested in *Shari'ah*-compliant investments or business activities.

(b) **Profit sharing in *Musharakah***

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

(c) **Guarantee in Musharakah contract**

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

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

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

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

Shari'ah issues		
Item	*Shari'ah* requirement	Observation
Two agreements in one	Shari'ah prohibits the combination of two agreements in one transaction that are made conditional upon each other	It is still permissible for the contracting parties to combine the two contracts of Musharakah and ijara into one document as long as both were concluded separately and do not overlap
Refinancing	The transaction may be seen as two contracts (old and new contract) in one	It is akin to having a new partner in a new partnership in the same venture/asset, albeit with different value. The first Musharakah financing must be terminated for the new Musharakah to take place
Ownership	As a partner in the ownership of the property, the financier shares the responsibility and risks arising from the said property. In an ijara relationship, the owner (lessor) has to bear the cost of basic and structural maintenance while the occupying party (customer/lessee) shall bear the routine and operational maintenance of the property	Since the customers' ultimate objective of engaging in the transactions is to own an asset, and not merely to rent it for a certain period of time, it has been arguably accepted that the customer should bear all the costs, particularly when the customer is acknowledged as the sole legal owner in the document of title
	The general principle expounds that takaful of an asset is the responsibility of the owner; however some stress that it should be at the expense of the hirer	Some Shari'ah legal opinions affirmed that it is lawful to make the hirer responsible for a known amount of insurance as it may then become part of the lease payment
Wa'ad (unilateral promise)	By virtue of the wa'ad, the customer shall be obliged to acquire the bank's ownership share in the property at the buyout amount when there are changes in circumstances resulting in illegality, even if it is not caused by the customer	In contemporary juristic opinions, wa'ad becomes legally binding if it is made conditional upon the fulfilment of an obligation and the promisee has already incurred expense on the basis of such a promise
Compensation	Some view penalties for late payment of rentals as not permissible	The AAOIFI Shari'ah Rules for ijara and ijara muntahiya bittamlik provided that the lessee shall undertake to donate a certain amount or percentage of rental due in the case where there is no good reason for late payment
		There are slight divergences in the legal documentations, while a legal documentation explicitly requires such compensation to be donated to any registered charitable organisation or utilised for any charitable purpose; the other documentation is silent in this regard

(continued)

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

Regulatory Requirements of Musharakah Financing

Risk Management

The distinct risk profile of *Musharakah* contract, which is a form of equity participation, exposes the IIFS to various types of risks, such as counterparty credit risk, market risk, liquidity risk and reputational risk. An IIFS acts as a partner in a *Musharakah* contract and is exposed to the risk of losing its capital upon making payment of its share of capital in a *Musharakah* contract. A *Musharakah* can expose the IIFS either to capital impairment risk or to "credit risk", depending on the structure and purpose of the *Musharakah* and the types of asset in which the funds are invested (IFSB-2, 2005).

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

IFSB has recognised the significance of this contract and the Guiding Principles of Risk Management (IFSB-1, 2005) provide a set of guidelines of best practices for establishing and implementing effective risk management in IIFS including *Musharakah*, which give practical effect to managing the risks underlying the business objectives that IIFS may adopt.

The capital invested through *Musharakah* may be used: (1) to purchase shares in a publicly traded company or privately held equity, or (2) invested in a specific project, portfolio or through a pooled investment vehicle. In the case of a specific project, IIFS may invest at different investment stages.

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

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

Capital Adequacy Requirements

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

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

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

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

Regulatory Issues
Some regulatory authorities view that the 300–400 % RW is too high.

Shari'ah-Compliant Securitisation of *Musharakah*-Related Exposures

Apparently *Musharakah*-based contracts demand higher capital adequacy requirements, but IIFS can also benefit from taking exposures in *Musharakah* in terms of capital relief through *Shari'ah*-compliant securitisation. The IFSB has recognised this under IFSB-7 (2009), where business ventures organised as *Musharakah* partnerships by IIFS can be securitised, and the resultant *suk*uk are tradable. This is for relief from higher capital requirements on these exposures; however, an originating IIFS may exclude securitised exposures from the calculation of its risk-weighted assets only if all of the conditions have been met as set under asset derecognition criteria in IFSB-7 (2009).

Role of the Regulatory Authority

The role of regulatory authority is also important to be underlined. The regulatory authority should satisfy itself that adequate policies and procedures are in place for *Musharakah* exposure risk management, taking into account the IIFS's appetite and tolerance for risk. In addition, the regulatory authority should also ensure that IIFS has sufficient capital when engaging in equity investment activities. In regard to calculating minimum capital requirements for *Musharakah* exposures, regulatory should provide adequate guidance to IIFS, who wishes to employ regulatory slotting criteria approach as stated in IFSB-2 (2005).

Conclusion

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

The regulatory authority should be open to providing adequate incentives for risk and profit sharing (Musharakah financing) and the Islamic finance industry needs to adopt more conformed standards to enhance system predictability and stability while promoting greater awareness among fund suppliers about the terms and conditions of profit sharing under different contractual arrangements. For instance as illustrated and well articulated in one of the papers of Sundararajan (2007): for an IAH who largely provides funds on a Mudarabah basis and the Islamic financial institution which invests these funds (often commingled with shareholders' and other funds) in various Islamic financial contracts (like salam, istisna', Musharakah) the risk is the expected variance in the measure of profit distribution between investment account holder (IAH) and bank. IFIs have to recognise that this uncertainty or Mudarabah risk can arise from a variety of factors both systemic and bank specific. Risk mitigation for IAH can be achieved through use of profit equalisation reserves (PER), investment risk reserves (IRR) and variation in mudarib's share.

In this regard, IFSB has provided guidelines for Musharakah financing and IFSB Guiding Principles on Risk Management have served a good purpose. They provide guidance for different risks to which Islamic finance industry is exposed and offer guidance on the methodology for credit risk, market risk, liquidity risk, operational risk, equity investment risk and rate of return risk for different types of financial transactions.

References

IFSB. (2005). *IFSB-2: Capital adequacy standard for institutions (other than insurance institutions) offering only Islamic financial services*.

IFSB. (2005). *IFSB-1: Guiding principles on risk management for institutions (other than insurance institutions) offering only Islamic financial services (IIFS).*

IFSB. (2009). *IFSB-10 Guiding principles on Shari'ah governance for institutions offering Islamic financial services, 2009*.

Sundararajan, V. (2007). Risk characteristics of Islamic products: Implications for risk measurement and supervision. In S. Archer & R. A. A. Karim (Eds.), *Islamic finance: Regulatory challenge*. Singapore: Wiley.

Tahani, N. (2014). *Equity based financing in Islamic banks*. Case study of Dubai Islamic Bank.