International Islamic University Malaysia
IIUM Institute of Islamic Banking and Finance (II*i*BF)

Title:

MUSHARAKAH AS AN ISLAMIC FINANCIAL STRUCTURE FOR VENTURE CAPITAL: ITS POTENTIALS AND POSSIBLE APPLICATIONS FOR SMALL AND MEDIUM ENTERPRISES (SMES) IN MALAYSIA

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Principal Researchers:

Prof. Dr Azman Mat Noor
Assoc. Prof. Dr. Razali Haron
Asst. Prof. Dr. Nor Razinah Mohd. Zain

Co-Researchers:
Mr. Abdullah Hidayat
Dr. Tuan Badrul Hisyam Tuan Soh
Prof. Dr. Noraini Mohd. Ariffin
Dr. Abdulmajid Obaid Hasan Saleh

Research Officers/Assistants:
Mohammed Yahya Alrashedi

Date:
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This research is dedicated to the Muslim Ummah and all players of Islamic banking and finance, both in Malaysia and all around the world.

CONTENT

CHAPTER 1
BACKGROUND OF THE RESEARCH

1.0 INTRODUCTION

Innovations of financing products are crucial for the sustainability of Islamic banking and finance. The versatile financing products may capture the continuous interests among the stakeholders from different sectors. It is also important, especially for the end-users or customers. With the requirements of Shariah-compliance nature, financing products in Islamic banking and finance provide a new paradigm in their applications. This is important to distinguish Islamic financing products with those products that are offered by the conventional banks. It is obvious that financing products as offered by the conventional banks are limited in their structures. Thus, they confine the created relationships with their customers depending solely on the creditor-debtor relationship. A different scenario can be observed from the Islamic financing products that stand out with versatile relationships that can be created between the Islamic banks and their customers depending on the agreed terms of the contracts.

Islamic banking and finance or IBF in Malaysia continues to progress since its first successful experiment in 1980s. It stands out as one of the most successful global hubs for Islamic banking and finance worldwide. In facing the economic challenges which are resulted from the global pandemic COVID-19, it seems that they do not prevent the continuous growth of the Islamic banking and finance, even though its pace is recorded slower in comparison to the year of 2020. Nevertheless, it is forecasted that there will be around 50% of Malaysian banking assets fulfil Shariah-compliance requirements by 2030.[1] This is apparent with the increase of free-interest loans as financing products that are set to be issued annually by 10% to 15% within a duration of 5 years. With such percentage, the Islamic banking and finance in Malaysia is expected to grow extensively in the Southeast Asia. This is confirmed by the Association of Islamic Banking and Financial Institutions Malaysia or AIBIM.[2] The total value of Islamic financing in Malaysia is recorded reaching USD$149 billion at the end of 2019, which covers 35% of the banking system's loans.[3] With such tremendous growth, it is crucial for Islamic banks to continue to issue innovative financing products to the financial market, either for local or international customers or investors.

By observing Malaysian financial market, there are several popular financing products that are currently offered by the Islamic banks. Instead of depending on a

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[1] Market Research Malaysia, "Half of Malaysia's Assets to be Islamic by 2030," last modified March 10th, 2020, accessed April 4th, 2022, https://www.marketresearchmalaysia.com/insight/malaysia-banking-assets

[2] AIBIM, "Half of Malaysia's Banking Assets to be Islamic in next decade," last modified March 5th, 2022, accessed April 4th, 2022, https://aibim.com/news/half-malaysia-banking-assets-to-be-islamic

[3] Market Research Malaysia, "Half of Malaysia's Assets to be Islamic by 2030," last modified March 10th, 2020, accessed April 4th, 2022, https://www.marketresearchmalaysia.com/insight/malaysia-banking-assets

specific financing product, such as *Bay Bithaman Al-Ajil* which was popular during their first phase of development, financing products as offered by the Islamic banks are versatile in nature. Nowadays, there are a variety of innovative financing products that can be traced such as *Mudharabah*, *Wadiah*, *Musharakah*/*Musharakah*, *Murabahah*, *Ijarah*, *Tawaruq* and etc. All of these financing products have their own advantages and strengths in their applications towards enhancing the development of Islamic banking and finance industry. Moreover, these Islamic financing products have potentials that can be used as modes or instruments for Islamic venture capital by Islamic banks in Malaysia.

1.1 BACKGROUND OF RESEARCH

Musharakah can be easily understood as 'sharing' or 'to share'. *Musharakah* is a joint-venture based financing product that depends on the establishment of a partnership between two parties that appreciates the notion of profit-loss sharing as stipulated under Shariah. In relation to its practice, *Musharakah* is already practiced even before the coming of Islam. It is later cleansed from any prohibited elements with the enforcement of Shariah. *Musharakah* is tremendously practiced, especially during the golden era of Islamic civilization. Currently, the application of *Musharakah* is available in Islamic banking and finance industry. *Musharakah* allows a financier to receive a specific return depending on a certain pre-determined ratio. In any instance of losses, the financier is also facing losses in the same proportion with the entrepreneur. In the usual practice in Islamic banking and finance, both Islamic bank and their customer or investor have their shares in a specific venture. Both parties are eligible to its management. In relation to the parties' rights, it is quite flexible depending on the parties' agreement. Nonetheless, the application of *Musharakah* may be varied depending on their jurisdictions. However, they cannot depart from its original principle of profit-loss sharing as conferred under Shariah.

Based on the above backdrop, this research intends to explore on *Musharakah* as Islamic financial structure for venture capital in relation to the selected small and medium enterprises (SMEs) in Malaysia. Islamic venture capital is recognized as an important part of economic sector in Malaysia. Thus, it is crucial for the continuous advancement of Islamic banking and finance in Malaysia. This study is essential to evaluate the current practice of *Musharakah* and its possible applications. This is necessary to open a further discussion on the innovation of products that based on *Musharakah*. At the same time, relevant issues and its potentials need to be highlighted accordingly. This is important to enhance the application of *Musharakah* as an Islamic financing structure for venture capital by Islamic banks. It also allows the creation of future innovative financing and investment/funding products based on *Musharakah*.

This chapter is divided into several parts for the purpose of an effective discussion. After this section, it follows with: (i) the statement of problem; (ii) research objectives; (iii) research questions; (iv) hypotheses; (v) the gap of the research; (vi) significance of the research; and (vii) scope and limitation of research.

1.2 STATEMENT OF PROBLEMS

The trace of venture capital practices can be found since the end of the World War II. At the earlier stage of their development, the United Kingdom owns the second largest venture capital industry after the United States of America's.[4] The practices of venture capital received their prominent in Japan and Australia in the 1970s.[5] Other parts of Asia followed such practices as early as in 1980s.[6] Majority of these practices are conventional in nature that support the interest-based profit-making businesses. Conversely, Shariah-compliance venture capital and its practices are based on the Islamic commercial and transactions principles which can be traced since the beginning of Islam[7].

With the emergence of modern Islamic banking and finance, the Islamic financial structures for Shariah-compliance venture capital are made possible to be applied across jurisdictions. Unfortunately, the Shariah-compliance venture capital and its practices remain isolated from the mainstream practices of Islamic banking and finance industry. This situation happens due to the scarce researches done to explore Islamic financial structures that have potentials to support Shariah-compliance venture capital that may connect Islamic banks with newly established companies or enterprises that are in need for financing and investment/funding.

Malaysia is one of globally recognized countries in the world that places a high interest in the development of their Islamic banking and finance industry. Besides of having normal depositors, small and medium enterprises (SMEs) are also frequent customers for Islamic banks. Islamic banks in Malaysia have opportunities to assist the continuous development of Shariah-compliance venture capital by offering suitable Islamic financing structure for small and medium enterprises (SMEs).[8] Majority of these SMEs are depending on appropriate venture capital from Islamic banks to continue to progress in their businesses, while they directly or indirectly assist the growth of economy. This is true, especially in relation to the local businesses. Furthermore, by making Shariah-compliance venture capital as one of significant

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[4] Kenney, M. "Venture Capital." *International Encyclopaedia of the Social & Behavioural Sciences*, (2001): 16158-16161; Gompers, Paul, and Josh Lerner. "The venture capital revolution." *Journal of Economic Perspectives* 15, no. 2 (2001): 145-168.

[5] Kenney, Martin, Kyonghee Han, and Shoko Tanaka. "The globalization of venture capital: the cases of Taiwan and Japan," in *Financial Systems, Corporate Investment in Innovation and Venture Capital.* (Cheltenham: UK and Northampton, MA: Edward Elgar, 2004), pp. 52-83.

[6] Lockett, A., & Wright, M. "Venture capital in Asia and the Pacific Rim." *Venture Capital,* 4 (3) (2002), 183–195.

[7] Hasan, Rusni, Sa'id Adekunle Mikail, and Muhamad Arifin. "Historical development of Islamic venture capital: an appraisal." *Journal of Applied Sciences Research* 7 (13) (2011): 2377-2384.

[8] Boocock, J. Grahame, and John R. Presley. "Equity Capital for Small and Medium-Sized Enterprises in Malaysia: Venture Capital or Islamic Finance," *Managerial Finance* (1993); Sin, Khoo Cheok. "The success stories of Malaysian SMEs in promoting and penetrating global markets through business competitiveness strategies," Copenhagen Discussion Papers, (2010) No. 2010-33; Hashim, Fariza. "SMEs' impediments and developments in the internationalization process: Malaysian experiences," *World Journal of Entrepreneurship, Management and Sustainable Development* (2015).

mainstreams in Islamic banking and finance industry, it will assist the growth of SMEs in Malaysia.

Currently, there are a variety of Islamic financing products that are used and applied in Islamic banking and finance in Malaysia. Reaching towards 2030, it is estimated that 50% of banking assets will be in compliance with Shariah principles. In achieving such target, apparently that 10% to 15% free-interest financing products should be issued by Islamic banks annually.[9] Instead of considering to create new kind of financing products, it is better to look closely on the available financing products as exist in the current financial market. Not only they are already tested based on a realistic practice, their applications are also indicated the real challenges that need to be overcame.

Musharakah is a well-known innovative financing product that scarcely offered by Islamic banks in Malaysia. Instead of reinventing the wheel, it is crucial to look closely to *Musharakah* as an Islamic financing structure that offers a unique joint-venture based financial relationship between the Islamic bank and their customers. Thus, by looking closely to *Musharakah*, this research explores the possibility of having Shariah-compliance venture capital based on *Musharakah* that can be offered by Islamic banks to small and medium enterprises (SMEs) in Malaysia. This is either for the purpose of financing or investing/funding. It is believed that *Musharakah* can be utilized as a suitable Islamic financing structure in meeting such purposes to the relevant and interested SMEs.

1.3 RESEARCH OBJECTIVES

Based on the above elaboration, the research objectives of this research are as follows:

(i) To examine the current practice of *Musharakah* as Islamic financial structure in Islamic banks in Malaysia;

(ii) To examine the current practice of accounting treatment on *Musharakah* as Islamic financial structure in Islamic banks in Malaysia;

(iii) To identify the key challenges for *Musharakah* as Islamic financial structure from legal and regulatory perspectives;

(iv) To identify the key challenges for *Musharakah* as Islamic financial structure from Shariah perspective;

(v) To recommend model(s) of *Musharakah* for purposes of financing and investment/funding to selected SMEs.

[9] AIBIM, "Half of Malaysia's Banking Assets to be Islamic in next decade," last modified March 5th, 2022, accessed April 4th, 2022, https://aibim.com/news/half-malaysia-banking-assets-to-be-islamic

1.4 RESEARCH QUESTIONS

Consistent with the above research questions, this research is intended to find the answers for the following research questions:

(i) What is the current practice of *Musharakah* as Islamic financial structure in Islamic banks in Malaysia?

(ii) What is the current practice of accounting treatment on *Musharakah* as Islamic financial structure in Islamic banks in Malaysia;

(iii) What are the key challenges for *Musharakah* as Islamic financial structure from legal and regulatory perspectives?

(iv) What are the key challenges for *Musharakah* as Islamic financial structure from Shariah perspective?

(v) What is/are the suitable model(s) of *Musharakah* for purposes of financing and investment/funding to selected SMEs?

1.5 HYPOTHESIS

It is hypothesized from this research that *Musharakah* can be used as an Islamic financial structure for venture capital by Islamic banks to the selected SMEs, for the purpose of either financing or investment/funding.

1.6 THE GAP OF RESEARCH

Theory and practices of *Musharakah* as an Islamic financial structure for venture capital by Islamic banks needs to be explored, while current practice indicates differences between its real application and principles. So far, there is absence of current research that looks closely to the application of *Musharakah* as an Islamic financial structure for venture capital, either for investment/funding or financing. Same goes to the application of *Musharakah* from Shariah perspective, where a close look should be done in identifying the reality of the practice. Accounting treatment for *Musharakah* needs to be discussed from its real sense, together with its legal and regulatory requirements for venture capital by Islamic banks in Malaysia. This research is important, especially by opening a possibility of Shariah-compliance financing or investment/funding by Islamic banks for small and medium enterprises (SMEs) to survive in the Malaysian competitive market.

1.7 SIGNIFICANCE OF THE RESEARCH

This research evaluates the current practice of *Musharakah* as an Islamic financial structure offered by Islamic banks in Malaysia. This is especially done in order to identify the practical and Shariah-compliance challenges that may be faced by *Musharakah* in their real applications. Instead of inventing the wheel, this research allows a cogent consideration to be given towards *Musharakah* as an Islamic financial structure to be used significantly to further advance the Islamic banking and finance industry in Malaysia. Due to the joint-venture based financing innovation, it is believed that *Musharakah* financing products are the best products that can be used in relation to Islamic venture capital in Malaysia. At the same time, *Musharakah* can be used to achieve sustainability for Islamic banking and finance with a real involvement in economic activities.

1.8 SCOPE AND LIMITATION OF RESEARCH

The scope of this research is limited by the provided research objectives. This research is also carried out to find answers for the research questions and to test the existence of hypotheses. Not only strengthen with the findings from literature review, the overall results will depend on proposed models of Islamic financing structures that are deemed suitable for venture capital in Malaysia. This research is limited to *Musharakah* financing which has been offered by limited number of Islamic banks in Malaysia. Additionally, recommendations as provided from this research are based on the understanding and experiences of the researchers based on the collected data as received. There are suggestions made by the researchers based on their own evaluations and thus, they stand out with educational and practical merits for the consideration of Islamic banking and finance industry in Malaysia.

CHAPTER 2
MUSHARAKAH: ITS CONCEPT AND CURRENT PRACTICES

2.0 INTRODUCTION

This chapter is provided to discuss about the understanding on the concept of *Musharakah* and its current practices as can be found in Islamic banking and finance industry in Malaysia. This chapter is provided to reach the first and the third research objectives. At the same time, this chapter is intended to provide necessary answers for the first and the third research questions. In order to ensure the consistency in the flow of the discussion, this chapter is divided into two main segments, which consist of Part A and Part B. Part A provides the discussion on the understanding of *Musharakah* concept. Part B is provided to discuss the application of *Musharakah* in the real practice.

2.1 PART A: UNDERSTANDING THE CONCEPT OF *MUSHARAKAH*

Shariah-compliance contracts as applicable in the Islamic banking and finance industry can be divided into four general classifications. They are: (i) sale-based contracts; (ii) partnership-based contracts; (iii) lease-based contracts; and (iv) supporting contracts.[10] Under the second classification i.e., partnership-based contracts (*Uqud al-Ishtirak*), there are several types of well-known contracts that are used in Islamic banking practices. *Musharakah* is one of these well-known partnership-based contracts.

The term '*Musharakah*' found its root from the word *Shaaraka* which means to share.[11] It basically refers to the partnership between two or more parties to finance a business venture where all parties contribute capital either in the form of cash or in-kind.[12] *Musharakah* is widely used in the present day particularly when a reference is made with regard to the equity-based Islamic mode of financing. However, it connotes a rather limited understanding as compared to its equivalent term '*Shirkah*' (sharing or partnership) which is used more commonly in the works of literature of Islamic jurisprudence.[13]

In general, *Musharakah* can be divided into two categories. The first category is *Shirkah Al-Milk* (propriety partnership). A propriety partnership refers to the joint ownership of two or more persons over one particular property.[14] This type of partnership could take place voluntarily (referred to as *Ikhtiyariyah*) or compulsorily

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[10] Rusni Hassan et al., *Islamic Banking and Takaful* (Pearson Malaysia Sdn. Bhd., 2011), p.61; Aznan Hasan, *Fundamentals of Shari'ah in Islamic Finance* (Kuala Lumpur: IBFIM, 2011), p.469; Marjan Muhammad and Mezbah Uddin Ahmed, eds., Islamic Financial System: Principles and Operations (Kuala Lumpur: ISRA, 2011), p. 205.

[11] Hamzah, Zaid, and Ahcene Lahsasna. *Islamic private equity and venture capital: principles and practice*. Kuala Lumpur: IBFIM, 2011, p.55.

[12] Ibid.

[13] Usmani, Muhammad Taqi Usmani. *An Introduction to Islamic Finance*. Maktaba Ma'ariful Quran, 2007, p.31

[14] Ibid.

(referred to as *Ijbariyah*). As for the former, the ownership is established in the instance where the partners jointly purchase an asset, or it is obtained by them as a result of will or a gift.[15] As for the latter, the partnership comes into existence automatically such as in the case of inheritance where all the entitled legal heirs inherit and come into the joint ownership of the deceased's property.[16]

The second category is *Shirkah Al-Aqd* (contractual partnership). This type of partnership differs from the propriety partnership in the sense that it is a commercial partnership, whereby the latter does not come into existence by a mutual agreement to share profits and risks. Thus, it is hardly to be considered as a partnership as can be understood in the commercial sense. It can be further divided into several types. For instance, in terms of the capital contribution, it can be classified into three categories, namely: (i) *Shirkah Amwal* (monetary partnership), (ii) *Shirkah Amal* (labour partnership), and (iii) *Shirkah Wujuh* (partnership in goodwill).

The first category refers to the arrangement where all the partners invest some capital (the nature of capital includes the monetary form/ cash as well as in-kind).[17] The second category, which is also known as *Shirkah Abdan*, *Shirkah Taqabbul* or *Shirkah Sina'i* refers to the partnership where all the partners are jointly undertaking to provide some services to their customer and the earned profit (through the payment of the rendered service) will be distributed among them based on the pre-agreed ratio.[18] As for the third category, it is a bilateral agreement between two or more parties to conclude a partnership based on the partners' reputation to buy an asset with a deferred payment for the purpose of making a profit from its sale while they undertake to fulfil their obligation to the percentages determined by the partners.[19]

For instance, A and B form a partnership in goodwill where they buy a commodity from a vendor which cost them RM1000. Instead of paying the price, both of them use their reputation to convince the vendor to grant them with deferred payment. They also make an agreement between both of them that the profit share ratio for this partnership will be 50:50. After succeeding to sell the commodity with RM1500, they pay the vendor the cost price (RM1000) and share the surplus (RM500) as their profit based on the pre-agreed ratio. Therefore, each of them gains RM250 (50 per cent of the whole profit).

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[15] Dusuki, Asyraf Wajdi. *Islamic Financial System: Principles & Operations.* International Shari'ah Research Academy for Islamic Finance (ISRA), 2011, p.166

[16] Usmani, Muhammad Taqi Usmani. *An Introduction to Islamic Finance*. Maktaba Ma'ariful Quran, 2007, pp. 31-32

[17] Abd Ghadas, Zuhairah Ariff and Engku Ali, Engku Rabiah Adawiah. "Partners' Limited: Limited Liability in Partnerships Structure: An Overview of the Common Law and the Shariah." Shariah Law Report, no. 1 (2010): 45.

[18] Usmani, Muhammad Taqi Usmani. *An Introduction to Islamic Finance*. Maktaba Ma'ariful Quran, 2007, p.32

[19] Dusuki, Asyraf Wajdi. *Islamic Financial System: Principles & Operations.* International Shari'ah Research Academy for Islamic Finance (ISRA), 2011, p.247

From the perspective of terms of the contract, the contractual partnership can be divided into two types, namely *Shirkah Mufawadhah* (unlimited partnership) and *Shirkah Inan* (limited partnership).[20] *Shirkah Mufawadhah* refers to the unlimited investment partnership in which each partner contributes equally to the capital and enjoys full and equal authority in transacting with the partnership capital or property.[21] In this partnership, partners are regarded as the agents of each other as well as acting as surety for other partners.[22] As such, all partners, according to some of the jurists, are responsible for all dealings done by the other partner as they share all rights and obligations equally.[23] These jurists also seem to take a strict approach to the question of equality as they deem the individual equality in all respects as one of the prerequisites for a valid *Mufawadhah* partnership. For instance, the partnership between an adult and a minor is invalid even with the permission of the minor's parents due to the inequality in personal status.[24]

The question of equality also extends to the religious affiliation where the *Mufawadhah* partnership cannot be formed between a Muslim and a non-Muslim. In these jurists' argument, such 'mixed' *Mufawadhah* partnership may engage with the commercial transactions where some of which might not be in compliance with Shariah thus disqualifying the Muslim partner from the full participation as entailed by a *Mufawadhah* partnership.[25] However, another group of jurists have taken a different approach in this respect. For them, the term *Mufawadhah* in partnership is confined to the nature of the relationship between the partners and does not extend to any other aspect of the association.[26] Thus, there is no requirement for equality in the personal status of the prospective partner. Rather, it connotes a general partnership mandate by which each partner confers upon his colleague full authority to dispose of their joint capital in any manner intended to benefit their association.[27]

On the other hand, *Shirkah Inan* (limited partnership) partially resembles the features of many legal modern limited partnerships, which does not require equality in the partners' contribution nor in the legal right for using the partnership property.[28] The partners are to contribute a specific amount of money in such a way that gives each of them a right to deal in the assets of the partnership on condition that the profit

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[20] Ibid, pp. 246-247

[21] Abd Ghadas, Zuhairah Ariff and Engku Ali, Engku Rabiah Adawiah. "Partners' Limited: Limited Liability in Partnerships Structure: An Overview of the Common Law and the Shariah." Shariah Law Report, no. 1 (2010): 45.

[22] Ibid.

[23] Al-Zuhaily, Wahbah. *Financial Transactions in Islamic Jurisprudence Vol. 1*. Trans. Mahmoud A. El-Gamal . Dar al-Fikr, 2003, p. 452

[24] Joni Tamkin Bin Borhan and Mohamad Taqiuddin bin Mohamad, "Conducts of Partners in al-Shirkah al-Mufawadah: An Analysis from Hanafi's Classical Sources" (paper presented at Seminar Ekonomi Islam Peringkat Kebangsaan 2009), Equatorial Hotel Bangi, 20th to 21st October 2009).

[25] Ibid

[26] Ibid

[27] Ibid

[28] Al-Zuhaily, Wahbah. *Financial Transactions in Islamic Jurisprudence Vol. 1*. Trans. Mahmoud A. El-Gamal . Dar al-Fikr, 2003, p. 452

is to be distributed according to the pre-agreed ratio.[29] In terms of the legal right in dealing with the partnership asset, each partner may only transact with the partnership capital according to the terms of the partnership agreement and to the extent of the joint capital. Hence, this makes their liability towards the third parties as several but not in joint.[30] Each partner shall only be responsible for dealings that he performed and only bears the loss in the proportion to his contribution to the partnership's capital.[31]

<table>
<tr><th colspan="7">Musharakah/Shirkah</th></tr>
<tr><td colspan="7">Literal definition: to share
Technical definition: the partnership between two or more parties to finance a business venture where all parties contribute capital either in the form of cash or in-kind.</td></tr>
<tr><td colspan="2">Shirkah Al-Milk
Definition: A propriety partnership which involves the joint ownership of two or more persons over one particular property.</td><td colspan="5">Shirkah Al-Aqd
Definition: A contractual partnership where the partnership is influenced by the mutual contract entered by the partners/parties.</td></tr>
<tr><td colspan="2">Categories based on nature of partnership</td><td colspan="3">Categories based on capital contribution</td><td colspan="2">Categories based on contractual agreement</td></tr>
<tr><td>Ikhtiyariyah

Voluntary partnership: comes into existence when the partners jointly purchase an asset, or as a result of will or a gift.</td><td>Ijbariyah

Compulsory partnership: come into existence automatically such as in the case of inheritance.</td><td>Shirkah Amwal

Monetary partnership: when all partners invest some capital in their partnership.</td><td>Shirkah Amal (Shirkah Abdan/ Shirkah Taqabbul/ Shirkah Sina'i)

Labour partnership: when all partners agreed to provide some services to their customers and earn profits.</td><td>Shirkah Wujuh

Partnership in goodwill: when partners agreed to use their reputations to buy certain assets for the partnership.</td><td>Shirkah Mufawadhah

Unlimited partnership: happens when each partner contributes equally to the capital and enjoys full and equal authority in transacting with the partnership capital or property.</td><td>Shirkah Inan

Limited partnership: happens when the partners contribute a specific amount of capital in which give them a certain right to deal with the partnership's assets where the profit is distributed based on the pre-agreed ratio.</td></tr>
</table>

Table 1.0: Categories of *Musharakah*

There is another type of partnership-based contracts which is known as *Mudharabah* (profit sharing and loss bearing). Some Muslim jurists regarded it as a type of *Musharakah,* although they described it as a silent partnership. Technically, it refers to the partnership in profit where the capital is provided by the *Rabbul Mal*

[29] Dusuki, Asyraf Wajdi. *Islamic Financial System: Principles & Operations.* International Shari'ah Research Academy for Islamic Finance (ISRA), 2011, p.246

[30] Abd Ghadas, Zuhairah Ariff and Engku Ali, Engku Rabiah Adawiah. "Partners' Limited: Limited Liability in Partnerships Structure: An Overview of the Common Law and the Shariah." Shariah Law Report, no. 1 (2010): 45.

[31] Al-Zuhaily, Wahbah. *Financial Transactions in Islamic Jurisprudence Vol. 1*. Trans. Mahmoud A. El-Gamal . Dar al-Fikr, 2003, p. 452

(capital provider) while the counterparty, known as *Mudharib* provides labour.[32] This makes the arrangement in *Mudharabah* different as compared to the typical arrangement in *Musharakah* where all the partners shall contribute their capital to the investment.

Another significant difference between these two models is pertaining to the element of loss bearing. As mentioned before, in *Musharakah*, the incurred loss from the investment shall be shared by all the partners to the extent of their capital contribution. However, in the case of *Mudharabah*, the loss will be solely borne by the capital provider, while the *Mudharib*'s 'loss' is restricted to the fact that his labour/efforts or skills have gone in vain and his work is not fruitful.[33]

2.1.1 Bases for Entitlement of Profit in *Musharakah* from the Islamic Jurisprudence Standpoint

Musharakah is among the major business models with the idea of risk sharing that serves as the backbone of their structures. Muslim jurists unanimously agree that, in principle, the concept of *Musharakah* denotes mutual risk taking by each partner whereby he/she bears the relevant risks of the business venture and therefore is entitled to a portion of profit, if any. However, they appear to hold different opinions as to the basis for partners' entitlement to the profit in a *Musharakah* business venture. These differences had eventually led to the existence of different views on the validity of some forms of *Musharakah*. These different views can be seen from: (i) the opinion of Hanafi and Hanbali schools of laws; (ii) the opinion of Maliki school of laws; and (iii) the opinion of Shafie school of laws.

2.1.1.1 The View of Hanafi and Hanbali Schools of Laws

In this regard, a prominent jurist of the 6th century from the Hanafi school of laws by the name of Al-Kasani had mentioned that the entitlement to profit in the case of *Musharakah* depends on three subjects (bases). The first basis is wealth (*Mal*) which is obvious as the profit is derived from the growth of the asset he contributed as capital into the venture. The second basis is labour (*Amal*) where the one who provides his energy and workmanship to the business venture is entitled to a portion of profit such as a *Mudharib* in the case of *Mudharabah*. The final basis is liability (*Dhaman*) where the one who contributes it is entitled to a portion of the business profit as the compensation for his liability to bear the loss should it incurs. In his opinion, if the *Mudharib* is made to bear all the losses by virtue of the agreement entered between him and capital provider, the *Mudharib* is entitled to all the profit of the venture.[34]

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[32] Dusuki, Asyraf Wajdi. *Islamic Financial System: Principles & Operations.* International Shari'ah Research Academy for Islamic Finance (ISRA), 2011, p.249

[33] Usmani, Muhammad Taqi Usmani. *An Introduction to Islamic Finance*. Maktaba Ma'ariful Quran, 2007, pp. 47-48

[34] Al-Kasani says in this respect: The original [ruling], in our view, is that entitlement to profit is due to wealth or labour or liability for bearing loss. As for the entitlement due to wealth, it is obvious because profit is a growth in the capital and belongs to its owner. It is for this reason that the Rab al-Mal in the contract of Mudharabah is entitled to profit. As for labour, the Mudharib is entitled to profit due to his

A similar view held by Ibn Qudamah, the renowned jurist consults of the Hanbali school of laws. In his opinion, the partner is entitled to profit due to his contribution of wealth, labour or both. As for *Dhaman,* he argued that it becomes the basis for the entitlement to profit in the case of *Shirkah Abdan* as much as it does in the case of *Mudharabah* where in both cases, the partners (in *Shirkah Abdan*) and the *Mudharib* (in *Mudharabah)* provide labour work.[35] Based on this position, both Hanafi and Hanbali schools of laws permit all three types of *Mushrakah*; *Shirkah Amwal*, *Shirkah Abdan* and *Shirkah Wujuh*.

2.1.1.2 The View of Maliki Schools of Laws

The situation as mentioned above, however, does not fully illustrate the position held by the Maliki school of laws. It is because the jurists of this school had ruled out the liability *per se* to be the basis of profit entitlement in *Musharakah*. As such, *Shirkah Wujuh* is deemed as invalid since in this type of *Musharakah*, there is neither monetary capital nor labour work is contributed. Instead, the basis of the partnership is merely the liability for the price of goods purchased on credit.

As for *Shirkah Amwal*, it is accepted as a valid partnership since wealth is a valid basis for profit entitlement.[36] In the case *Shirkah Abdan*, the jurists of this school are of the opinion of its validity although they might be in dispute as to the basis for the profit entitlement. Some of them asserted that labour is not an independent basis but

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labour, and likewise the partner. As for liability (Dhaman), if the Mudharib were made to bear the liability for loss, he would be entitled to the entire profit [of the Mudharabah] as compensation for his liability due to the fact that profit [entitlement] goes with liability [emphasise added]. Refer 'Alauddin Abu Bakar bin Mas'ud Al-Kasani, *Badai' Sanai' fi Tartibi Asy-Syarai'* (Vol 7, Ali Muhammad Muawwadh and Aadil Ahmad Abdul Maujud eds, Dar Al-Kutub Al-Ilmiyyah 2003), 517.

[35] Ibn Qudamah says: Labour ('Amal) is a basis for entitlement to profit. It is, therefore, allowed for the partners to have differing shares in the profit even if both of them contribute labour, similar to the case of two Mudharibs engaged with one [investor at two different profit-sharing ratios]. That is because one of them may be more expert in trading and more capable than the other; hence, he can stipulate a greater share of the profit for his labour, similar to stipulation of profit for the labour of the Mudharib. This partnership [ie Sharikat al-'Inan] is based on both wealth and labour. Each partner would be entitled to profit if they contributed only one of them. Likewise, they are entitled due to a combination of the two. When there is no stipulation, then the profit is divided among them according to their capital contributions. However, when there is a stipulation, it is the primary consideration and must be honoured. Refer Abdullah bin Ahmad, *Al-Mughni* (Vol 7, 3rd edn, Dar 'Aalam al-Kutub 1997), 138. Also, he says: Dhaman is a basis for entitlement to profit, as evidenced in Sharikat al-Abdan (labour partnership). The acceptance of work imposes liability upon the person accepting the work [as an independent contractor] and provides a basis for entitlement to profit. It is, therefore, similar to the acceptance of wealth in Mudharabah. The labour of the worker [in Sharikat al-Abdan] entitles him to profit just as the labour of the Mudharib does [in Mudharabah]. [Sharikat al-Abdan] is thus considered like Mudharabah. Refer Abdullah bin Ahmad, *Al-Mughni* (Vol 7, 3rd edn, Dar 'Aalam al-Kutub 1997) 113

[36] In this regard, it is reported that Imam Malik had said that loss is commensurate with the partners' capital (wealth) and profit are commensurate with their capital (wealth). Refer Sahnun bin Saeed Al-Tanukhi, *Al-Mudawanah Al-Kubra* (Vol 12, Wizarah Al-Syuun Al-Islamiyah Wa Al-Auqaf Wa Al-Dakwah Wa Al-Irshad Al-Mamlakah Al-Arabiah Al-Suudiah), 59-60.

rather subservient to wealth.[37] However, it is also can be traced in some of the school's legal scriptures that labour might as well be deemed as an independent basis for the profit entitlement as it may substitute the wealth.[38]

2.1.1.3 The View of Shafie Schools of Laws

The approach taken by the Shafie school laws seems to be the most stringent as compared to the others since partnership, according to its jurists, is confined to the partnership in wealth only. It is the only basis for the profit entitlement and likewise, the loss is shared on such basis.[39] Hence, the only valid form of partnerships under *Shirkah Al-Aqd* is *Shirkah Amwal*.

2.1.2 General Requirements of *Musharakah*

The variety of opinions held by the jurists is not limited to the question pertaining to the basis of profit entitlement in *Musharakah* which had led to the different positions towards the legality of a certain form of *Musharakah* as explained above. Rather, the discourse extends to some other aspects which are more general, covering most of the types of *Musharakah*. These aspects are like the nature of capital, the rule pertaining to the profit and loss distribution as well as the termination of *Musharakah* venture. Such requirements demonstrate the ability of *Musharakah* as a business model to promote justice and operate the idea of risk sharing as entailed by *Maqasid Al-Shariah*.

2.1.2.1 Nature of Capital

The first aspect is pertaining to the nature of capital. Most of the jurists are of the opinion that the contributed capital for the purpose of *Musharakah* venture should be in the monetary form (cash) whereby contribution in the form of commodities or goodwill (in-kind) is not acceptable. This position is taken by considering the possibility of a partnership contract to be terminated and the partners have to resort to the redistribution of the joint capital among themselves. If the joint capital in question is, for instance, in the form of commodities such redistribution would not be able to take place as they may have been sold at that point of time.[40] In addition, commodities are always distinguishable from each other, whereby, a partnership essentially means the mixing of capital in the sense that any part of the partnership's capital that perishes must perish in the property of all partners.[41] The absence of this

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[37] Muhammad bin Ahmad bin Muhammad bin Ahmad bin Rusyd Al-Hafid, *Bidayatul Mujtahid wa Nihayatul Muqtasid* (Vol 4, Muhammad Subhi Hassan Hallaq ed, Maktabah Ibnu Taimiyyah 1994), 9.

[38] Sahnun bin Saeed Al-Tanukhi, *Al-Mudawanah Al-Kubra* (Vol 12, Wizarah Al-Syuun Al-Islamiyah Wa Al-Auqaf Wa Al-Dakwah Wa Al-Irshad Al-Mamlakah Al-Arabiah Al-Suudiah), 42-43.

[39] Al-Sharbini says: "Profit and loss are based on the capital contributions." Muhammad bin Muhammad Al-Khatib Al-Sharbini, *Mughni Al-Muhtaj Ila Ma'rifati Maani Alfaz Al-Minhaj* (Dar Al-Kutub Al-Ilmiyyah, 2000).

[40] Usmani, Muhammad Taqi Usmani. *An Introduction to Islamic Finance*. Maktaba Ma'ariful Quran, 2007, p. 38

[41] Al-Zuhaily, Wahbah. *Financial Transactions in Islamic Jurisprudence Vol. 1*. Trans. Mahmoud A. El-Gamal . Dar al-Fikr, 2003, p. 459

feature defeats the purpose of establishing a partnership, i.e. to mutually attain profit from the pooled asset. As each asset still exclusively belongs to its owner's private ownership, any profit derived from such asset will be solely owned by its owner.

The second group of jurists, however, holds the contrary position. For them, the capital does not necessarily have to be in cash but can also be in-kind.[42] For them, in the case where the contributed capital is the commodity, the partner's share shall be determined based on the commodity evaluation according to the market price prevalent at the date of the contract.[43] There is also an approach taken by the third group of jurists where they make a distinction between the commodities which can be replaced with other similar commodities should they be damaged (*Zawatul Amthal*) and the commodities which cannot be replaced in such situation but need to be compensated by paying their value instead (*Zawatul Qeemah*). They held that the former group of commodities is eligible to be the capital of *Musharakah* partnership while the latter cannot form part of the shared capital.[44]

It is apparent that the disagreement among the jurists in this respect revolves around the issue of *Gharar* (uncertainty) in terms of the value of the capital contributed. *Gharar* is deemed as one of the major prohibited elements in Islamic finance since it causes injustice and oppression on the involved parties as well as infringes the fundamental principle of contract, such as mutual consent. It may also bring closer to those practices that are against the spirit of justice. In the case of *Musharakah*'s capital, *Gharar* may trigger certain problematic circumstances in the event where the *Musharakah* needs to be terminated, and the partners have to resort to the redistribution of the join capital as mentioned before. Hypothetically speaking, if the capital is a commodity, it may have been sold at the point of time where the redistribution is sought, or the value of commodity might be fluctuating. Such situations make the existence or the value of the capital uncertain should it need to be redistributed and potentially drag the partners into a dispute among themselves. In addition, having clear information about the value of the capital is essential since the loss distribution ratio has to be proportionate to the percentage of capital contribution. Therefore, the uncertainty in terms of the capital value (such as due to the value which keeps fluctuates, for instance) may also cause injustice and difficulty to determine the right portion of loss to the partners.

However, this position appears to be not favourable to the authorities and standard setting organisations in the present days. For instance, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), a standard setting body based in Bahrain, in their Shariah standard no.12 pertaining to Partnership (*Musharakah*) and Modern Companies rules that it is permissible, with the agreement

[42] Ibid, p. 460
[43] Usmani, Muhammad Taqi Usmani. *An Introduction to Islamic Finance*. Maktaba Ma'ariful Quran, 2007, p. 38
[44] Ibid, p. 40

of the partners, to participate in *Musharakah* partnership by non-cash assets (in-kind) after evaluating their cash equivalent in order to determine the share's value.[45]

The same position is also held by Shariah Advisory Council (SAC) of the Central Bank of Malaysia or BNM. In its *Musharakah* Regulatory Policy, SAC held, inter alia, that the capital for a *Musharakah* partnership may be in the form of cash or in-kind including intangible assets.[46] In addition, it also requires that in the case where the capital is in kind, it shall be valued in monetary terms at the time of entering into the contract either by agreement between the partners or by a third party which may include experts, valuers, or any other qualified person.[47]

This requirement, which conforms to the position held by the second group of jurists as mentioned above, seems to be able to mitigate the issue of uncertainty and the potential dispute as mentioned above since the value of the capital will be valued by the independent third party based on a pre-fixed date, i.e., the time of entering the contract. In addition, the existence of uncertainty, generally, does not necessarily render the arrangement void if it is minor (*Gharar Yaseer*). Furthermore, allowing the capital in the form other than cash also seems more practical and can serve the interest of modern business better such as in the case of Sukuk where how the capital is being contributed in the form of non-cash).

Therefore, the issue of uncertainty in this respect cannot prevail against the legitimate interest based on the legal maxim which reads "what is prohibited out of pretext may be allowed for the prevailing good".[48] The uncertainty, if exists, may be deemed as minor thus allowable.

2.1.2.2 Profit and Loss Distribution

The second aspect is regarding the profit and loss-sharing arrangement. This point is among the most frequent points to be addressed in any literature work pertaining to *Musharakah*. This is because the arrangement in profit and loss between partners is the hallmark of *Musharakah*, the adherence to which ensures its effectiveness in manifesting the idea of risk sharing as well as its conformity to the principle of fairness as propagated by *Maqasid Al-Shariah*.

From the Islamic commercial law standpoint, in order to avoid any element of *Gharar* which may lead to future dispute, the ratio of profit sharing between partners must be pre-determined at the point of the conclusion of the contract. The return cannot be a sum of money or a percentage of the capital but in the form of an

[45] Accounting and Auditing Organization for Islamic Financial Institutes (AAOIFI), 'Shari'a Standard (12) Partnership (Musharaka) and Modern Companies', para. 3.1.2.1
[46] Bank Negara Malaysia, 'Musyarakah' (April 2015), para.15.2
[47] Ibid, para 15.3
[48] Kotb Rissouni, 'The Precept: "What is Prohibited out of Pretext May be Allowed for the Prevailing Good" Applied Foundation Study' (2009) Majallah Jamiah asy-Syariqah lil Ulum asy-Syar'iyyah wal Qanun

undivided percentage of profit.[49] In this respect, paragraph 3.1.5.1 of AAOIFI Shariah standard no.12 reads "profit distribution mode among partnership parties should be stipulated in the partnership contract, and profit distribution should be determined as common percentages of profit, and not by a lump-sum amount or percentage to capital".[50]

As to the question of the allowed quantum, the jurists disagree whether the profit should be proportionate to the partner's capital contribution or it may vary. Some of them opined that it is mandatory for each partner to get profit in proportion to his investment.[51] Therefore if, for instance, the partner contributed 25 per cent of the total investment capital, then he is entitled up to 25 per cent of the profit derived from the venture. The second opinion offered by the jurists is that the profit share does not necessarily to be proportional to the capital contributed. Rather, it may be determined in accordance with the agreement between the partners.[52] As such, it is permissible if a partner, who contributed 25 per cent of the total capital to share the profit with his partner equally, provided such arrangement is mutually agreed between them beforehand. It is mentioned in paragraph 16.2 of the *Musharakah* Regulatory Policy of BNM that "The profit-sharing ratio (PSR) in the *Musharakah* shall be proportionate to the capital contribution of each partner unless mutually agreed otherwise at the time of entering into the *Musharakah* contract".[53]

There is also third opinion pertaining in this respect which partially similar to the second opinion (the profit does not necessarily in proportionate with the capital contributed) except in the circumstance where a partner stipulated an express condition in the agreement that he will remain as a sleeping partner (a partner which only contribute capital to the venture and does not involve in the operation of the venture) throughout the tenure of the venture. In such a case, his share of profit cannot be more than the ratio of his investment.[54] This last position is observed to be adopted by the AAOIFI in its Shariah standard where paragraph 3.1.5.3 of Shariah standard no.12 read:

> "In principle, profit percentage should be equivalent to the percentage of the capital share; and partnership parties are entitled to agree on profit percentage different from the capital share, provided that the percentage

[49] Dusuki, Asyraf Wajdi. *Islamic Financial System: Principles & Operations.* International Shari'ah Research Academy for Islamic Finance (ISRA), 2011, p. 248

[50] Accounting and Auditing Organization for Islamic Financial Institutes (AAOIFI), 'Shari'a Standard (12) Partnership (Musharaka) and Modern Companies', para. 3.1.5.1

[51] Usmani, Muhammad Taqi Usmani. *An Introduction to Islamic Finance*. Maktaba Ma'ariful Quran, 2007, p. 36

[52] ibid 36-37

[53] Bank Negara Malaysia, 'Musyarakah', para.16.2

[54] Usmani, Muhammad Taqi Usmani. *An Introduction to Islamic Finance*. Maktaba Ma'ariful Quran, 2007, p.37.

> in excess to capital share should not be assigned to the party who stipulated not to work".[55]

As for the loss distribution, it is unanimously agreed by the jurists that the loss incurred from the investment shall be borne by the partners in accordance to their capital contribution. This is due to the fact that loss is the event of capital depletion where a partner is expected to bear only the loss from the portion of his investment. Paragraph 3.1.5.4 of AAOIFI Shariah standard no.12 states that:

> "Loss percentage should be equal to the percentage of capital participation, and it is not permitted to agree that one of the parties should bear the loss or assign loss at percentages different than ownership shares. It is not forbidden, upon realisation of loss, that one party bears the loss without prior stipulation".[56]

Paragraph 17.1 of the *Musharakah* Regulatory Policy of BNM echoes the similar position by stating: "Any loss incurred by the *Musharakah* shall be borne by the partners proportionate to their capital contribution to the *Musharakah*".[57] This position is derived from the Islamic legal maxim that says, "The profit should be based on the mutual agreement and the loss should be limited to the capital contributed".

To run a *Musharakah* venture, every partner has the right to take part in its management and to work for it or, upon a mutual agreement, appoint one of them to be the managing partner.[58] This is different as compared to *Mudharabah*, since in the latter, the capital provider (*Rabbul Mal*) has no right to participate in managing the business. In this regard, the AAOIFI Shariah standard no.12 clearly held that each partner (in *Musharakah*) reserves the right to perform activities within the interest of the business such as purchasing and selling at spot or deferred payment while they need to obtain the permission of partners for actions that entail damages such as giving donation or granting loans.[59] In such a case where the partner also acts as the managing partner, he is entitled to an agreed remuneration for his service in addition to his share in profit sharing as a partner.[60] Apart from that, it is also permissible for the partners to appoint a third party (non-partner) as the manager. In such a case, the manager is entitled to an assigned remuneration taken from the partnership expense.[61]

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[55] Accounting and Auditing Organization for Islamic Financial Institutes (AAOIFI), 'Shari'a Standard (12) Partnership (Musharaka) and Modern Companies', para. 3.1.5.3

[56] Accounting and Auditing Organization for Islamic Financial Institutes (AAOIFI), 'Shari'a Standard (12) Partnership (Musharaka) and Modern Companies', para. 3.1.5.4

[57] Bank Negara Malaysia, 'Musyarakah', para. 17.1

[58] Usmani, *An Introduction to Islamic Finance* (n 260) 41-42

[59] Accounting and Auditing Organization for Islamic Financial Institutes (AAOIFI), 'Shari'a Standard (12) Partnership (Musharaka) and Modern Companies', para. 3.1.3.1

[60] Noraziah Che Arshad and Abdul Ghafar Ismail, 'Shariah Parameter for Musharakah Contract: A Comment' (2010) 1(1) International Journal of Business and Social Science 145

[61] Accounting and Auditing Organization for Islamic Financial Institutes (AAOIFI), 'Shari'a Standard (12) Partnership (Musharaka) and Modern Companies', para. 3.1.3.3

2.1.2.3 Dissolution of *Musharakah*

Under the notion of justice, mutual agreement is the key concept in the dissolution of *Musharakah,* it may be dissolved by several ways such as it reaches its maturity (the date of which is already determined in the contract, hence mutually agreed) or by the agreement among all partners in *Musharakah* or by actual dissolution of assets should they participated in a specific deal.[62] Any partner may also, without having to close down the partnership, invoke his withdrawal by serving notification of the same to other partners while such action will not have any repercussion on the outstanding dealings.[63]

In the circumstance where the *Musharakah* partnership is decided to be terminated, the underlying asset shall be distributed between the partners on the pro rata basis provided that the capitals are in cash.[64] If it is in another form, the mutual agreement among the partners shall determine whether they shall resort to the liquidation or partition of the asset.[65] On the other hand, if the *Musharakah* is going to continue its course, the staying partners may opt to purchase the leaving partner's share or, in the case where there is a dispute over the share price for instance, the leaving partner may compel the other partners to liquidate or distribute the assets among themselves.[66]

2.1.3 Legal and Regulatory Framework for *Musharakah*

Generally, there are three categories of laws which can be considered important under this discussion. They are: (i) the enabling/regulatory laws; (ii) transactional laws; and (iii) the procedural laws. In order to evaluate the legal and regulatory framework for *Musharakah*, it is important to look at (i) the existing enabling or regulatory laws and (ii) transactional law that applicable within Malaysia. The procedural laws are only operated in the emergence of disputes between the contracting parties, especially when they want to bring the disputes before the courts. Thus, it is considered not so relevant within this discussion.

The referred enabling laws are: (i) the Central Bank of Malaysia Act 2009 (CBMA 2009); and (ii) Islamic Financial Services Act 2013 (IFSA 2013). While the transactional laws that required to be looked at are: (i) the Contract Act 1950 and (ii) the Partnership Act 1961 (PA 1961). To ensure the comprehensiveness of the discussion, the relevant policies as issued by BNM relating to *Musharakah* is also considered in this discussion.

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[62] Accounting and Auditing Organization for Islamic Financial Institutes (AAOIFI), 'Shari'a Standard (12) Partnership (Musharaka) and Modern Companies', para. 3.1.6.3
[63] Ibid, para. 3.1.6.1
[64] Usmani, Muhammad Taqi Usmani. *An Introduction to Islamic Finance*. Maktaba Ma'ariful Quran, 2007, p. 42
[65] ibid
[66] Ibid, pp. 42-43

2.1.3.1 Central Bank of Malaysia Act 2009 (CBMA 2009)

As described by the CBMA 2009 itself, this is an Act that provides for the establishment of BNM as the regulator for Islamic banking and finance industry, its administration, objects, functions and powers, and including any consequential or incidental matters. Section 5 of CBMA 2009 enumerates the principal objects and functions of BNM. It aims to promote monetary and financial stability conducive to the sustainable growth of the Malaysian economy whereby its primary function is, inter alia, to regulate and supervise financial institutions which are subject to the laws it enforces.[67]

Although this Act is neither designated exclusively for the governance of the Islamic financial services institutions or IFIs such as the IFSA 2013, nor it is addressing the issue of risk sharing directly, there are a number of its provisions that are significant in regulating and supervising these entities under which the operation of *Musharakah* mainly takes place. For instance, section 2 defines the term 'Islamic financial business' as any financial business in ringgit or other currency which is subject to the laws which BNM enforces and is consistent with the Shariah. Section 27 establishes the duality of the financial system in Malaysia where it shall consist of the conventional financial system and the Islamic financial system. Section 60 provides that BNM shall be cooperating with the Government of Malaysia and its agencies including the statutory body, supervisory authority, international and supranational organization to develop and promote Malaysia as an international Islamic financial centre.

CBMA 2009 also provides for a conducive and facilitative environment for the development of Islamic finance. This is demonstrated, inter alia, through the establishment of the SAC by virtue of section 51. As explained earlier, SAC plays a significant role in the ascertainment of Islamic law on any financial matter and issue a ruling upon the reference made to it. It also acts as the advisor for both the BNM and the IFIs (and to any person as provided under any written law) on any Shariah issues relating to Islamic financial business, its activities and transactions. Furthermore, the SAC also shall advise the BNM which has been empowered by virtue of section 59 with the authority to issue written circulars, guidelines, or notices on Shariah matters relating to the Islamic finance business carried by the IFIs. These guidelines have proven to be an important element of the development of the Islamic finance industry in Malaysia by providing the practical standard operational procedures (SOPs) for numerous Islamic business arrangements as well as addressing the issues arising in the industry.

2.1.3.2 Islamic Finance Services Act 2013 (IFSA 2013)

The second piece of legislation that should be considered is the IFSA 2013. It is an Act to provide for the regulation and the supervision of Islamic institutions, payment systems and other relevant entities and the oversight of the Islamic money

[67] Central Bank of Malaysia Act 2009, s. 5(1) and s.5(2)(c)

market and Islamic foreign exchange market to promote financial stability and compliance with Shariah and for related consequential or incidental matters. Unlike CBMA 2009 which regulates both conventional and Islamic financial institutions, the IFSA 2013 is promulgated specifically as an omnibus legislation to regulate and supervise the IFIs in Malaysia such as Islamic banks through which products such as *Musharakah Mutanaqisah* home financing and *Musharakah Sukuk* are being developed and marketed as well as to promote the adherence to Shariah.

This Act has come into force on 30 June 2013 after being approved by the Malaysian Parliament in December 2012 and received the royal assent on 18 March 2013. It amalgamates several separate laws under a single legislative framework. They are: (i) the Payment Systems Act 2003, (ii) the Exchange Control Act 1953, (iii) the Islamic Banking Act 1983 (IBA 1983) and (iv) the Takaful Act 1984 which were repealed on the same date of its enforcement. The promulgation of this Act does mark a significant legal development for Islamic finance industry in Malaysia as it provides a far more detailed regime toward a transparent and regulated industry rather than only focusing on licensing of institutions, simple regulation of ownership and business conduct and the powers of the BNM to control the institutions as what had been seen under the IBA 1983.[68]

The IFSA 2013 comprises a total of 291 sections and 16 schedules. It provides a comprehensive legal framework from the matters starting from licensing to winding up of an institution as what can be observed in Part III (Authorization) and Part XIV (Division 3−Winding Up). A number of unpreceded new elements in the regulatory and supervision of the IFIs in Malaysia have also been added to this new Act. For instance, Division 1 of Part XVI which contains section 229 until section 244 is pertaining to the power of enforcement and penalties provided to the BNM. By virtue of this Act, the BNM may cause an investigation to be made, seize relevant documents or items and take civil or criminal actions against any parties. Such provisions did not exist in the previous IBA 1983 but instead adopting the similar provisions from the then Banking and Financial Institutions Act 1989 (BAFIA 1989) which has been repealed by the introduction of the Financial Services Act 2013 (FSA 2013).[69]

In order to strengthen the corporate and Shariah governances of the IFIs, the roles and functions of key individuals of these institutions are also being clarified through this Act. For instance, sections 65, 66 and 67 clarify the functions and duties of the board of directors whereby section 68 is regarding the disqualifications of a person from being, inter alia, appointed as the chairman of the board of directors, director, chief executive officer or senior officer.

Part IV of this Act deals with the Shariah requirements. Division 1 of this part is pertaining to Shariah compliance in which the duty of IFIs in ensuring the compliance with Shariah (section 28) as well as the power of BNM to specify standards on Shariah

[68] Mohd. Johan Lee and Umar Oseni, *IFSA 2013: Commentaries on Islamic Banking and Finance* (CLJ Publication 2015) 5
[69] Ibid, p. 183

matters (section 29) are being spelt out. Division 2 of the same part deals directly with the issue of Shariah governance where the establishment of the Shariah committee (section 30) and duties of the committee and its members are being specified (section 32). All these facts being said, the promulgation of the IFSA 2013 amplifies the clear aspiration of Malaysian legal segment to achieve the greater alignment with the Shariah in all matters related to Islamic finance.

2.1.3.3 Transactional Laws

In relation to *Musharakah* and its practices, the most important legislation that should be considered is the Partnership Act 1961. The Partnership Act 1961 is considered since it is the only reference available under the Malaysian legal system that discussed about partnership which is almost similar to the nature of Musharakah. Even though in the recent years, Malaysia has its own Limited Liability Partnership Act 2012 (LLPA 2012), the researchers found that it is less suitable for the discussion here. The LLPA 2012 is introduced in providing new provisions which altered the original concept of partnership which is applicable under the common law.

2.1.3.3.1 Partnership Act 1961 (PA 1961)

The first piece of legislation from the second group (transactional laws) is the PA 1961. It is an Act of parliament which is in *pari materia* with the English Partnership Act 1890. Both statues are almost identical in content despite the section numbers differing. Containing forty-seven sections, PA 1961, which has been revised in 1974, is divided into five parts; Part I−Preliminary, Part II−Nature of Partnership, Part III−Relations of Partners to Person Dealing with Them, Part IV−Relations of Partner to One Another, Part V−Dissolution of Partnership and Its Consequences.

As discussed previously, *Musharakah* covers a broad understanding for it is classified into various groups by the jurists, depending on which aspect those jurists were looking from. Nevertheless, in general term, the connotation that *Musharakah* brings revolves around the arrangement between two or more parties to combine their assets, labours or liabilities for the purpose of making a profit. Since such an arrangement is essentially a partnership from the legal standpoint, the PA 1961 becomes among the relevant transactional laws in the case of *Musharakah*.

2.1.3.3.2 The Relevance of the PA 1961

As explained earlier, the way in which the Malaysian legal system works has excluded *Shariah* from being the governing law for matters related to Islamic finance. Notwithstanding the existence of provisions such as section 28 of the IFSA 2013,[70] as well as other circulars, guidelines and so forth which entail the obligation on the IFIs to ensure that all of their business activities comply with *Shariah*, such directives

[70] Section 28 of IFSA 2013 reads: s 28. (1) An institution shall at all times ensure that its aims and operations, business, affairs and activities are in compliance with Shariah.

remain general and limited insofar permitted by the civil court as the competent court for Islamic finance adjudication.

Furthermore, section 5 of the Civil Law Act or CLA 1956 entails the applicability of the common law of England and the rules of equity to commercial cases including partnership in the circumstance where there is no written law on such matters. This position is in line with the provision under section 47(1) of the PA 1961 which requires that the partnership venture must comply with the law prescribed by the Act although the rules of equity and common law of England may be applicable, as long as there is no contradiction between them and the Act.[71]

Taking all these facts into consideration, it is asserted here that the applicable law for *Musharakah* is the PA 1961. The applicability of the common law of England and the rules of equity ends with the existence of the written law i.e., the PA 1961, and since there is no exemption made by the court or any written law to exclude *Musharakah* from being a subject of the Act, it shall remain under the purview of the PA 1961.

2.1.3.3.3 PA 1961 Vis-À-Vis Musharakah

It is asserted that risk sharing is an essential element in a partnership from the Islamic finance standpoint. Nevertheless, such issue is not specifically addressed by any provision in the PA 1961. Presumably, this is due to the fact that even though this Act, which is in *pari materia* with the English Partnership 1890, demonstrates the convergence of the idea of partnership with *Musharakah* to certain extent, it also demonstrates the divergence in the understanding of those two i.e., partnership recognised under the PA 1961 and *Musharakah* as prescribed under the Islamic jurisprudence. One of the instances for such convergence and divergence is pertaining to the form of partnership as entailed by the provided partnership's definitions.

Section 3 of the PA 1961 defines partnership as '*the relationship which subsists between persons carrying on business in common with a view of profit*'. The Islamic commercial law, on the other hand, has its own way of presenting the discussion of *Musharakah* partnership. The jurists of Hanafi school of law defined *Musharakah* as a contract between a group of individuals who share the capital and profits.[72] The jurists from the Maliki school of law defined it as the right for all the partners to deal with any part of the partnership's joint property.[73] As for the jurists from the Hanbali school of law, *Musharakah* is the sharing of rights to collect benefits from or deal in the properties of the partnership whereby the jurists of Shafie school of law referred *Musharakah* as an establishment of collective rights pertaining to some property for two or more people.[74]

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[71] Partnership Act 1961, s. 47(1)
[72] Al-Zuhaily, Wahbah. *Financial Transactions in Islamic Jurisprudence Vol. 1*. Trans. Mahmoud A. El-Gamal . Dar al-Fikr, 2003, p. 447
[73] ibid
[74] ibid

An overall analysis over the definitions of partnership as mentioned above would be able to show that partnership, as entailed by section 3 of the PA 1961, is similar to the one entailed by the Hanafi jurists since both refer to the commercial arrangement between the partners serving as a vehicle to carry out business in common with the aim to generate profit from it.

As such, the concept of partnership is only confined within the scope of *Shirkah Al-Aqd* as established in the Islamic commercial law, while omitting another type of *Musharakah,* namely *Shirkah Al-Milk*. *Shirkah Al-Milk*, as entailed by the definitions offered by the jurists of Maliki, Shafie and Hanbali schools of law, implicates the establishment of shared rights among a group of people over an asset as to enjoy the benefit derived from it or to deal in it without necessarily having a commercial aspect embedded in such sharing. For the purpose of this study, such position, therefore, triggers a serious concern since the *Musharakah Mutanaqisah* home financing in Malaysia is to take *Shirkah Al-Milk* as its underlying structure thus put the product's legal status at stake (more on this point shall be addressed later).

The discrepancy between the concept of partnership as understood in the PA 1961 and *Musharakah* of Islamic commercial law can be observed further by referring to section 4 of the PA 1961 where it provides for certain circumstances that cannot be construed as a partnership.[75] In this respect, section 4(a) reads, 'joint tenancy, tenancy

[75] Section 4 of the PA 1961 reads: In determining whether a partnership does or does not exist, regard shall be had to the following rules:

a) joint tenancy, tenancy in common, joint property, common property, or part ownership does not of itself create a partnership as to anything so held or owned, whether the tenants or owners do or do not share any profits made by the use thereof;
b) the sharing of gross returns does not of itself create a partnership, whether the persons sharing such returns have or have not a joint or common right or interest in any property from which or from the use of which the returns are derived;
c) the receipt by a person of a share of the profits of business is prima facie evidence that he is a partner in the business, but the receipt of such a share, or of a payment contingent on or varying with the profits of a business, does not of itself make him a partner in the business; and in particular—
    i. the receipt by a person of a debt or other liquidated amount, by instalments or otherwise, out of the accruing profits of a business does not of itself make him a partner in the business or liable as such;
    ii. a contract for the remuneration of a servant or agent of a person engaged in a business by a share of the profits of the business does not of itself make the servant or agent a partner in the business or liable as such;
    iii. a person being the widow or child of a deceased partner, and receiving by way of annuity a portion of the profits made in the business in which the deceased person was a partner, is not, by reason only of such receipt, a partner in the business or liable as such;
    iv. the advance of money by way of loan to a person engaged or about to engage in any business on a contract with that person that the lender shall receive a rate of interest varying with the profits, or shall receive a share of the profits, arising from carrying on the business, does not of itself make the lender a partner with the person or persons carrying on the business or liable as such:

in common, joint property, common property, or part ownership does not itself create a partnership as to anything so held or owned'. This provision further asserts that notwithstanding *Shirkah Al-Milk* is a recognised form of partnership under the Islamic commercial law, it does not receive such recognition from the PA 1961 since a mere joint property does not constitute a partnership under the Act. As such, this position blurs the legal status of the *Musharakah Mutanaqisah* home financing even further.

Section 4(c) of the PA 1961 is also relevant in this respect. This section provides that the mere receipt of a share of the profits from a business does not automatically make the recipient a partner, hence denies the establishment of partnership.[76] Section 4(c)(ii) further excludes the person who receives remuneration from a share of the profits of a business from a person engaged in the business from being a partner (hence no partnership). It seems that this section rules out *Mudharabah* (a form of *Musharakah*) from the list of the recognised form of partnership under the PA 1961. In *Mudharabah* arrangement, the *Mudharib* will be participating in the business venture not through the capital contribution. Instead, his participation takes place by extending his entrepreneurship skill and labour force. In return, he is entitled to a certain pre-determined portion of profit derived from the venture which whereby in the event of loss, such loss will be solely borne by the capital provider, *Rabbul Mal*. *Mudharib*, as such, receives a share of the profit of the business as the consideration of the 'service' extended, the exact circumstance referred to in section 4(c)(ii).

Based on the arguments as mentioned above, it is, therefore, asserted that notwithstanding the convergence of the fundamental ideas of partnership under the PA 1961 and the Islamic commercial law, the Act fails to recognise certain forms of *Musharakah* partnership such as *Shirkah Al-Milk* and *Mudharabah*. Such failure triggers concern on the status of certain *Musharakah*-based product such as *Musharakah Mutanaqisah* home financing which is structured based on the concept of *Shirkah Al-Milk*.

2.1.3.4 Musharakah Regulatory Policy

As provided by CBMA 2009 and further reiterated in the IFSA 2013, the BNM is empowered to specify standards pertaining to *Shariah* matters in respect of carrying business, affair or activity which requires the ascertainment of Islamic law by the SAC as well as to specify standards relating to the matters which do not require the ascertainment of Islamic law.[77] In addition, the BNM may also specify standards on

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Provided that the contract is in writing and signed by or on behalf of all the parties thereto; and

v. a person receiving, by way of annuity or otherwise, a portion of the profits of a business in consideration of the sale by him of the goodwill of the business is not, by reason only of such receipt, a partner in the business or liable as such.

[76] Samsar Kamar Latif, *Partnership Law in Malaysia* (International Law Book Services 2015), 9

[77] Section 29(1) and 29(2) of the IFSA 2013 read:

29. (1) The Bank may, in accordance with the advice or ruling of the Shariah Advisory Council, specify standards—

prudential matters such as corporate governance and risk management as well as on business conduct to financial service provider to ensure financial consumers will receive fair, responsible and professional service.[78] Further, the BNM also has the authority to issue guidance in writing consisting of such information, advice or recommendation as it regards appropriate with respect to the provisions of IFSA 2013 which can be facilitative for the purpose of carrying out and achieving the regulatory objectives of the Act.[79]

Pursuant to such, a regulatory policy by the title '*Musharakah*' has been issued by the BNM on 20 April 2015 and comes into effect starting from 1st of June 2016. This regulatory policy was issued with the aim to provide reference on the *Shariah* rulings associated with *Musharakah*, setting out key operational requirements pertaining to the implementation of *Musharakah* as well as to promote end-to-end compliance with *Shariah* requirements including adherence to sound banking practices and safeguarding customers' interest.

(a) on Shariah matters in respect of the carrying on of business, affair or activity by an institution which requires the ascertainment of Islamic law by the Shariah Advisory Council; and

(b) to give effect to the advice or rulings of the Shariah Advisory Council.

(2) In addition, the Bank may also specify standards relating to any of the following matters which does not require the ascertainment of Islamic law:

(a) Shariah governance including—

(i) functions and duties of the board of directors, senior officers and members of the Shariah committee of an institution in relation to compliance with Shariah;

(ii) fit and proper requirements or disqualifications of a member of a Shariah committee; and

(iii) internal Shariah compliance functions; and

(b) any other matter in relation to the business, affair and activity of an institution for the purposes of compliance with Shariah.

[78] Section 135(1) and 135(2) of the IFSA 2013 read:

135. (1) The Bank may specify standards on business conduct to a financial service provider for the purposes of ensuring that a financial service provider is fair, responsible and professional when dealing with financial consumers.

(2) Without limiting the generality of subsection (1), standards specified under that subsection may include standards relating to—

(a)transparency and disclosure requirements including the provision of information to financial consumers that is accurate, clear, timely and not misleading;

(b)fairness of terms in a financial consumer contract for financial services or products;

(c)promotion of financial services or products;

(d)provision of recommendations or advice including assessments of suitability and affordability of financial services or products offered to financial consumers; and

(e)complaints and dispute resolution mechanisms.

[79] Section 277 of the IFSA 2013 reads:

277. The Bank may issue guidance in writing to any person or to any class, category or description of persons consisting of such information, advice or recommendation as it considers appropriate—

(a) with respect to the provisions of this Act;

(b) for the purpose of carrying out or achieving the regulatory objectives of this Act; or

(c) with respect to any other matter which, in the opinion of the Bank, is desirable to give information, advice or recommendation.

The provisions in this policy can be divided into two categories, namely 'S' and 'G'. S denotes the standard, requirement or specification which are made mandatory. Failing to comply with such may lead to one or more enforcement actions. G, on the other hand, refers to the guidance which consists of information advice and recommendation with the aim to promote mutual understanding and adoption of sound industry practices which are encouraged to be adopted.[80] It comprises four parts where the first part (Part A) gives an overview for the policy. The second part (Part B) provides the compulsory *Shariah* requirements pertaining to *Musharakah* and its optional practices. Part C and Part D spell out the operational requirements on governance and oversight, structuring, risk management, financial reporting, and business and market conduct where the former focuses on the *Musharakah* venture while the latter focuses on the *Musharakah* financing.

As explained earlier, the jurists from different schools of law had a number of disagreements among themselves over certain issues involving *Musharakah*. These disagreements which led to the production of various rulings and positions had been properly recorded in the Islamic law literature works. Nevertheless, since the regulatory policy is meant to serve as the operation manual rather than a mere reference in the Islamic law, it needs to be clear and precise in terms of the direction it wishes the operation of *Musharakah* to be carried out. For instance, Muslim jurists have disputed over the legality of capital contributed to a *Musharakah* venture which is not in cash form. However, the policy indicates its preference in this issue by allowing the partners of *Musharakah* to contribute their capital in the form of cash or in-kind, including intangible assets. Should the latter be the case, the said in-kind capital shall be valued in monetary terms either by an agreement between the partners or by a third party such as experts, valuers, or any qualified at the point of time where the partners enter into the *Musharakah* contract.[81] As such, while admitting there is a dissenting view offered by the jurists in this regard, as far as the Malaysian context is concerned, such question is no longer relevant.

2.1.3.4.1 Salient Requirements of the Musharakah Regulatory Policy: Capital of Musharakah

Through its provisions, the *Musharakah* Regulatory Policy does not only seek to ensure that the validity of *Musharakah* operation is achieved. Rather, the way it is constructed signifies the aspiration from the regulatory side to uphold and propagate the idea of justice through the promotion of risk sharing idea and the avoidance of the prohibited elements such as *Riba* and *Gharar*. The provisions pertaining to the capital requirement and profit and loss distribution among the instances to exemplify this fact.

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[80] Bank Negara Malaysia, 'Musyarakah' (n 294) para. 7.2

[81] Paragraph 15.2 and 15.3 of the Musharakah Regulatory Policy read:
G15.2 The capital may be in the form of cash or in-kind, including intangible assets.
S15.3 Where the capital is in-kind, it shall be valued in monetary terms either by agreement between the partner by a third party, which may include experts, valuers, or any other qualified person, at the time of entering into the musyarakah contract.

In terms of *Musharakah* capital, the earlier discussion had addressed the nature of the permissible capital, whether it must be in cash or it might also be otherwise. However, there is another equally important point in this respect which needs to be addressed, namely debt as the capital of *Musharakah*. In this case, jurists unanimously agreed that debt such as receivables cannot be contributed as the capital of *Musharakah*. This is because the capital, should it be in the form of debt, cannot be immediately used for the purpose of *Musharakah* operation thus defeats the meaning of *Musharakah* which entails the co-mingling of the assets and the mutual rights of the partners to transact with them from the beginning.[82] Allowing debt to be contributed as capital, thus, would endanger the existence of partnership with uncertainty or *Gharar*.

The reason for such prohibition becomes stronger in the circumstance where one of the partners is the creditor who loans his money to the other partner and contributes the receivable as the capital. Such a situation triggers the risk of *Riba* because the receivable that is contributed as the capital may be construed as a loan which renders benefit (in the form of the entitlement to the *Musharakah* profit). As dictated by a well-known maxim established by the jurists, every loan which renders benefit is deemed as *Riba*, thus prohibited.[83]

As such, the *Musharakah* regulatory policy rules that all forms of debts shall not qualify as capital, including all receivables and payments due from other partners or third parties.[84] Such position is consistent with the position taken by the AAOIFI in this respect. In its *Shariah* Standard no. 12, AAOIFI also rules that it is not permitted for mere debt to represent participation share in the partnership's capital unless the debt is appending to other item which is contributed as capital (for instance a manufacturing facility contributed as capital with all its rights and obligations).[85] Adhering to this requirement is rather important not only to ensure the validity of *Musharakah* but also to safeguard the *Maqasid Al-Shariah* that aims to uphold the justice by eliminating the element of *Gharar* in the commercial transaction. As well as to avoid the *Musharakah* arrangement from being fictitious which is manipulated as a stratagem to *Riba*.

The *Musharakah* regulatory policy also addresses another important point in this respect pertaining to the guarantee on the *Musharakah* capital. It is held by the majority of jurists that no guarantee is allowed to be extended on the *Musharakah* capital. This is due to the fact that *Musharakah* falls under the rubric of *Uqud Amanah*, the contract that is entered based on trust.[86] This is as opposed to another type of contract namely *Uqud Dhamanah*, which is entered based on guarantee. In the case of

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[82] Abdullah bin Ahmad, *Al-Mughni* (Vol 7, 3rd edn, Dar 'Aalam al-Kutub 1997), p.125

[83] Asyraf Wajdi Dusuki and Adelazeem Abozaid, 'Fiqh Issues in Short Selling as Implemented in The Islamic Capital Market in Malaysia' (2008) 21(2) JKAU: Islamic Econ. 63

[84] Paragraph15.5 of the Musharakah Regulatory Policy reads: S15.5 All forms of debts shall not qualify as capital, including all account receivables and payments due from other partners or third parties.

[86] Asmadi Mohamed Naim and others, Issues of Taqsir, Taaddi, Guarantees and Managing Moral Hazard in Mudarabah and Musharakah Products (2013) ISRA Research Paper 58/2013, 24

Musharakah, the partners are entrusting each other with their contributed capital and expected to cooperate in deriving profit from the venture which will be enjoyed together rather than one party has to assume an additional responsibility of making sure that the capital of the other party is protected.[87] As the *Musharakah* property ceases to be the original owner's personal property but the venture's property instead, each partner is deemed as to release his counter partners from the responsibility to guarantee the capital should it damage or loss provided such damage or lost are genuine (not incurred out of negligence, for instance).[88]

Failing to adhere to this requirement will lead to several uncalled consequences. Firstly, the guarantee on capital of *Musharakah* venture, should it be given, will turn the nature of the contract from a trust-based contract into a non-trust-based/guarantee-based contract thus makes the contributed capital effectively as a loan given to the venture.[89] As such, the profit derived from the investment activities would be similar to the interest which is tantamount to *Riba*.

Guaranteeing the capital will also cause the *Musharakah* to be a risk-free investment. In such a case, the guaranteed partner will have the chance to gain profit while does not have to expose himself to the risk of losing his capital. This violates the core trait of a *Musharakah* arrangement as a risk sharing vehicle where the partners are expected to have 'skin in the game' in order to justify their entitlement to the profit. Hence, the *Musharakah* regulatory policy rules that the capital invested shall not be guaranteed by any of the partners or the manager of the venture. However, the partners are to be held liable and shall indemnify the venture for the loss of capital should the loss arise from their misconduct, negligence or breach of specified terms.[90] This position appears to be similar with the AAOIFI *Shariah* standard which also does not permit the stipulation of capital guarantee by partner except for the case of misconduct, negligence or breach of specified terms (*Shariah* standard no.12, paragraph 3.1.4).

Nevertheless, the *Musharakah* regulatory policy does allow for each partner to be required to provide collateral which shall only be liquated in the three circumstances as mentioned above (i.e., in cases of misconduct, negligence or breach of specified terms). A guarantee can also be provided by an independent third party guarantee, provided that the execution of such guarantee shall be done via a separate contract and the independency of the guarantor must be proved in such a way where the partner has no majority ownership or has control over the guarantor or vice

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[87] Aznan Hassan and Zaharuddin Abdul Rahman, 'Musharakah: Isu Jaminan Perlindungan Modal dan Pengukuhan Kredit' (Muzakarah Cendekiawan Syariah Nusantara 5 2011), 6

[88] Ibid, p.8

[89] ibid

[90] Paragraph 15.14 and 15.15 of the Musharakah Regulatory Policy read:
S15.14 The capital invested shall not be guaranteed by any of the partners and/or the managers.
S15.15 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.

versa.[91] Such position is in line with that has been mentioned by the AAOIFII *Shariah* standard as it also allows the stipulation of the party to provide collateral to be liquated during those three events as mentioned above. It also allows an independent third party to undertake to bear the loss on behalf of the partners provided that the third party does not own or is owned by the guaranteed party by more than 50 per cent (*Shariah* standard no.12, paragraph 3.1.4.2 and 3.1.4.3).[92] Understandably, such threshold is set as to indicate the independency of the third party (the party which offers the guarantee) from the party who enjoys the extended guarantee.

For the sake of argument, it might be argued that the permission to provide collateral or guarantee from a third party in order to avoid the capital impairment jeopardises the core nature of *Musharakah* pertaining to risk taking. This argument, however, can be rebutted in several ways. Firstly, the permission to provide collateral does not apply in every circumstance. Rather, it is only applicable in the case of misconduct, negligence or breach of specified terms. Since it is submitted that *Musharakah* is a trust-based arrangement, the partners, therefore are expected to assume the fiduciary duty. The collateral, should it be provided, is only meant to mitigate the risk of failing to fulfil this particular duty. As for the risk associated with the business activities, the collateral does not give any influence whatsoever which makes the nature of the *Musharakah* intact.

Secondly, as to the permission of having a guarantor, such permission can only be exercised with two conditions, i.e., the guaranteeing party must be totally independent (legally and financially) from the partners and the arrangement shall not be embedded in the venture's agreement but to be treated as a separate arrangement. Therefore, the guarantee can be considered as a supplement arrangement only whereby the execution of the venture does not depend on it. Furthermore, a strict requirement has been imposed to gauge the degree of independency of the guaranteeing party. This would be sufficient to ensure that the permission cannot be manipulated by the partner to provide or receive a guarantee, directly or indirectly.

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[91] Paragraph 18 of the Musharakah regulatory policy reads:
18. Arrangement for guarantee
S18.1 Partners in musyarakah shall not guarantee the capital and/or profit.
G18.2 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.
S18.3 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

[92] It is worth to note here, as for the third party guarantee, AAOIFI requires that it should be given without reward whereby the Musharakah regulatory policy of BNM is silent on this point.

As such, the fundamental trait of *Musharakah* in terms of risk taking will be safely preserved.

2.1.3.4.2 Salient Requirements of the Musharakah Regulatory Policy: Profit and Loss Distribution

Profit and loss distribution is another crucial aspect in a commercial arrangement such as *Musharakah*. AAOIFI had adopted the opinion saying that the profit is not necessarily proportionate to the capital contributed, except in circumstances where a partner had stipulated express condition in the agreement that he will remain throughout the tenure of the venture. Thus, his share of profit cannot be more than the ratio of his investment. Such position is different from the one held by the *Musharakah* regulatory policy as it rules that the profit-sharing ratio in *Musharakah* shall be proportionate to the capital contribution of each partner, unless mutually agreed otherwise at the time of entering into *Musharakah* contract.[93] As for the loss, it is explained earlier that there is no dispute among the jurists that it should be proportionate to the capital contribution. As such, the *Musharakah* regulatory policy and the AAOIFI *Shariah* standard take the similar position in this respect.

It is interesting to observe here that the *Musharakah* regulatory policy is quite detailed in its description of profit and loss distribution. There is a clear requirement of not stipulating a pre-determined fixed amount of profit to any partners which may deprive the profit share of the other partner.[94] This requirement is important as by adhering to it, the arrangement shall uphold the implementation of risk sharing and the notion of justice since the return is determined by the actual performance of the venture while its failure makes the arrangement behave similarly to a fixed-income instrument such as the *Riba*-based loan.

Looking from another perspective, the prohibition of prefixing the amount of profit will effectively motivate the partners to execute the investment with due diligence since their gain depends on the performance of the venture. This certainly will stimulate an economic environment with a positive culture which encourages the real economic activities through entrepreneurship, something which is in line with the concept of *Hifz Mal* (the protection of wealth) championed by *Maqasid Al-Shariah*.

The *Musharakah* regulatory policy also prescribes two methods of profit recognition that may be used. The first is the realisation based on the actual liquidation of the assets of the venture, known as *Al-Tandid Al-Haqiqi*. The second method, known as *Al-Tandid Al-Hukmi*, is the recognition in accordance with an acceptable profit recognition method which may include valuation according to the acceptable market methodology or the independent valuation or the valuation based on the estimated

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[93] Paragraph 16.2 of the Musharakah regulatory policy reads:
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.
[94] Paragraph 16.5 of the Musharakah regulatory policy reads:
S16.5 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.

figures. Should the profit be recognised by the latter, a final consolidation and adjustment shall be undertaken to determine the actual profit. The *Musharakah* regulatory policy does allow a sum of money to be distributed prior to the valuation, provided such paid amount that exceeds the actual profit must be adjusted. Such stipulation of adjustment is important to ensure that the profit distribution is reflecting the actual performance of the venture and a fair wealth distribution can take place.[95]

There is also another point which is rather important to be highlighted at this juncture pertaining to the two concepts of *Musharakah,* namely *Shirkah Al-Aqd* and *Shirkah Al-Milk*. The *Musharakah* regulatory policy has put *Musharakah Mutanaqisah* for the purpose of asset acquisition in a relatively new perspective. Paragraph 21.2 reads, "Musharakah Mutanaqisah with an asset acquisition must be governed by the principle of Shirkah al-Milk and therefore must have the effect of Shirkah al-Milk …". Paragraph 31.1 further reads, "Musharakah financing refers to a financing using a Musharakah contract structured to reflect a debt-based financing risk profile which is in line with the *Shariah* concept of Shirkah al-Milk". What is interesting here is the characterisation (termed as *Takyif Fiqhi*) given to the *Musharakah Mutanaqisah* home financing. It construes this particular financing instrument as *Shirkah Al-Milk* rather than *Shirkah Al-Aqd*. As *Musharakah*, in its original sense, connotes the equity ownership of the partners, this characterisation needs to be examined further, especially in terms of the ability of the *Musharakah* arrangement with this kind of character to uphold the idea of risk sharing which is the substratum of this particular arrangement.

2.1.3.5 Legal Recognition: An Analysis on the True Nature of Musharakah in Light of Section 3 of the PA 1961

As to recap, it is established that all cases related to the Islamic finance, in the Malaysian context, are subject to the federal laws which are highly influenced by the English common law system. Also, since there is no proven exclusion as to the governing act, the prima facie case shows that *Musharakah*, as a form of partnership, falls under the purview of the PA 1961. Therefore, this subtopic seeks to analyse the

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[95] Para. 16.8 to 16.11 of the Musharakah Regulatory Policy read as the following:
S16.8 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).
G16.9 In the case of profit recognised based on constructive basis, a profit reserve may be created.
S16.10 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.
S16.11 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.

recognition held by this act towards *Musharakah* and subsequently, the *Musharakah* products.

It is mentioned earlier that there is an inconsistency between the IFSA 2013 and the *Musharakah* Regulatory Policy as the former construes *Musharakah Mutanaqisah* as an equity financing whereby the latter construes it as a debt financing; both are proven to be contradicted in a number of aspects including the compatibility with the idea of risk sharing. Up to the present time, such inconsistency is yet to be resolved through any means such as the adjudication before the court of law. Therefore, the finding from this analysis is important as it shall help to infer the reality of *Musharakah Mutanaqisah* home financing within the existing legal and regulatory framework and how such reality gives impact on the implementation of risk sharing.

This study has also asserted that although the understanding of *Musharakah* in the Islamic commercial law does converge with the idea of partnership as provided by the PA 1961 in several aspects, nevertheless, the Act fails to fundamentally recognise and comprehensively include *Musharakah* as a form of partnership. This is demonstrated through the provisions like section 4(a) and section 4(c). Section 4(a) provides among the things that are not being recognised by itself as a partnership, are joint property, common property, or part ownership. As such, the provision effectively excludes *Shirkah Al-Milk*. Although it is a legitimate form of *Musharakah* it is not recognised as a partnership under the PA 1961.

Section 4(c) further provides that the mere receipt of a share of the profits of a business does not automatically make the recipient a partner. Section 4(c)(ii) excludes a person who receives remuneration by a share of the profits of a business from a person engaged in the business from being a partner, thus, denies the existence of a partnership. This exclusion, therefore, rules out *Mudharabah*, a form of *Musharakah* from the recognised forms of partnership under the PA 1961. The party who runs the business *(Mudharib*) in a *Mudharabah* arrangement will get into the business not by contributing capital but extending his entrepreneurship skill and labour force instead (while the capital will be contributed by the other party, the *Rabbul Mal*).

The above assertions lead to the discussion like the following; since it is proven that the PA 1961 does not recognise several forms of *Musharakah*, how does the law regard the *Musharakah Mutanaqisah* home finance and *Musharakah Sukuk*. To answer this, an in-depth perusal on section 3 of the Act will be undertaken. Section 3 of the Act defines partnership as 'the relationship which subsists between persons carrying on business in common with a view of profit'. Hence, a partnership, by virtue of this provision, must contain certain essential elements namely (i) business[96], (ii) carried on in common and (iii) with a view of profit. In addition, the real intention in entering the contract shall also be accounted in order to determine the existence of a partnership. Nevertheless, these elements, jointly or separately, however, appear to inflict various incompatibilities with the *Musharakah Mutanaqisah* home financing as well as the *Musharakah Sukuk.*

[96] Section 2 of the PA 1961 provides that 'business' includes every trade, occupation, or profession.

2.1.3.5.1 The First Element – Business in Common

The Federal Court case of *Chooi Siew Cheong v Lucky Height Development Sdn. Bhd. & Anor*[97] is among the important cases in which the legal principle in respect to the essential elements of a partnership as mentioned above is established. In this case, the plaintiff's father (landowner) and a developer had entered into a joint agreement (joint venture agreement) to develop a piece of land into a housing estate. The developer, through a deed of assignment, assigned all his right and liabilities under the joint venture agreement to the first respondent (first defendant) while the landowner, through an agreement, assigned all his rights to the appellant (plaintiff). The agreement also provided, inter alia, for the landowner to transfer the developer's lots in favour of the first respondent (first defendant) as well as for the appellant (plaintiff) to be made as a permanent director of the first respondent (first defendant). The first respondent (first defendant) was to hold all the developer's lots as the trustee until the completion and discharge of all of its obligations as specified in the joint venture agreement. In the circumstance where it failed to carry on with the housing development, the joint venture agreement required all the developer's lots to be re-transferred to the appellant (plaintiff).

Upon the first respondent (first defendant)'s failure to observe the conditions to construct the houses and therefore in breach of the said agreements, the appellant (plaintiff) sought in the High Court for the re-transfer of the developer's lots, only to realise that the second respondent (second defendant) had lodged a prohibitory order against the land in question, claiming the land was registered under the name of the first respondent (first defendant) who turned out to be a judgement debtor (to the second respondent/second defendant) for works undertaken by it on the land. It also claimed that it had no knowledge of any agreement between the appellant (plaintiff) and the first respondent (first defendant) at all material time.

The trial Judicial Commissioner dismissed the application by the appellant (plaintiff) and affirmed the second respondent (second defendant)'s entitlement to file the prohibitory order and held that the sought re-transfer of the land could not be granted without first satisfying the judgement sum. He based his decision on the ground, inter alia, that as a party to the joint venture agreement, the plaintiff was a partner within the meaning of the term provided by the PA 1961. As a partner of the first respondent (first defendant), he was responsible for the debts of the partnership. This is in addition to the fact he was a permanent director of the first respondent (first defendant) as well. The appellant (plaintiff) appealed to the Federal Court. However, the appeal was dismissed.

Notwithstanding the learned Federal Court judges affirmed the decision made by the High Court on several bases, they, however, did not agree with the Judicial Commissioner of the High Court where the latter had construed the plaintiff as a partner within the meaning of the term as provided by the PA 1961. According to

[97] [1995] 1 MLJ 513

them, in determining whether or not a partnership exists, the intentions of the parties as it appeared from the whole facts of the case and the contract, they had entered to must be considered.

In this case, the appellant (plaintiff), through his father who was the party to the initial agreement, had provided the land and the first respondent (first defendant) was to provide the capital, labour and services to develop and build the land. Both were to share the ultimate product (terrace houses and shophouses which to be built in two phases) based on the agreed proportions (17:83 in the first phase and 23:77 in the second phase, all in the developer's favour) in such a way where each was to take certain sublots to the exclusion of other (with or without building erected thereon) with a complete freedom to deal or dispose as they respectively wished. That being said, each party had intended a wholly separate business which denies the element of 'business carried on in common' as required by section 3 of the PA 1961. Based on this fact, there is no partnership in existence between them in this case.

An old English case, *Coope & Ors v Eyre & Ors*[98] also established, inter alia, the similar principle. In brief, the plaintiffs sold oil to the defendants which is to be received as soon as it was boiled and ready. By way of collateral security (two bills of exchange, placed in the hands of plaintiffs, one of which was accepted by the defendants-Eyre, Atkinson and Walton), both parties agreed that the plaintiffs should keep the oil in their possession till future date. Should the defendants did not pay for it upon the agreed future date, the plaintiffs were to authorise the broker to resell it at the best possible price, and the difference of the price will be deducted from the bills placed in their hands. It turned out that the defendants neither paid for the oil nor took it away and the bill of exchange that had been accepted by the defendants was presented to them for payment and refused. The action was brought before the court for the recovery of payment.

It was insisted by the defendants that the contract for sale was made between the plaintiffs and Eyre only. The agreement entered between themselves did not constitute partnership (thus they are not the partners to Eyre) but merely a sub-contract. This is to exclude themselves from being jointly held liable should the verdict is in favour of the plaintiffs. Therefore, like in the previous case, the same question was brought before the court; whether or not a partnership exists between the defendants. Delivering his opinion, Gould, J (one of the trial judges) asserted that a partnership did not arise since 'there was no communication between the buyers as to profit or loss'. Every defendant secured his share of oils respectively and no interference with the share of the others but to manage his share as his wish.

Lord Loughborough (the other trial judges), concurred with what has been said by Gould J. Admitting that communion of profit and loss is essential in this question, he added that for a partnership to be constituted the shares must be joint though not necessarily be equal. If the partners be jointly concerned in the purchase, they must also be jointly concerned to sale in the future. As this is not the case, which effectively

[98] [1788] 1 H. Bl. 37

denies the existence of 'business carried on in common', the partnership, therefore, did not exist. As such, together with other evidence, it was decided the only party liable (and from the legal standpoint, the only party the credit was given to) is Eyre.

2.1.3.5.2 The Second Element – Real Intention

Apart from the commonality aspect in business, other things such as the real intention, the relevant incidents which may include written or verbal agreement, the conduct of the parties at all times as well the surrounding circumstances may also be the determinant in ascertaining the status of a partnership. This was, inter alia, established through the case of *Aw Yong Wai Choo & Ors v Arief Trading Sdn Bhd & Anor.*[99] In this case, the plaintiffs had entered into a sale and purchase agreement with the first defendant, a housing developer, where the land on which the houses were planned to be built belonged to the Perak state government, the second defendant. The first defendant failed to undertake the construction. Nevertheless, it was continued by the second defendant. Upon the completion, the second defendant asked the plaintiffs to pay the houses with higher prices than what they had agreed with the first defendant, claiming that the houses were built with the superior specifications as compared to those that had been agreed before (between the plaintiffs and the first defendant.)

Refusing to such, the plaintiffs claimed that both defendants had become partners in the business of developing housing estate and building houses on the land. Pursuant to which the agreement between the plaintiffs and the first defendant was entered. Hence, a legal remedy (specific performance) was sought after. In its defence, the second defendant denied, inter alia, that it was a partner to the first defendant by claiming it was merely sought to help the latter on a social or moral duty. Further, it claimed that it was never be the plaintiffs' intention to enter into a contract with it. As a non-party to the contract in question, hence, it could not be sued for the contract.

It was held by the court, inter alia, that a partnership did exist between the defendants. In the quest to determine the existence of the partnership, the court must find the real intention of the involved parties which is not necessarily the expressed intention. Rather, the relevant factors such as the relevant incidents, written or verbal agreement, the conduct of the parties at all times and all surrounding circumstances are also to be taken into consideration. In this case, there are several things that indicate the existence of the partnership between them.

Among the instances is the provision in the agreement between the first and second defendant that provides 50 per cent of the profit of the development to be given to the latter, thus giving rise to prima facie evidence of partnership. Admitting that the said provision did not constitute partnership conclusively, the court had also considered all the provisions in the agreement, particularly the ones pertaining to the joint appointment of architects, surveyors and so forth, the reserved right to the second defendant to inspect the project to ensure everything complied with all

[99] [1992] 1 MLJ 166

specifications and the right to inspect all books of accounts and the accounts which were required to be properly kept and audited. In addition, the brochure distributed to the potential buyers mentioned a 50/50 joint venture between the first defendant as the developer and the second defendant as the landowner. Therefore, the court granted the specific performance as prayed.

The discussion above triggers the question on the position of the *Musharakah Mutanaqisah* home financing under the PA 1961. As mentioned earlier, the product is meant as a financing tool through which the finance provision is provided by the bank to its customer. On the part of the bank, the aim is to gain profit from the selling price of its portion of the property as well as the rental payment made by the customer. The customer, on the other hand, seeks to acquire the house. As such, there is no common business carried between both parties. This situation, therefore, disqualifies this product as a partnership recognised under the PA 1961. In addition, it is also claimed that the agreement used between the bank and its customer clearly states that this product is not a partnership and some agreements go to the extent where it is mentioned that no agency is implied.[100] This poses a serious implication since the agency is among the essential elements of *Musharakah* with the commercial goal.

The same concern is also relevant in the case of *Musharakah Sukuk*, particularly in the issuance where an intermediary entity, known as Special Purpose Vehicle (SPV) is involved. SPV is a separate legal entity, set up by the originator/obligor (the original party seeking the fund) with the sole purpose of facilitating the transaction.[101] It serves as the issuer of *Sukuk* as well as the trustee over the funds received from the investors. Typically, the originator contributes in-kind (eg business venture) while the SPV contributes cash normally from the proceeds of *Sukuk* issuance.[102] Both will enter into the *Musharakah* agreement in which specifies, inter alia, the profit and loss sharing ratio. Such profit (and loss) will be then distributed to the investors (via the SPV) in the form of periodic distribution amounts which will take place annually or semi-annually, depending on the agreement.

On the one hand, the existence of SPV admittedly is important and benefits both parties, the originator and the investors (*Sukuk* holders). Being a bankruptcy-remote body, any change in the originator's structure such as dissolution, merger or acquisition will not render effect to the relation it has with the *Sukuk* holders.[103] Furthermore, the SPV is liable to the *Sukuk* holders for default or delay, if any, rather than the originator thus minimises the risk to the originator.[104] On the other hand, having SPV in the bigger picture of *Musharakah Sukuk* arrangement would make *Sukuk* holders, in the real sense, are not the partners in the venture. Rather, the partnership is created between the originator and the SPV which makes both as the actual partners

[100] Haneef, Kunhibava and Smolo (n 323)
[101] Abdullah Saeed and Omar Salah, 'Development of Sukuk: Pragmatic and Idealist Approaches to Sukuk Structure' (2014) (1) J.I. B.L.R 41
[102] Securities Commission Malaysia (n 337)
[103] Saeed and Salah (n 550)
[104] ibid

of the venture. As such, the question of whether or not the arrangement is a partnership recognised under the PA 1961 once again arises.

As established before, it is essential in a partnership for all partners to carry on the business in common. However, in this case, there is no common business carried out by both parties. The originator is seeking for the fund for its interest (eg specified project development or maybe merely for the company's working capital or other purposes) whereby the SPV is purposely being set up to serve as the conduit through which the money from the *Sukuk* holders is pooled. The latter (SPV) has no common interest in the business but only to channel the money into the venture while the *Sukuk* holders, apart from not being the partners, are merely the financiers whom their return happens to be determined by the performance of the venture.

From another angle, the intention of *Sukuk* holders to be partners concerned with the venture activity can be highly doubted given the existence of various mechanisms embedded in the *Sukuk's* structure, particularly *Musharakah Sukuk*. Among the examples for the said mechanisms is the purchase undertaking through which the obligor of *Sukuk* will undertake to buy back the underlying asset from the *Sukuk* holders as can be seen in the structure of *Musharakah Sukuk*. Upon the dissolution declaration or the scheduled dissolution (whichever earlier), the obligor shall acquire the *Sukuk* holders' undivided proportionate beneficial interest in the *Musharakah* asset at the price which shall be calculated based on a certain pre-agreed formula.[105] This mechanism allows the total return to the *Sukuk* holders to be 'fixed' or 'guaranteed', especially if the purchasing price is at face value of the *Sukuk*. In such a case, the risk presented by the *Sukuk* will be no longer based on the performance of the asset (*Musharakah* business) but the creditworthiness of the obligor (purchase undertaking provider) as it assumes the ultimate obligation to repay the *Sukuk*.[106]

This may indicate *Sukuk* holders, from the beginning of their subscription to the *Sukuk*, did not intend to be partners of the venture but to act as mere creditors instead. Furthermore, the *Sukuk* structure may also feature the top-up payment mechanism. The *Sukuk* holders were promised with the expected return from the venture of each tranche (for example, 6 per cent). Should the actual return fall short of this expected return (for example, 4 per cent), the obligor shall cover the difference (2 per cent) via the top-up payment.[107] Although this payment may be set-off later, the existence of this mechanism further casts doubt on the intention of the *Sukuk* holders; whether they genuinely want to be partners in the venture whom their return will be based on the performance of the venture or to be the creditors whom their return is guaranteed regardless of the venture performance. Should the latter prevail, *Musharakah Sukuk* is certainly disqualified to be recognised as a partnership under the PA 1961.

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[105] Principle Terms and Conditions of Proposed Sukuk Musharakah Programme by Putrajaya Holdings Sdn. Bhd. (n 344)

[106] Securities Commission Malaysia (n 337)

[107] Principle Terms and Conditions of Proposed Sukuk Musharakah Programme by Putrajaya Holdings Sdn. Bhd. (n 344)

2.1.3.5.3 The Third Element – View of Profit

The existence of partnership in the *Musharakah Mutanaqisah* home financing can also be challenged based on the absence of the profit motive as required by the PA 1961. In fact, the case of *Coope & Ors v Eyre & Ors* as mentioned earlier also established that a simple co-ownership of property cannot constitute a partnership, something which is consistent with section 4(a) of the PA 1961 as discussed earlier. This certainly disqualifies the *Musharakah Mutanaqisah* home financing as a form of partnership since the *Musharakah* regulatory policy clearly provides that the *Musharakah Mutanaqisah* product with the purpose of asset acquisition shall be deemed as *Shirkah Al-Milk*, a non-profit partnership established in acquiring a property with co-ownership between the bank and its customer. It might be argued that in this arrangement, the bank intends to make a profit. However, this argument is inaccurate for several reasons.

On the bank's side, the profit is not generated from the *Musharakah* itself *since Musharakah* is only used in the stage where the bank and its customer jointly own the property. Rather, it is derived from the rental payment by the customer (*Ijarah*) as well as the sale of the bank's portion to the customer (*Bai*). On the customer's side, the intention may not be to generate profit but to acquire the house for his basic necessity (shelter).

The similar argument may also relevant in *Musharakah Sukuk* although it might not necessarily be the case all time. Should the pooling of assets be intended for the parties to jointly own or acquire the asset (which will be determined by the agreement) rather than to generate profit, the contract shall be deemed as *Shirkah Al-Milk* instead of *Shirkah Al-Aqd*.[108] Notwithstanding *Sukuk*, in general, is an investment tool, the structure that invokes *Shirkah Al-Milk* shall be exposed to the risk of not being recognised as a partnership by the law for the reasons as mentioned earlier.

There are also some other provisions in the PA 1961 which make it impossible for the *Musharakah* products to be recognised as a partnership. For instance, section 6 provides for the partnership to be called a firm and the name under which the business is undertaken is called the firm name.[109] Since the current practice of the *Musharakah Mutanaqisah* and also *Musharakah Sukuk* does not require a firm to be established, the practice is therefore against the act.[110] Section 47(2) further provides the maximum

[108] Securities Commission Malaysia (n 337)

[109] Section 6 of the PA 1961 reads:

6. Persons who have entered into partnership with one another are, for the purposes of this Act, called collectively a firm, and the name under which their business is carried on is called the firm name.

[110] Ahmad Zafarullah Abdul Jalil and others, 'Challenges in the Application of Mudarabah and Musharakah Concepts in the Islamic Finance Industry in Malaysia' [2013] ISRA Research Paper 56/2013, 23

number of partners permitted for a partnership is not more than twenty.[111] The restriction imposed by this section might not be problematic in the case of the *Musharakah Mutanaqisah* home financing since the arrangement typically involves a bank and a customer. However, it is definitely not practical to impose such restriction on the *Musharakah Sukuk* where the number of investors might be more than 20 to correspond with the sought fund which typically huge.

As such, notwithstanding the brand name that the *Musharakah Mutanaqisah* home financing (and *Musharakah Sukuk* as well) contains the term *Musharakah* which implies partnership, these products fail to meet the requirements for an arrangement to be recognised as one as established by the PA 1961 as well as the judgements from the courts. Although the conflict of nature (whether the products, especially the *Musharakah Mutanaqisah* home financing, are equity-based or debt-based) is yet to be resolved, the assertion of this failure infers that these products are not based on equity. Moreover, as highlighted in the note earlier, these products are to be booked in a financial report in the same group of other debt-based products since the financial report regards the actual substance of the product (its economic substance or financial reality) rather than its form.

2.2 PART B: MUSHARAKAH IN PRACTICE

This section presents a few of selected themes which are derived based on a systematic analysis of available literature review which is relevant to *Musharakah* in practice.

2.2.1 SHARIAH-COMPLIANCE VENTURE CAPITAL AND ITS RELATIONSHIP WITH ISLAMIC BANKING AND FINANCE

The emergence of modern Shariah-compliance venture capital can be associated directly or indirectly with the growth of the Islamic banking and finance industry. Nowadays, the term 'venture capital' is more frequently used and associated with Islamic capital market. Venture capital can be understood as "a form of financing that provides funds to early-stage, emerging companies with high growth potential, in exchange for equity or an ownership stake"[112]. According to Metrick and Yasuda,[113] venture capital has five main characteristics: (i) it involves a financial intermediary strategy where the investor's capital is utilized directly to the company's portfolio; (ii) it usually involves private companies; (iii) it involves an active role in monitoring and helping the company's in its portfolio; (iv) it helps to maximize its financial return by existing investments through a sale or an initial public offering; and (v) it allows the internal growth of the invested company. The normal investors in venture capital are

[111] Section 47(2) of the PA 1961 reads: 47. (1) ... (2) Nothing in this Act shall be read to permit any association of more than twenty persons to be formed or to carry on any business in partnership contrary to 14(3)(b) of the Companies Act 1965[Act 125].

[112] Corporate Finance Institute (2021). *Venture Capital*. Retrieved from https://corporatefinanceinstitute.com/resources/knowledge/finance/what-is-venture-capital/

[113] Metrick, A., & Yasuda, A. (2021). *Venture capital and the finance of innovation*. John Wiley & Sons.

independent or well-off investors, investment banks, and any other financial institutions which are governed by the existing laws.

Venture capital can be carried out in five different stages of business as provided in Table 1.0 below:

Stages of Business	Explanation
Seed capital	The company is a new company without products. The investment capital is used to produce sample product, administrative set-up costs, fund market research, etc.
Start-up capital	The company is a start-up company with available products. The investment capital is used for recruitment of employees, finalizing products, promotions, marketing, etc.
Early-stage capital	The company exists in the market for two to three years, has well-organized management team, and sales are increasing. The investment capital is used to increase sales or improve the productivity.
Expansion capital	The company is well established in the market. The investment capital is used to upgrade the company to its next level of growth, such as to enter a new market.
Late-stage capital	The company is well established in the market, with steady sales and revenue. The investment capital is used to increase capacity, increase the efficiency of marketing, increase working capital, etc.
Bridge financing	The company is well established in the market. The investment capital is used to attract public financing through a stock offering, to widen the business spectrum, starts the initial public offerings, etc.

Islamic venture capital can be traced back to the early beginning of Islam. It is noted here that there is a scarce literature relating to Islamic venture capital, especially in relation to the modern setting of Islamic banking and finance industry. Thus, all and any relevant literature are used here to develop the comprehensive

understanding regarding the topic of the research. According to Hassan et. al,[114] the emergence of Islamic venture capital can be divided into two major phases. Firstly, the emergence of classical Islamic venture capital that dated back to the early history of prophethood. It may also go further to the pre-Islamic history. Secondly, the emergence of modern Islamic venture capital which landmarked with the establishment of Mit Ghamar Bank, as the first experiment of modern Islamic bank.

With the continuous growth of Islamic banking and finance globally, there are a lot of efforts made to revive the practices of Islamic financial structures that derived and confirmed with the principles of Islamic law of transactions. At the same time, the application of those Islamic financial structures is suit to be applied according to the existing laws of the countries. The most prominent Islamic financial structures that can be referred to in the practice of Shariah-compliance venture capital are *Musharakah* and *Mudarabah*.

2.2.3 MUSHARAKAH AS ISLAMIC FINANCIAL STRUCTURE

Both of *Musharakah* and *Mudarabah* as financial structures are taken with a high interest among Islamic banking practitioners for equity-based financing instruments.[115] In comparison between these two Islamic financial structures, *Mudarabah* is more frequently used for hire purchase transactions, while *Musharakah* is more inclined to be used for venture capital activities.[116] According to earlier researches, *Musharakah* and *Mudarabah* are frequently offered by Islamic banks since they increased value for the banks.[117] This can be seen from the existence of proper and discrete monitoring, and their familiar attributes to debt-based financing. Both of these Islamic financial structures allow the applications in the Islamic banking and finance to meet the objectives of *Maqasid Al-Shariah*. While, at the same time, they assist in the acquisition of assets for the involved parties in line with the requirements of Shariah and the modern laws. They also allow the rapid activities of economy that support the socio-economic development, especially for locals.

However, it is noted that both of *Musharakah* and *Mudarabah* are considered less favourable equity-based financing contracts in the Islamic banking and finance industry, in comparison to debt-based financing.[118] This situation happens due to the

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[114] Hassan, R., Mikail, S.A. and Arifin, M. (2011), "Historical development of Islamic venture capital: an appraisal", Journal of Applied Sciences Research, Vol. 7 No. 13, pp. 2377-2384.

[115] Rahman, A. A., Nor, S. M., & Salmat, M. F. (2020). The application of venture capital strategies to musharakah financing. *Journal of Islamic Accounting and Business Research*.

[116] Ibid.

[117] Muda, R. and Ismail, A.G. (2010), "Profit-loss sharing and value creation in Islamic banks", Journal of Business and Policy Research, Vol. 5 No. 2, pp. 262-281.; Shaikh, S.A. (2017), "Poverty alleviation through financing microenterprises with equity finance", Journal of Islamic Accounting and Business Research, Vol. 8 No. 1, pp. 87-99, doi: 10.1108/jiabr07-2013-0022.

[118] Abdul-Rahman, A., Abdul Latiff, R., Muda, R. and Abdullah, M.A. (2014), "Failure and potential of profit-loss sharing contracts: a perspective of new institutional economic (NIE) theory", Pacific Basin Finance Journal, Vol. 28, pp. 136-151.; Hassan, M.K. and Aliyu, S. (2018), "A contemporary Islamic banking literature", Journal of Financial Stability, Vol. 34, pp. 12-43.; Abdul-Rahman, A., Abdul-Majid, M. and Kj, N.F. (2019), "Equity-based financing and liquidity risk: insights from Malaysia and

existence of higher risks involved in both of the contracts, in comparison to other Islamic financial structures that are available in the market. In comparison between *Musharakah* and *Mudarabah*, *Mudarabah* is much more familiar among customers due to its attributes that are more similar to debt-based financing which involves cost-plus-profit. Meanwhile, *Musharakah* allows the creation of partnership between the contractual parties with an appreciation of profit-loss sharing concept. In describing the application of *Musharakah* in relation to venture capital, Rahman et. al[119] highlighted that:

> "In principle, the financing of business capital represents equity-based financing, which emphasises risk and profit sharing between investors and entrepreneurs (Abdul-Rahman and Mohd Nor, 2016; Othman et al., 2017). This partnership brings advantages to both parties. Entrepreneurs do not have to bear the burden of debt that requires scheduled repayments, whereas investors will gain the advantages of technology know-how as a result of the partnership. Investors may also serve as a mentor to their partner such as help to formulate the company's corporate strategy and enhance its performance with new network financing and markets (Nordin et al., 2005)".

It is identified that there are several reasons on the preference of *Mudarabah* to *Musharakah* as traceable from the Islamic banking and finance industry. *Musharakah* involves a higher risk, where a preference is given to other Islamic financial structures that are have less risks and more suitable for a short-term investment.[120] This is due to the lack of liquidity of Islamic banks when they are participating with medium- to long-term investments. There is also an apparent risk when comes to the operation of project that involved *Musharakah* agreement. Due to the nature of *Musharakah*, it is open for a risky partnership that requires additional monitoring cost, the lack of transparency in markets, and the depositors' reluctant to have the sharing of risks in the operation of project.

Additionally, according to Rahman et. al,[121] "the *Musharakah* mode of financing lacks the following aspects: clarity between shareholders and investors or

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Indonesia", International Journal of Economics, Management and Accounting, Vol. 27 No. 2, pp. 291-313., Abdul Rahman, A., Mohd Nor, S., & Salmat, M. F. (2020). The application of venture capital strategies to musharakah financing. *Journal of Islamic Accounting and Business Research*, *11*(4), 827-844.

[119] Abdul Rahman, A., Mohd Nor, S., & Salmat, M. F. (2020). The application of venture capital strategies to musharakah financing. *Journal of Islamic Accounting and Business Research*, *11*(4), 827-844, p. 828.

[120] Dar, H.A. and Presley, J.R. (2000), "Lack of profit loss sharing in Islamic banking: management and control imbalances", International Journal of Islamic Financial Services, Vol. 2 No. 2, pp. 3-18.; Ascarya, D.Y. and Rokhimah, G.S. (2008), "Efficiency analysis of conventional and Islamic banks in Indonesia using data envelopment analysis", Paper, Seminar and Sysposium on Implementations of Islamic economics to Positive Economics in the World as Alternative of Application of venture capital strategies 841 Conventional Economics System-. Toward Development in the New Era of the Holostic Economics, Universitas Airlangga Surabaya pp. 1-3.

[121] Abdul Rahman, A., Mohd Nor, S., & Salmat, M. F. (2020). The application of venture capital strategies to musharakah financing. *Journal of Islamic Accounting and Business Research*, *11*(4), 827-844, p. 831

depositors[122], detailed records,[123] and information on entrepreneurial abilities[124]. Information asymmetry occurs in *Musharakah* financing". Moreover, Haron and Lee[125] asserted that *Musharakah* financing may lead to credit risk related to capital impairment risk, which means that the capital provided by the financier may not be recovered. With the existence of those risks in mind, *Musharakah* should not be sublimed as an Islamic financial structure. Against all odds, it is possible to apply *Musharakah* as an Islamic financial structure for businesses that possess similar risks in practice.

2.2.4 MUSHARAKAH AND SHARIAH-COMPLIANCE VENTURE CAPITAL

The volume of global investment in Shariah-compliance assets is increasing, and Islamic finance assets have surpassed the figure of US$2tn.[126] Although Islamic finance is gaining ground at a quick pace, it has mostly relied upon the replication of interest-based financing instruments, and questions are now being raised whether Islamic finance is different in any respect from its conventional counterpart.[127] Instead of replicating conventional finance products, the promotion of equity contracts based upon risk-sharing principles is the ideal way forward for Islamic finance.[128] In this respect, the venture capital investment mode has the potential of becoming an ideal Shariah-compliant arrangement. This is provided certain modifications are incorporated in its structure, underlying contracts and line of business. This is acceptable since venture capital involves investment in real economic activities. In real economic activities, returns/profits are earned through the active involvement of investors and participation in the business risk, which is in fact, the real essence of Islamic banking and finance.[129]

Shariah-compliance venture capital needs to be promoted in the Islamic banking and finance industry, especially to assist the small and medium enterprises.

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[122] Greuning, H.V. and Iqbal, Z. (2007), "Banking and the risk environment", in Archer, S. and Abdel Karim, R.A. (Eds), Islamic Finance: The Regulatory Challenge, John Wiley and Sons (Asia), pp. 11-39.
[123] Iqbal, M. and Molyneux, P. (2005), Thirty Years of Islamic Banking: History, Performance, and Prospects, Palgrave MacMillan
[124] Sadr, K. and Iqbal, Z. (2002), "Choice between debt and equity contracts and asymmetrical information: some empirical evidence", Islamic Banking and Finance: New Perspectives on Profit-Sharing and Risk, Edward Elgar, Cheltenham, UK and Northampton, MA, pp. 139-151.; Iqbal, M. and Molyneux, P. (2005), Thirty Years of Islamic Banking: History, Performance, and Prospects, Palgrave MacMillan.
[125] Haron, A. and Lee, J. (2007), Inherent Risk: Credit and Market Risks, in Archer, S. and Abdel Karim, R.A. (Eds), John Wiley and Sons (Asia), pp. 94-120.
[126] IFSB (2018a), "Islamic financial services industry stability report 2018", Islamic Financial Services Board, available at: www.ifsb.org/download.php?id=4811&lang=English&pg=/sec03.php (accessed 20 June 2018).
[127] Chong, B.S. and Liu, M.-H. (2009), "Islamic banking: interest-free or interest-based?", Pacific-Basin Finance Journal, Vol. 17 No. 1, pp. 125-144.

[128] Smolo, E., & Mirakhor, A. (2010). The global financial crisis and its implications for the Islamic financial industry. *International Journal of Islamic and Middle Eastern Finance and Management*.
[129] Elsiefy, E. (2014). Fundamental requirements for building an Islamic venture capital model. *Accounting and Finance Research*, *3*(1), 1-55.

Moreover, Islamic venture capital's investments do not differ from their conventional counterparts, except that they must comply with the principles of Shariah. While, conventional venture capital's funds can be exploited through any profitable business opportunity, Islamic venture capital cannot be invested in sectors that are prohibited by Shariah. Businesses that involve prohibited materials such as liquor, pork, adult entertainment or other proscribed activities are identified as contrary to Shariah. The core for the continuous growth of Islamic venture capital in term of investment/funding and financing depend on the formation of contract and strong bond of partnership. This is suitable with the application of *Musharakah*. At the same time, they appoint Shariah advisors to provide continuous guidance on permissible lines of business and acceptable structures of instruments,[130] which fits with the current practices of Islamic banking and finance.

2.2.6 MUSHARAKAH AND ITS CURRENT PRACTICES IN IBF

In Malaysia, there are several Islamic banks that notably introduced *Musharakah* based products to their customers. Based on the retrieval of product disclosure sheets as made available by Islamic banks in Malaysia, there are two types of financing products that are based on *Musharakah*. Majority of these financing products depend on the operation of *Musharakah Mutanaqisah* or also known as the Diminishing *Musharakah*.

Product	Islamic Banks
Musharakah (Asset Acquisition)	1) Affin Islamic Bank Berhad 2) RHB Islamic Bank Berhad 3) HSBC Amanah 4) Public Islamic Bank Berhad 5) Standard Chartered Saadiq
Musharakah Home Financing-*i*	1) Maybank Islamic (M) Berhad 2) Ambank Islamic 3) Bank Muamalat (M) Berhad 4) OCBC Al Amin 5) Kuwait Finance House 6) Asian Finance Bank

Those Islamic banks that are offering *Musharakah* based products have given different names for their products which may cause a difficulty in identifying them as based on *Musharakah* concept. Regardless of the products' name as called by their respective Islamic banks, their operational steps remain the same. These operational steps are as the followings:

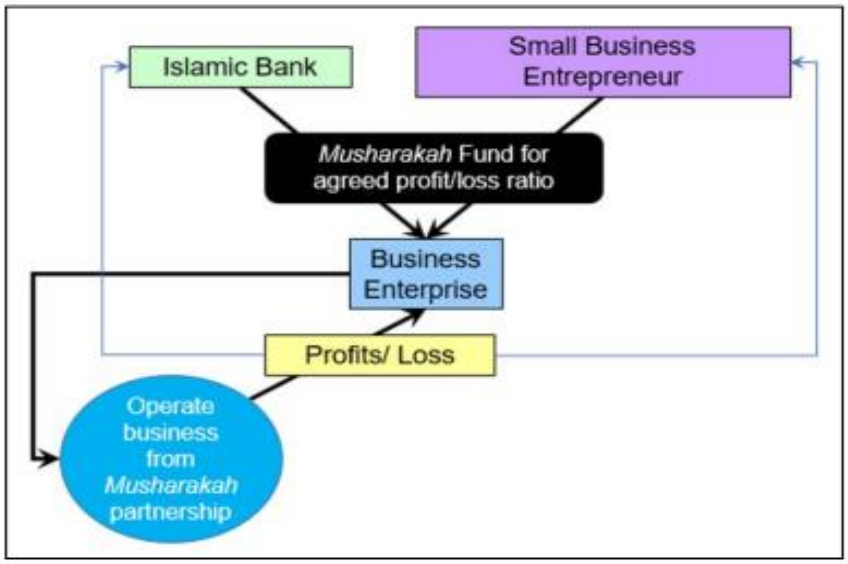
- Step 1: Under the Shariah concept of *Musharakah Mutanaqisah*, the Bank and the Customer jointly purchase an identified property ("Property") where the Customer shall contribute a certain sum as the initial payment ("Customers

[130] Hamzah, Z. (2011), Islamic Private Equity and Venture Capital: Principles and Practice, IBFIM, Kuala Lumpur.

Initial Acquisition Payment") towards part purchase of the Property and the Bank shall contribute a certain sum being the balance of the initial payment ("Bank's Initial Acquisition Payment") towards the purchase of the Property.

- Step 2: The Bank leases its share of Property to the Customer on the basis of *Ijarah Mawsufah Fi Zimmah* (Forward Leasing) during construction and Ijarah (Lease) upon completion of property (whichever applicable).
- Step 3: The Bank then appoints the Customer as its service agent in relation to the Property upon the terms as stated in the Service Agency Contract.
- Step 4: The Customer shall pay to the Bank instalment payments ("Instalment Payment") which comprise: (i) Acquisition Payment being payment towards acquiring the Bank's ownership share in the Property; and (ii) Rental Payment being payments for the lease of the Property.
- Step 5: As a result of the Instalment Payment made under the *Musharakah Mutanaqisah* Term Financing-I, the Customer's ownership share in the Property will increase and the Bank's ownership share will decrease proportionately until the Property is wholly and fully owned by the Customer.
- Step 6: The Rental Payment shall cease immediately upon the Customer having fully acquired the ownership share in the Property from the Bank.
- Step 7: If the Property cannot be occupied due to construction of the Property being abandoned which cannot be revived, the advance rental as duly paid by the Customer, will be refunded to the Customer in the manner as determined by the Bank.

Beside of having the operation of *Musharakah Mutanaqisah* for home financing, *Musharakah* for partnership joint venture is considered vital for investments in Malaysia and Indonesia.[131] It is believed that due to the confidentiality of information, these venture capital companies and the involved Islamic banks do not reveal their identities (including details of their agreements).



[131] Thaker, M. A. B. M. T., Thaker, H. B. M. T., & Pitchay, A. B. A. (2020). Leveraging islamic banking and finance for small business: Exploring the conceptual and practical dimensions.

Musharakah joint venture
Source: Thaker et. al (2020)

In this kind of *Musharakah* for partnership joint venture, the Islamic bank is cooperated with a small business entrepreneur for a certain business venture where they agreed to have *Musharakah* fund with the profit and loss ratio. In the case of loss, each of the parties cover for their own losses, without having any return from their partners in the *Musharakah* partnership's joint venture.

Under the Malaysian law, pursuant to Schedule 4 of Capital Markets and Services Act 2007, it is specified that any corporation that intends to apply to be a venture capital corporation, it is essential to register with the Securities Commission Malaysia (SCM). At the same time, the provisions under the Guidelines for Registration of Venture Capital Corporations and Venture Capital Management Corporations as issued by the SCM in 2015 should be followed accordingly (under section 377 of the Capital Markets and Services Act 2007 (CMSA) read together with section 76 of the CMSA). Any corporation that wants to continue their operation as an Islamic venture capital is required to appoint a Shariah advisor. Based on the required procedures of the 2015's Guidelines which read together with the relevant provisions of CMSA 2007, a venture capital company in Malaysia should be a corporation established under the Company Act 2016, fulfils the registration requirements under the 2015's Guidelines and at least has a minimum of RM100,000.00 as their capital to start with.

It is important to highlight that the researchers found there is a huge gap in the practices of *Musharakah* as applied nowadays with its theoretical understanding as can be found from the principles of Shariah. Moreover, due to the different nature of Malaysian legal and regulatory framework that was derived from the common law, it is noted here that *there is no fit-for-all application* with the principles of Shariah. Nonetheless, it is not necessarily meant that there is a serious contradiction in their applications. Thus, the appreciation on the harmonization process should be considered with an open heart. The identified challenges are:

(i) The nature of *Musharakah*: based on the legal analysis done, the nature of *Musharakah* is not well captured under the Malaysian laws, except as rightly described under the BNM's *Musharakah* Guidelines (as issued in 20th April 2015). The most similar legislation that can be said consistent with the nature of *Musharakah* is the Partnership Act 1961 (PA 1961). Nevertheless, the PA 1961 only captures the essence of *Shirkah Al-Aqad* (pursuant to section 3 PA 1961).

(ii) The applicable laws for *Musharakah*: if the nature of *Musharakah* is followed closely and by applying direct application of Malaysian (common) laws, the applicable laws would be different, as compare to what is practiced nowadays in IBF. It is noted that BNM gives preference to Shariah contract-based regulatory policy that insists on Shariah-compliance and the fulfilment of operational requirements. This regulatory approach allows a flexibility in

product innovations and creativity in contractual drafting, without any contradiction with the existing laws.

(iii) *Musharakah* in practice: for *Musharakah* based products (either for the purpose of financing or investment/funding), it is necessary for the Islamic banks to follow the existing laws and the guidelines as provided by the BNM. Based on the current practice, Shariah contract-based regulatory policy is consistent with the application of the existing laws in Malaysia. Thus, there is no contradiction. However, the issue on whether the existing laws capture the true nature of *Musharakah* (for both *Shirkah Al-Aqd* & *Shirkah Al-Milk*), it remains debatable from the conceptual basis. From the legal practice, the provisions of PA 1961 only enforceable once the PA 1961 is made as the reference legislation in the concluded agreement between parties. So far, the financing products under IBF do not make such references, especially in *Musharakah* based product agreements.

CHAPTER 3
MUSHARAKAH AND ACCOUNTING TREATMENT

3.0 INTRODUCTION

This chapter is prepared to achieve the second research objective and the research question on what is the current practice of accounting treatment on *Musharakah* as Islamic financial structure in Islamic banks in Malaysia.

Financial reporting is a formal record of an entity's transactions and activities, usually in the form of financial statements. Financial statements provide a wide range of users with financial information on the economic or financial impact of activities or events. A set of financial statements includes a statement of financial position, a statement of profit or loss, a statement of changes in equity, a statement of cash flows, and notes to the financial statements. An entity prepares financial statements in accordance with generally accepted accounting principles in order to offer a wide range of users, including lenders, creditors, and existing and potential investors, with the financial information they need to make informed economic decisions.

The generally accepted accounting principles relevant for Malaysia include the accounting standards issued by the International Accounting Standards Board (IASB) and Malaysian Accounting Standard Board (MASB). In addition, Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) is a Bahrain non-profit organisation founded in 1991 with the main objective of the developing and issuance of standards for the global Islamic finance industry. Consistent with this objective, AAOIFI has issued a total of 100 standards in the area of Shariah, accounting, auditing, ethics and governance for the use of Islamic financial institutions. The founding members of AAOIFI are the Islamic Development Bank, Dallah Al-Baraka, Faysal Group, Al-Rajhi Banking & Investment Corporation, Kuwait Finance House and Al-Bukhary Foundation.

3.1 AAOIFI FAS NO. 4

FAS 4 is the AAOIFI standard that deals with *Musharakah* financing. This standard aims at setting out accounting rules for recognizing, measuring and disclosing the transactions of *Musharakah* financing in Islamic banks. Accounting rules for recognition and measurement of *Musharakah* capital are based on the following:

(i) The Islamic bank's share in *Musharakah* capital is recognized upon receipt or made available to the partnership under the title "*Musharakah* Financing" in the statement of financial position.

(ii) If the bank's share is in the form of trading assets or non-monetary assets, it should be valued at fair value. Any difference between the carrying amount of the assets in the bank's books and the fair value is recognized as profit and loss in the income statement.

Other than that, an Islamic bank can present the profit or loss component as part of a single comprehensive income statement or as a separate income statement. Profits or losses that begin and terminate within a financial period must be recognised in the Islamic bank's accounts at the time of liquidation in respect of the Islamic bank's share in *Musharakah* financing transactions. In addition, the financial statements, management can conduct financial reviews to summarise and explain the key aspects of the entity's financial performance and financial standing, as well as the major risks it faces.

In the case of a Diminishing *Musharakah* contract, the Islamic bank's participation in the Diminishing *Musharakah* shall be measured at historical cost at the end of a financial period after deducting the historical cost of any share given to the partner. In the Islamic bank's income statement, any difference between historical cost and fair value of the percentage of share sold should be adjusted.

In the case of constant *Musharakah,* the Islamic bank's share in the constant *Musharakah* capital should be measured at the end of the financial period at historical cost (the amount which was paid or at which the asset was valued at the time of contracting). However, if the *Musharakah* is diminishing (*Musharakah Mutanaqisah*), then the Islamic bank's share in the diminishing *Musharakah* should be measured at historical cost after excluding the sold portion (historical cost). The fair value of the "sold" portion constitute its selling price. Any difference between fair value and historical cost is the bank's profit or loss in the Islamic bank's income statement.

Furthermore, if the diminishing *Musharakah* is liquidated before the full transfer to the partner, the amount recovered in respect of the Islamic bank's share shall be credited to the Islamic bank's *Musharakah* financing account, and any profit or loss resulting from the difference between the book value and the recovered amount shall be recognised in the Islamic bank's income statement. When the *Musharakah* is terminated or liquidated, the Islamic bank's due share of the *Musharakah* capital (after accounting for any profits or losses) remains unpaid when the account is settled, the Islamic bank's share is recognised as a receivable due from the partner.

Relating to the presentation and disclosure, *Musharakah* financing is presented as an asset in the Islamic bank's Statement of Financial Position. Any loss provision under *Musharakah* Financing shall be deducted from *Musharakah* Financing. *Musharakah* financing profits or losses are presented in the Islamic bank's income statement. Accordingly, rules from the FAS no. 1 on the General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions disclosure must be observed. Besides the above, AAOIFI's FAS 4 requires disclosure in the financial statements if the Islamic bank has made any provision for loss of its capital in the *Musharakah* financing during that period. In practice, the banks provide for this in the statement of financial position itself and this is more in line with international standards on asset impairment.

3.2 MFRS 11 AND MFRS 9

Musharakah financing could use MFRS 11: Joint Arrangement. According to MFRS 11, a Joint Arrangement is one in which two or more parties' joint control. Joint operation and joint venture are the two types of joint arrangements. A joint operation is a joint arrangement in which the parties that have joint authority over the arrangement have rights to the assets and obligations for the liabilities. A joint venture is a partnership in which the parties that share control of the arrangement have rights to the arrangement's net assets.

MFRS 11 stated that: "In terms of right to assets for joint operation, the contractual arrangement establishes that the parties to the joint arrangement share all interests (e.g., rights, title or ownership) in the assets relating to the arrangement in a specified proportion (e.g., in proportion to the parties' ownership interest in the arrangement or in proportion to the activity carried out through the arrangement that is directly attributed to them). While for joint venture, the contractual arrangement establishes that the assets brought into the arrangement or subsequently acquired by the joint arrangement are the arrangement's assets. The parties have no interests (i.e., no rights, title or ownership) in the assets of the arrangement".

Furthermore, participants to joint arrangements are frequently required to provide guarantees to third parties that, for example, obtain a service from the joint arrangement or provide funding to it. The provision of such guarantees, or the parties' commitment to do so, does not always imply that the joint arrangement is a joint operation. If the parties have obligations for the arrangement's liabilities, this aspect determines whether the joint arrangement is a joint operation or a joint venture. Furthermore, MFRS 9 would be more applicable to *Musharakah* Financing, which requires *Musharakah* assets being accounted for at fair value. The transition to IFRS 9 would result in *Musharakah* assets to be recognised in profit or loss.

Under MFRS 9, a financial asset can only be measured at amortised cost if it satisfies both the business model and the SPPP tests. If either or both conditions are not met, then the *Musharakah* should be measured at fair value (through other comprehensive income or profit or loss. Typically, the SPPP test is undertaken to determine if the structure and cash flows of the *Musharakah* financing align with the basic lending arrangement. Essentially, what this means is that the profit element considers the time value of money, the credit risk associated with the instrument, the basic lending risks and costs and the profit margin. A *Musharakah* financing may not satisfy the SPPP test primarily because the excess profit from the financing or losses is shared with the Islamic bank.

3.3 BANK NEGARA MALAYSIA GUIDELINES ON *MUSHARAKAH* FINANCING

The Musharakah Financing Policy Document published by Bank Negara Malaysia encompass both necessary Shariah requirements and voluntary practises to

assure the validity of *Musharakah* financing. According to the Policy Document, an Islamic bank must maintain the accounting records and other records in a in a timely manner which will sufficiently enable the preparation and reporting of financial statements that give a true and fair view. In addition, the Islamic bank must follow the requirements set forth in the Bank Negara Malaysia 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) and all applicable MFRS. The financial disclosure for the *Musharakah* venture shall include the following:

(i) the initial capital contribution;

(ii) the outstanding or recoverable value by sector including any losses incurred or provisions made during the period; and at the pre-contractual stage.

The Guidelines on Financial Reporting for Islamic Banking Institutions, also stated that: "The information shall include comprehensive description of the *Musharakah* venture, which includes the contractual relationship between the partners; the concept of profit-sharing and loss sharing; the overview of the transaction's structure; the roles, responsibilities, rights and obligations of the partners; the key terms and conditions of the *Musharakah* contract; and the requirements, if any, for guarantee and/or collateral (including the rights and obligation of the partners on the collateral pledge)".

In terms of the product disclosure sheet, an Islamic bank must include the minimal information required by the Guidelines on Product Transparency and Disclosure. It is also worth noting that the Bank Negara Malaysia policy documents require an Islamic bank to publish salient features of a *Musharakah* venture in the legal documentation to help partners comprehend the *Musharakah* contract's terms and conditions.

Aside from that, an Islamic bank should give the partner with proper disclosure, such as early notice of changes to the terms and conditions, features, rights and obligations, and fees and charges (if applicable). When an Islamic bank is the managing partner, the Islamic bank must also disclose the *Musharakah* venture's performance to other partners and carry the liability that comes with being a managing partner.

CHAPTER 4
SHARIAH DISCUSSION ON MUSHARAKAH

4.0 INTRODUCTION

This chapter is prepared to achieve the fourth research objective and the research question on what are the key challenges for *Musharakah* as Islamic financial structure from Shariah perspective. As highlighted previously, the most frequent reference to *Musharakah* in practice, majorly related to *Musharakah Mutanaqisah* (MM). Thus, the key challenges from Shariah aspects as discussed here are related to MM. These identified challenges are: (i) the different views of Muslim scholars on MM's characteristics; (ii) the MM's related issues for financing of real estate or manufacturing production.

4.1 THE CONCEPT AND DEFINITION OF DIMINISHING PARTNERSHIP

Diminishing partnership is a composite term with multiple contemporary definitions. One of these was stipulated in Article Two of the Jordan Islamic Bank Law, issued in 1978 CE. It defines it as:

"The entry of the bank as a financing partner—in whole or in part—in a project with an expected income, on the basis of an agreement with the other partner that the bank shall obtain a proportionate share of the net income actually achieved with the right to keep the remaining part, or any amount of it agreed upon, so that that part is allocated to repaying the principal of the financing provided by the bank."[132]

The Journal of the Islamic Fiqh Academy (*Majallat Majmaʿ al-Fiqh al-Islāmī*) defines it as a partnership in which one of the two partners promises his partner to sell him all or part of his share at any time, he wants by means of a contract that they shall establish when the intent to sell is formed.[133] The AAOIFI Standards stated it as:

"Diminishing *Mushārakah* is a form of partnership in which one of the partners promises to buy the equity share of the other partner gradually until the title to the equity is completely transferred to him. It is necessary that this buying and selling should not be stipulated in the partnership contract. In other words, the buying partner is allowed to give only a promise to buy. This promise should be independent of the partnership contract. In addition, the buying and selling agreement must be independent of the partnership contract. It is not permitted that one contract be entered into as a condition for concluding the other."[134]

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[132] *Majallat Majmaʿ al-Fiqh al-Islāmī*, no. 13, vol. 2, pp. 533-4.
[133] *Majallat al-Majmaʿ al-Fiqhī*, vol. 4, p. 1411.
[134] ĀOIFI, *Shari'ah Standards*, Accounting and Auditing Organization for Islamic Financial Institutions, Bahrain, 2017, Standard on Musharakah, Para 5/1.

4.2 THE SHARĪʿAH CHARACTERISATION OF DIMINISHING PARTNERSHIP

Contemporary jurists have various views regarding the characterisation of diminishing partnership according to data on the intended objectives and the applications. We summarise them in four views:

The first view: **It is a type of contractual partnership; i.e., limited partnership (*shirkat ʿinān*).**

This group believes that diminishing partnership is limited partnership, which is a partnership formed between two or more people who participate in establishing a project; each party contributes both capital and labour. Among those who have this opinion: Dr. Muḥammad ʿUthmān Shubayr, Dr. ʿAbd al-Razzāq al-Hītī, Dr. Nazīh Kamāl Ḥammād, Dr. Wahbah al-Zuhayli, Dr. Aḥmad Muḥyī al-Dīn, Professor Murtaḍā al-Turābī, Dr. ʿAbdul Sattār Abu Ghuddah, Dr. Muḥammad ʿUthmān Shubayr, Dr. Amīrah ʿAbd al-Latīf Mashhūr, and others.

Their evidence for that:

a. The nature of the diminishing partnership fully applies to the limited partnership contract, as the purpose of both is to achieve profit by investing the joint funds in a specific project.

b. It is noted that most of the financing operations in the practice of Islamic banks stipulate in the terms of their contracts that the partner contribute at least a small part of the capital while the bank finances the largest part of the project.[135]

This is how it was stated in the AAOIFI Shariʾah Standards:

"The general rules for partnerships must be applied to a diminishing partnership, especially the rules for Sharikat al-'Inan. Therefore, it is not permitted that the contract of diminishing partnership includes any clause that gives any of the parties a right to withdraw his share in the capital."[136]

An objection may be raised against this characterisation: that one of the parties to the diminishing partnership does not benefit from the profit that is sought and common to all parties in *shirkat al-ʿinān* (limited partnership). This is because one of the parties promises to purchase, and the promise becomes binding from that time, whether at

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[135] Nūr al-Dīn al-Kawāmilah, *Al-Mushārakah al-Mutanāqiṣah wa Tatbīqātuhā al-Muʿāṣirah fī al-Fiqh al-Islāmī*. Dār al-Nafāʾis, Amman, 2013, p. 85. Cf. Muḥammad ʿUthmān Shubayr, *Al-Muʿāmalāt al-Māliyyah al-Muʿāṣirah fī al-Fiqh al-Islāmī*, 6th edn. Dār al-Nafāʾis, Amman, 2007, p. 336; Wahbah al-Zuhayli, *Naẓariyat al-Damān*, 7th edn. Dār al-Fikr, Damascus, 2002; ʿAbdul Sattār Abū Ghuddah, *Buhūth fī al-Muʿāmalāt wa al-Asālīb al-Maṣrafiyyah al-Islāmyyah*, Majmūʿat Dallah al-Barakah, 2013, 1st edn.; *Majallat Majmaʿ al-Fiqh al-Islāmī*, no. 13. 1422H.

[136] ĀOIFI, *Shari'ah Standards*, Accounting and Auditing Organization for Islamic Financial Institutions, Bahrain, 2017, Musharakah, article 5/2.

nominal or market value. The beneficiary is the bank; therefore, it cannot be imagined that the second party is [an actual] partner.

The second view: **It is *shirkat al-milk.***

The proponents of this view consider the partnership ending in ownership transfer to be in reality a joint ownership of property. Among those who said that: Dr. Ḥasan al-Shādhilī, Dr. Nazīh Kamāl Ḥammād, Dr. Qutb Mustafa Sano, and others. Among their evidence for that:

a. Each of the two parties to the diminishing partnership purchases the project or real estate that is the subject of the partnership with their own money.[137]
b. The property regarding which they agree to enter into a partnership comprises immovable assets such as real estate or movable assets such as an airplane, a ship, etc.[138]
c. The characteristics of this partnership are identical to joint ownership of property. Among the Islamic jurisprudence texts that define *shirkat al-milk* is the following from *Tabyīn al-Ḥaqāʾiq*: '*Shirkat al-milk* is of two types, involuntary and voluntary. The first occurs in an asset inherited by two men, and the second is in an asset which they buy, or it is gifted to them, or bequeathed to them, and they accepted.'[139]

Dr. Qutb Sano justified the characterisation of this transaction as voluntary joint ownership of property because it is based on two or more parties purchasing and acquiring ownership of a certain property such that the ownership of the property devolves on whichever of the two parties wants to buy it. This occurs after he has purchased his partner's share, because the purpose of the term from the beginning of the partnership's formation is usually to enable the customer to own the property or the income-generating project.[140]

d. The gradual sale of shares does not deviate from the objective of terminating the partnership by the transfer of ownership.[141]

Sheikh Nazīh Ḥammād arrived at the following jurisprudential classification of diminishing partnership, by saying: the classical jurisprudential texts have indicated beyond any doubt that one of the forms of the voluntary *shirkat al-milk* is what occurs through a joint purchase contract of a financial property that was agreed upon between the two parties from the beginning. It is identical to the form that is being

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[137] Nazīh Ḥammād, *Al-ʿUqūd al-Mustajiddah*, p. 28.
[138] Hasan ʿAlī al-Shadhilī, *Al-Mushārakah al-Mutanāqisah wa Ṣuwaruhā fī Ḍawʾ Ḍawābiṭ al-'Uqood al-Mustajiddah*, p. 437.
[139] ʿUthmān ibn ʿAlī al-Bāriʿī al-Zaylaʿī, Fakhr al-Dīn al-Hanafī, *Tabyīn al-Ḥaqāʾiq Sharḥ Kanz al-Daqāʾiq wa Hāshiyat al-Shilbī*, Al-Maṭbaʿah al-Kubrā al-Amīriyyah, Būlāq, Cairo, 1895, Vol. 3, p. 313.
[140] Sano, Mustafa Koutoub, *Al-Mushārakah al-Mutanāqisah wa Ḍawābiṭuhā al-Sharʿiyyah*, pp. 31-2.
[141] Wāʾil ʿArbiyāt, *Al-Maṣārif al-Islāmiyyah wa al-Muʾassasāt al-Iqtisādiyyah*. Dār al-Thaqāfah li al-Nashr wa al-Tawzīʿ, Amman, Jordan, 2006, p. 62.

practiced in the financing arrangement called 'diminishing partnership', so ponder it.[142]

The third view: Its forms are sometimes joint ownership of property and sometimes contractual partnership.

Among those who take this position are Sheikh Muḥammad Taqi Othmani,[143] and Professor Dr. ʿAlī Aḥmad al-Sālūs.[144] Its classification is sometimes closer to the joint ownership of property when it is used to finance housing, cars, etc., while it is closer to a contractual partnership when it is intended for investment rather than financing.[145] Their argument is that the nature of financing differs from the nature of investment on which contemporary companies are based. Therefore, it is necessary to classify this transaction as the type closest to it of these two types, either joint ownership of property or contractual partnership, in Islamic jurisprudence.

Regarding Dr. Nazīh Ḥammād's opinion that it is joint ownership of property in the research he submitted to *The Journal of the Islamic Fiqh Academy*, Dr. Taqi Othmani commented: "I think that he was correct in this characterisation when this formula is used to finance housing or to finance cars for the personal use of the customer. However, if the objective of this formula is investment in means of production or in a commercial project, then it appears that it becomes a contractual partnership and does not remain joint ownership of property".[146]

The Shariah Board of BNM took the same approach in its decision by differentiating between financing by means of partnership to own property, which is considered a joint ownership of property, and financing for a commercial project, which is considered a contractual partnership.[147]

The fourth view: It is the will of the contracting parties that determines the type of *shirkah*, whether it is a joint ownership of property or a contractual partnership.

Some contemporaries, including Sheikh Dr. Walīd ibn Hādī, incline to the view that the will of the contracting parties is what determines the type of partnership, whether it is a joint ownership of property or a contractual partnership. He said:

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[142] Nazīh Ḥammād, *'Al-Takyīf al-Fiqhī li al-Shirkah Allatī Taqūm ʿalayhā Manẓūmah al-Mushārakah al-Mutanāqiṣah a-Hiya Shirkat al-Milk am Shirkat ʿAqd'*, op. cit., p. 21.

[143] *Majallat Majmaʿ al-Fiqh al-Islāmī al-Duwalī*, (Session 13, Kuwait, 1422H/2001CE), op. cit. vol. 2, p. 646.

[144] ʿAlī al-Sālūs, *'Al-Mushārakah al-Mutanāqiṣah wa Ṣuwaruhā wa Ḍawābiṭuhā al-Sharʿiyyah'*, *Majallat Majmaʿ al-Fiqh al-Islāmī al-Duwalī*, OIC, 2006, Session 15, pp. 9-10.

[145] Muḥammad Taqī Uthmānī. *Majallat Majmaʿ al-Fiqh al-Islāmī al-Duwalī*, vol. 2, p. 646; ʿAlī al-Sālūs, op. cit., pp. 9-10.

[146] *Majallat Majmaʿ al-Fiqh al-Islāmī al-Duwalī*, Research titled *'Al-Mushārakah al-Mutanāqiṣah'*, Session 13, p. 1031.

[147] Resolution of the Shariah Advisory Committee of Bank Negara Malaysia, second edition, meeting no. 135, May 28, 2013. The policy document on Musharakah, BNM/RH/STD 028-7, was issued based on this resolution on April 2015.

"Classifying diminishing partnership as either *shirkat al-milk* or *shirkat al-ʿaqd* without regard to the will of the contracting parties and the characteristics of the nature of the partnership is far from the principles of this chapter of the law. This is because the involuntary *shirkat al-milk* is clear and does not need clarification, and the fact that each is an outsider in the optional *shirkat al-milk* is also clear. Since it is devoid of textual permission and contractual permission, if there is a textual permission, it is not transformed into a contractual partnership".[148]

Identifying the Sharīʿah principle that underpins this issue from an examination of the principles of partnership in Islamic jurisprudence, it becomes clear that disposition is a governing criterion when dividing partnerships into joint ownership of property and contractual partnership. This criterion results from the will of the contracting parties because the form of the partnership is not determined by a Sharīʿah text that transcends rational comprehension. Thus, they may specify the form they want as long as it does not contradict the rules of contracting and partnership.

Choice of the Weightiest View:

The researcher finds the fourth view to be weightiest; that is: the jurisprudential classification of the partnership contract is determined by the will of the contracting parties, the characteristics the partnership project, and the proposed financing or investment structure. Based on this classification, it is necessary to reflect on the essence and characteristics of the partnership that the customer and the bank want. The bank must prepare two forms of the partnership contract, one of which is based on a joint ownership of property and the other on a contractual partnership, each separately. For example, if the customer wants to own the property or the project, and the bank wants a guarantee from the customer, then it takes the format of joint ownership of property. This will have various legal effects, the most important of which is the permissibility of the guarantee, the permissibility of purchasing at a previously specified price, and the requirement of permission for disposition. If the customer wants working capital for a commercial activity, and the bank wants to invest and does not ask for a guarantee, then it would be suggested to the customer to choose a contractual partnership model.

4.3 TREATMENT OF THE LAND PROVIDED BY THE CUSTOMER FOR THE PARTNERSHIP

Based on the view preferred above, there is an issue that needs to be addressed when there is a partnership between the bank and the customer in which the client provides the land and the bank provides the money for construction, financing thereby a project to establish a diminishing partnership. A number of questions arise regarding this issue. What is the type of relationship between the customer and the bank? And how can the distinguishing characteristic of undivided ownership (*shuyūʿ*)

[148] This is the approach of Sheikh Walīd ibn Hādī. His opinion was recorded in a number of scholarly interviews with his eminence on June 29, 2022, and August 20, 2022.

be achieved when it is classified as *shirkat al-milk*? A survey of partnerships in Islamic jurisprudence reveals that one of the characteristics of partnership is *shuyūʿ*.

In order for *shuyūʿ* to be achieved, it is necessary for the customer to sell part of the land to the bank. If we want to characterise this as a joint ownership of property, this is the first way to do it. The principle that underpins this stratagem from the Sharīʿah point of view is as stated in *Mughnī al-Muḥtāj*: 'The stratagem in a partnership in goods is for each one of them to sell some of his goods for some of the other's goods and to grant him authority of disposition of them.'[149] Just as the jurists accepted the stratagem here to convert the partnership in goods [into a contractual partnership] based on the reservation of some jurists about a partnership in goods, so too, in the absence of *shuyūʿ*, a stratagem is permissible here. The statement in the aforementioned text 'and to grant him authority of disposition of them' is another item of evidence that the structure of the partnership can be transformed from a joint ownership of property into a contractual partnership. Likewise, it may be transformed from a contractual partnership into a joint ownership of property based on the will of the contracting parties.

The second scenario is when the client does not want to sell the land, in which case the land will belong to the client. As for the bank, it puts all the money into the building; thus, the building becomes solely its property. If the customer provides part of the money for construction, the land is the property of the customer while the building will be jointly owned by the customer and the bank. This is based on the contract being classified as *shirkat al-milk*.

4.4 APPLICATIONS OF DIMINISHING PARTNERSHIP IN THE PURCHASE OF REAL ESTATE IN MALAYSIA[150]

There are three stages for the application of diminishing partnership in Islamic banks:

The First Stage: Joint Ownership between the bank and the customer, and it takes place through the *mushārakah* contract.

a. The customer selects the property he wants to buy, then signs a sale and purchase contract with the developer, and pays the down payment.
b. The customer goes to the bank and submits the application in order to obtain financing facilities.
c. After approval by the bank, the bank and the customer sign a contract of diminishing partnership. The aim of this contract is to own the property.

[149] Al-Sharbīnī, op. cit.

[150] See Mohd Shahril Mat Rani, et.al, Syirkah al-milk dan Syirkah al-Aqad Sebagai Asas Kepada Produk Pembiayān Musharakah Mutanaqisah: Analisis Daripada Perspektif Fiqah, Shariah Staff working paper, Shariah Division, Jabatan Perbankan Islam dan Takaful, Bank Negara Malaysia, 2017. pp. 4-5. Musharakah Policy Document, Islamic Banking and Takaful Department, Bank Negara Malaysia, 20 April 2015, p. 15.

e. The deposit paid by the customer to the developer represents the customer's contribution to the diminishing *mushārakah* project, while the bank's contribution is equal to the remaining financing amount.

The Second Stage: Leasing

a. After implementing the first step, the bank at this stage leases to the customer the property whose ownership has been attained.
b. The common practice in Malaysian banks is to lease only their share of the property to the customer, so that the rental amounts belong entirely to the bank.
c. The bank's share of the rental income is comparable to the financing profits received by conventional banks.

The Final Stage: Transfer of Ownership

a. During the lease period, the customer buys from the bank—at agreed intervals—shares or units that represent the bank's share of the property. This purchase is made by the customer paying an extra amount in addition to the rental amount.
b. The contract of sale and transfer of the bank's shares shall be executed with each of the customer's purchase of shares.
d. At the end of the lease term, once the customer has paid the full installments agreed upon with the bank, the property becomes fully owned by him.[151]

Some of the arrangements related to *mushārakah mutanāqiṣah* financing are as follows:

(i) The customer and the bank are considered co-owners in the use of the property, but the bank agrees to register the property in the name of the customer. The customer becomes the registered owner of the property, and the trustee on behalf of the co-owners of the usufruct (i.e., the bank and the customer). At this stage the customer is the registered owner, trustee and beneficiary, while the bank is another beneficiary. To prove the credit, a credit deed is drawn up and stamped, and that credit is recorded under Section 344 of the National Land Code.[152]
(ii) The customer pledges to the bank—as a security for the performance of his payment obligations—his share of the usufruct ownership of the real estate. However, since the property is registered in the name of the customer as the trustee of the customer and the bank (the beneficiaries), both beneficiaries agree that the customer—in his capacity as trustee—should register a pledge over the entire property in favour of the bank as security. In fact, the trustee should only pledge the customer's share of the land to the bank; there should be no registry of a pledge of the bank's share of the land. However, because the National Land Code allows for pledges only on 'the whole of the pledged land, not just a part

[151] '*Al-Mushārakah al-Mutanāqiṣah wa al-Qaḍāyā al-Qānūniyyah Dhāt al-Ṣilah*. International Shariah Research Academy. ISRA, Malaysia. Research presented at the Third Fiqhī Conference. Abu Dhabi Islamic Bank. http://iefpedia.com/arab/?p=24720, p. 5.
[152] Ibid. p. 7.

of it,' the trustee, with the approval of the bank, registers real estate insurance for the entire property in favour of the bank.[153]

(iii) In the event that the customer fails to pay and does not remedy this default, and if the customer has made a promise to the bank at the beginning of the property financing with diminishing partnership, the customer is obligated—in case of default—to acquire the remaining share of the bank, which leads to a debt that the customer pays to the bank. The Shariah Board of Bank Negara approved this arrangement of obligating the purchase promise in case of failure to pay the installments.[154]

(iv) If there is no promise, or it is impossible to execute the purchase obligation on the customer through the promise or stipulation of the trigger event in the contract, the bank sells the property to a third party under the terms of a pledge subject to the National Land Code. If the sale results in a surplus, the customer gets that surplus. In case of a deficit, the customer shall be obliged to pay the amount of the deficit to the bank.

(v) In the event that the customer fails to pay and does not remedy that default, the diminishing *mushārakah* can be terminated by selling the asset in the market. The partners share the proceeds of the sale according to the latest percentage of ownership shares (after covering all existing costs and payments such as existing rents and legal fees).[155]

(vi) If the customer made a promise to the bank at the beginning of the property financing with diminishing partnership, the customer is obligated—in case of default—to acquire the remaining share of the bank. This leads to a debt arising from the implementation of the purchase obligation due to the prior promise that the customer made to the bank.

4.5 ISSUES ARISING FROM DIMINISHING PARTNERSHIP FOR THE FINANCING OF REAL ESTATE OR MEANS OF PRODUCTION

There are a number of Sharīʿah issues related to the experience of applying diminishing *mushārakah*. These include:

First: Pending Conditions in a Sale

One of the conditions in diminishing partnership is that the bank divides its share into shares for purchase by instalments. The bank sells these shares subject to the partner paying the price; thus, he takes ownership of the share whenever he pays its price. Also, among the conditions is that the customer undertakes to buy all the shares of the bank in the event of his default and delay in payment. This condition is made contingent upon the customer's default, and sometimes upon other events beyond his control; it obliges him to purchase no matter what.

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[153] Ibid.

[154] Resolutions of the Shariah Advisory Committee of Bank Negara Malaysia, second edition, meeting no. 64, January 18, 2007, and meeting no. 65, January 30, 2007, p. 45.

[155] Ibid., p. 8.

The jurists differed regarding the ruling on making the sale contingent upon a future event. There are two views.

The first view: it is not permissible. It is the opinion of the majority of Ḥanafīs, Mālikīs, Shāfiʿīs, and the well-known view of the Ḥanbalīs.[156] They cited evidence, including:

1- It involves *gharar* (uncertainty) and gambling, as the two contracting parties do not know whether or not they will obtain the matter made dependent on it, or they may obtain it at a time when the interest of the seller and the buyer has changed.[157]

The answer to this is that making the sale conditional upon a condition is not the kind of *gharar* that is prohibited by Sharīʿah. This is because the Prophet (peace and blessings be upon him) forbade that something uncertain be sold, and he forbade selling what is uncertain, such as a sale year into the future, selling the offspring of a pregnant animal, and the sale of fruit before it appears to be ripe. He justified this by the risk involved in consuming money unlawfully, as he said: 'Do you see that if Allah forbids the fruit, then why would one of you take his brother's money?'

[This] is gambling and risk that entails consuming property unjustly, and it fluctuates between the possibility that he will get what he intended from the sale or not get it, even though his money will be taken in both cases. If he does not get it, his money would have been consumed unlawfully. But as for the sale itself, it is not *gharar*. It is an accomplished contract and is not called *gharar*, whether it is immediately executed or made contingent upon fulfilment of a condition in the future. The conditional vow is not called *gharar*, and the contract made contingent upon fulfilment of a condition in the future is called contingent and is not called *gharar*.[158]

Professor al-Ḍarīr discussed this response when he said:

"*Gharar* can be in the form of the contract, just as it is in its subject matter, and the clearest example of *gharar* in the form is the contingent contract. The two contracting parties do not know whether or not the contract will transpire; and if it does, they do not know when it will come to pass".[159]

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[156] Al-Zaylaʿī, *Tabyīn al-Ḥaqāʾiq*, Dār al-Kutub al-Islāmiyyah, Cairo, vol. 4, p. 131; cf. Muḥammad Ibn ʿĀbidīn, *Ḥāshiyat al-Durr al-Muḥtār ʿalā al-Durr al-Mukhtār, Sharḥ Tanwīr al-Absār*, Dār al-Kutub al-ʿIlmiyyah, Beirut, 1966, vol. 5, p. 254; Shihāb al-Dīn Aḥmad ibn Idrīs al-Qarāfī, *Anwār al-Burūq fī Anwāʾ al-Furūq* (*Kitāb al-Furūq*), ʿĀlam al-Kutub, Riyadh, 1947, vol. 1, p. 229, the Difference between Acceptance of a Condition and Acceptance of Contingency upon a Condition; Al-Suyūṭī, *Al-Ashbāh wa al-Naẓāʾir*, Dār al-Kutub al-ʿIlmiyyah, Beirut, 1990, p. 377; Sulaymān Al-Azharī, *Ḥāshiyat al-Jamal*, Dār al-Fikr, Beirut, n.d., vol. 3, p. 15; Manṣūr ibn Yūnus al-Buhūtī, *Kashshāf al-Qināʿ ʿan Matan al-Iqnāʿ*, 1983, vol. 3, p. 195.

[157] Al-Amīn al-Ḍarīr, *Al-Gharar fī al-ʿUqūd wa Āthāruh fī Taṭbīqāt al-Muʿaṣirah*, al-Dār al-Sudāniyyah li al-Kutub, Khartoum, 1990, p. 139; cf. al-Zuḥaily, *Al-Fiqh al-Islāmī wa Adillatuhu*, 1989, vol. 5, p. 132.

[158] Taqi al-Dīn Aḥmad ibn ʿAbd al-Ḥalīm Ibn Taymiyyah, *Naẓariyat al-ʿAqd*, ed. Muḥammad Hāmid al-Faqī, 1st edn. Dār al-Sunnah al-Muḥamadiyyah li al-Ṭibāʿah, Cairo, 1949, p. 227.

[159] Al-Amīn al-Ḍarīr, op. cit., p. 144.

2- They reasoned that the transfer of ownership in exchange contracts is by consent, and the pending contract does not contain consent, which is the basis for the validity of the contracts. As al-Qarāfī said:

"The transfer of property depends on consent, and consent only occurs with firm resolve, and there is no firm resolve with contingency. The contingent event may not occur, and it may be known to occur; for example, the arrival of a certain pilgrim and the harvest of the crops. However, the consideration in that is based on the genus of the condition, not its types and individuals; the general meaning is considered, not the particularities of the types and individuals".[160]

This was discussed by Sheikh Nazīh Ḥammād, who said:

"Consent is achieved in a sale that is contingent upon a future condition; the two parties to the sale agree to create the contract having this attribute since nothing else realises their interest regarding that. Thus, if that attribute is realised, the contract will come to pass; and if it doesn't, it will not".[161]

It can also be argued that consent is only with firm resolve, and that may be with a contingent condition; for example, selling with an option to annul and making a [contingent] bequest.

3- They argued that the nature of sales requires the transfer of the sold object at the time of the sale; that is, it takes effect upon it immediately, whereas contingency on a future event prevents ownership transfer.[162]

Sheikh ʿAbd al-Raḥmān al-Saʿdī answered this by saying:

"You say that the nature of the contract requires the transfer of the thing from one contracting party to the other, and that a [pending] condition contradicts it. If you mean by this that this is required by the absolute contract that has not been restricted by anything, then this is correct. All conditions and types of options are not included in this absolute [contract], and the same goes for pending conditions. But if you mean by this that it is required by the contract in every case, no one says that. It is valid to exclude usufruct and the subject of the contract for a period of time, and the stipulated option to annul is valid, and it is valid to postpone the price or the contracted subject matter. All of these prevent the immediate transfer of the contracted item to the other party, and the same applies here. This is supported by [the fact] that the stipulated option to annul in contracts is in fact a suspension of the contract, because if the one

[160] Al-Qarāfī, *Kitāb al-Furūq* op. cit., vol. 1, p. 229.
[161] Nazīh Ḥammād, *'Al-Taʿlīq bi al-Shart fī ʿAqd al-Bayʿ wa al-Hibah wa Atharuhu fī Taṭwīr Manẓūmatay al-Murābaḥah li al-Āmir bi al-Shirāʾ wa al-Ijārah al-Muntahiyah bi al-Tamlīk'*, Seventh Shūrā Fiqhī Conference. 19-20 December, 2017, p. 20.
[162] Al-Buhūtī, *Sharḥ Muntahā al-Irādāt*, 1993, vol. 2, p. 165.

who stipulated the condition completes the contract, it is concluded and completed; otherwise, it is annulled, so what is the difference between this and that?"[163]

The second view: It is permissible to make the sale contingent upon a pending condition if it is of benefit to the people and does not entail what Allah and His Messenger (peace be upon him) forbade. This is the view of Imam Aḥmad in a narration from him, and a view of the Ḥanbalīs that was chosen by Ibn Taymiyyah and his student Ibn al-Qayyim. They cited evidence, including:

1- They inferred from the Qurʾān: 'O you who believe, fulfill your contracts' [al-Māʾidah: 1]. Its relevance as evidence is that the Lawgiver commanded the fulfillment of conditions, and Muslims are bound by their conditions except for a condition that makes the forbidden permissible or makes the permissible forbidden.[164]
2- They inferred that this sale does not contradict the Book of Allah, that the basic principle in contracts is that they are lawful, and sales are what people customarily practice, whether they are immediately executed or pending.[165]
3- Every matter that entails an interest or fulfills a need of people, the Lawgiver does not forbid it but, rather, allows it. And contracts made contingent upon a pending condition fall under this category.

Ibn al-Qayyim said: "Suspension of contracts and of rescissions, donations, and commitments is something that may be called for by pressing necessity (*ḍarūrah*), need (*ḥājah*), or interest (*maṣlaḥah*); thus, the *mukallaf* (person assigned by the Lawgiver with moral duties) cannot dispense with it".[166]

In *al-Ikhtiyārāt al-Fiqhiyyah min Fatāwā Shaykh al-Islām Ibn Taymiyyah*, there is a section with the heading: If the seller said, 'I will sell [this] to you if you bring me such-and-such,' or '…if Zayd is satisfied,' then the sale and the condition are valid. It is one of the two views reported from Aḥmad.[167]

The Most Correct View

What appears to us preponderant is the opinion of the second party, which is the permissibility of suspending exchange contracts on a condition appropriate to the contract if it achieves a legitimate purpose and is in the interest of the contracting parties. That is due to the strength of the evidence, proofs and arguments they relied

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[163] ʿAbd al-Raḥmān al-Saʿdī, *Al-Munāzarāt al-Fiqhiyyah*, 1st edn., Riyadh: Maktabat Adwāʾ al-Salaf, 1420H/2000CE, p. 83.
[164] Ibrāhīm Ibn Mufliḥ, *Al-Mubdiʿ fī Sharḥ al-Muqniʿ*, Beirut: Dār al-Kutub al-ʿIlmiyyah, 1418H/1997CE, vol. 4, p. 59; cf. ʿAlāʾ al-Dīn Al-Baʿlī, *Al-Ikhtiyārāt al-Fiqhiyyah min Fatāwā Shaykh al-Islām Ibn Taymiyyah*, Dār al-Kutub al-ʿIlmiyyah, Beirut, 1421H/2000 CE, p. 109; Ibn Qayyim al-Jawziyyah, *Iʿlām al-Muwaqqiʿīn ʿan Rabb al-ʿĀlamīn*, Dār al-Fikr, Beirut, 1973, vol. 3, p. 387; Muḥammad Ibn ʿUthaymīn, *Al-Sharḥ al-Mumtiʿ ʿalā Zād al-Mustaqniʿ*, Riyadh: Dār Ibn al-Jawzī, 1422H/2001CE, vol. 8, p. 250.
[165] Ibn Taymiyyah, *Naẓariyat al-ʿAqd*, p. 227; Al-Saʿdī, *Al-Munāzarāt al-Fiqhiyyah*, p. 83.
[166] Ibn Qayyim al-Jawziyyah, *Iʿlām al-Muwaqqiʿīn ʿan Rabb al-ʿĀlamīn*, vol. 3, p. 387.
[167] ʿAlāʾ al-Dīn Al-Baʿlī, *Al-Ikhtiyārāt al-Fiqhiyyah min Fatāwā Shaykh al-Islām Ibn Taymiyyah*, vol. 1, p. 435.

upon. And the conditions upon which the sale is made contingent in diminishing *mushārakah* apply to these interests of all the parties.

Second: The Promise Issued by the Partner in the Diminishing Partnership That the Partner Will Own His Partner's Share

The promise made by the partner to give his partner ownership of his share in the future does not affect the essence of the contract. Rather, it is in the interest of both parties and does not violate the system of partnership or its process. Neither does it disturb its existence if one partner purchases all or part of his partner's share in successive contracts. This is part of the nature of partnerships; they are either permanent or temporary, whether there is a promise or not.[168]

There are various forms of promise and undertaking in the financing arrangement by diminishing *mushārakah*. These include the promise by the bank to transfer ownership of the shares, as well as the promise by the customer to gradually buy the shares, diminishing thereby the share of the bank. It also includes the customer's undertaking to assign his share of the profit generated from the partnership, or the return that he is entitled to, to purchasing a portion of the bank's share of the partnership. Another option is to divide the object of the partnership into shares, of which the customer acquires a certain number every period until the shares are purchased in full. This undertaking is set out in the agreement. The promise by each party is considered separately. One of the most important problems is the undertaking to purchase at either market or nominal value.

Since the jurisprudential classification of the decreasing share in the AAOIFI *Shariʾah Standards* is that it is a limited partnership (*shirkat al-ʿinān*), purchase at a nominal value is not permitted. Here is the text of the standard:

"5/7 It is permissible for one of the partners to give a binding promise that entitles the other partner to acquire, on the basis of a sale contract, his equity shares gradually, according to the market value or a price agreed at the time of acquisition. However, it is not permitted to stipulate that the equity share be acquired at their original or face value, as this would constitute a guarantee of the value of the equity shares of one partner (the Institution) by the other partner, which is prohibited by Shari'ah".[169]

However, the Standard permitted the repurchase in *shirkat al-milk* to be at a specified price. The specified price may be the nominal value.

"5/4/3 It is permissible in jointly owned property for a partner to sell his share to his partner with a promise from the seller to buy it from him, or a promise from his partner to sell it to him at its market value, or as agreed upon by the two contracting

[168] Wahbah al-Zuḥaylī, *Al-Mushārakah al-Mutanāqiṣah wa Ṣuwaruhā fī Ḍawʾ Ḍawābiṭ al-ʿUqūd al-Mustajiddah*, *Majallat Majmaʿ al-Fiqh al-Islāmī al-Duwalī*, issue 13, p. 865.
[169] The Standard on Musharakah, *Shariʾah Standards*, Accounting and Auditing Organization for Islamic Financial Institutions, Bahrain, para 5/8.

parties at the time, or at a specific price. The purchaser may lease his partner's share".[170]

The researcher believes **the weightiest view**—based on *shirkat al-milk* being the proper classification of diminishing partnership for the purpose of owning real estate or means of production, or for financial leasing or participation in production—is that the promise of ownership here may be at a nominal value or at market value. This is not considered a capital guarantee in the company because the partnership here is *shirkat al-milk* and not a contractual partnership.

The Shariah standards and operational requirements for *mushārakah* financing issued by the Central Bank of Malaysia are as follows:

"5/23 When a partner (obligee) breaches his promise to obtain shares in the partnership project as agreed upon, the other partner (obligee) may:

(a) demand the promise and compel the obligor to buy the share at market value or at fair value; or
(b) Sell the stake to a third party and claim from the promising customer any actual cost incurred in the transaction".[171]

Third: The Guarantee Requirement in Diminishing Partnership

Linguistically, *ḍamān* means commitment, guarantee and payment of compensation.[172] In Sharīʿah, it is the commitment to discharge an established right that is owed by someone else; it includes the guarantee of debt or to ensure the attendance of the one who owes the right—which is called *ḍamān al-nafs*—or to hand over a guaranteed asset, which is called *ḍamān al-ʿayn*. It is stated in *Mughnī al-Muḥtāj*: 'It is an established right owed by another, or bringing someone who owes it, or a guaranteed asset.'[173] A contemporary definition of it is the undertaking to compensate another for damage to property or loss of usufruct.[174]

The term *ḍamān* is used to refer to a guarantee to ensure that a person [appears at a certain place] and to a guarantee of property according to the majority of jurists, excluding the Ḥanafīs. It is also used to refer to compensation for damages, usurpations, defects, and accidental changes. It is also used to refer to financial guarantees; the commitment can be undertaken by a contract or without a contract.[175]

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[170] Standard 58 on Repurchase, *Shariʾah Standards*, Accounting and Auditing Organization for Islamic Financial Institutions, Bahrain.
[171] Musharakah Policy Document, Bank Negara Malaysia, 20 April 2015, p. 19.
[172] Ibrāhīm Anīs et al., *Al-Muʿjam al-Wasīt*, Majmaʿ al-Lughat al-ʿArabiyyah, 2004, p. 544.
[173] Al-Sharbīnī, *Mughnī al-Muḥtāj*, vol. 3, p. 198.
[174] Wahbah al-Zuhayli, *Naẓariyat al-Damān*, 7th edn. Dār al-Fikr, Damascus, 2006, p. 15.
[175] *Al-Mawsūʿah al-Fiqhiyyah al-Kuwaytiyyah*, vol. 28, p. 219.

Among the causes for a guarantee according to the Shāfiʿīs and Ḥanbalīs are the following:

a. A contract, such as [guarantee of] the sold item and the specified price before receipt and delivery in the sale contract.
b. Possession, either on the basis of trust; for example, in a deposit or partnership if infringement occurred, or without entrustment; for example, in usurpation or a voidable purchase.
c. Destruction of life or property[176]

The guarantee may be by a contract or without a contract as a result of one of the well-known causes for *ḍamān*, and all the provisions and types of guarantee apply in the diminishing partnership. The guarantees in financing by diminishing *mushārakah* include:

- First: Taking a pledge, which is the bank's request of the customer to pledge the property under financing; i.e., to pledge his shares in favour of the bank. That pledge is registered with the concerned authority until all the installments due on the customer have been paid. In the event that the customer fails to pay, the bank takes possession of the property and sells it in the market; thus, the bank safeguards itself.[177]
- Second: The bank requests its customer to participate in *takāful* or insurance to cover the loss of the property and provide protection to repay the financing amount in the event of the customer's death or incurable illness that may befall him during the financing period.
- Third: The bank requests its partner client to ensure that the bank is compensated for any damage or loss resulting from force majeure that causes the destruction of the real estate or the joint venture.

We note that some of the forms of guarantee used are contingent upon future events which may be undefined. As for the contingent guarantee, it comes under the heading of a contingent commitment, and some jurists permitted contingency in exchange contracts, just as they permitted it in donations.[178] As for a guarantee against an

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[176] Ibid., vol. 28, p. 227.

[177] Muḥammad ibn al-Sharīf ʿAwālī, *'Al-Mushārakah al-Mutanāqiṣah fī al-Masārif al-Islāmiyyah al-Dawliyyah'*, Islamic University of Madinah, vol. 3, no. 1, March 2019.

[178] The Mālikī scholar al-Ḥaṭṭāb stated:

> The ruling for a contingent undertaking of liability that is not related to an act of the offerer or the recipient of the undertaking is the same ruling as an absolute undertaking. Judgement shall be passed in accord with it if the contingent condition is realised. This is in case the beneficiary is a particular party, but if the beneficiary is not a particular party, judgement shall not be rendered in accord with it. Many detailed issues fall under its rubric.

He further stated in the chapter on guarantees:

> If a person tells someone, 'If so and so does not fully discharge your right, I will do so,' and he did not set a time limit for it, the ruling authority shall hold him accountable for the amount he considers appropriate. He shall then be liable to pay that money unless the debtor is present and has the means to pay. If he were to say, 'If he does not fully discharge your right before he dies,

undefined contingency, it was permitted by the majority of jurists but not by the Shāfiʿīs.[179] From the preceding, we can conclude that taking guarantees from the client who is a partner in a joint ownership of property is permissible, as long as it does not contradict the nature and requirements of *shirkat al-milk*. This is because he is considered an outsider vis-à-vis the shares of others. Just as it is permissible for him to act as a guarantor for transactions entailing debts and rights outside the partnership, so too is it permissible for him to guarantee here. If one of the partners buys the other's half from him and guarantees the price, this is permissible, whether at the nominal or market value, because he is an outsider and is making a donation. If Zayd took a loan from the bank and a person separate from the bank came and said, 'I guarantee you the million,' this is permissible. The same applies here because the partner in *shirkat al-milk* is treated like an outsider.

Based on what was mentioned earlier, from the point of view of those who classify diminishing partnership as a contractual partnership, we can say that some forms such as capital guarantee or profit guarantee are not permissible in a contractual partnership because they contradict the nature and requirements of such a partnership. The partner is like the agent; his possession is possession on trust, so he is not liable for what is damaged under his possession in the absence of negligence or transgression. As for the general guarantee due to infringement, negligence, or violation of terms, this may be stipulated in a contractual partnership or a joint ownership of property.

4.6 CONCLUSION

From the above, the following conclusions can be drawn:

1. The partnership contract (*shirkat al-ʿaqd*) is a financial contract whose form is determined by the will [of the contracting parties]. This is in line with the *fiqhī* principle that gives the will of the two contracting parties broad authority which accommodates all the diverse arising and evolving human needs. This is easier and kinder to people as long as it does not entail anything prohibited by the Lawgiver.

2. Diminishing partnership can be jurisprudentially classified as joint ownership of property of the same type as the optional *shirkat al-milk*, or as a contractual partnership. [The determination shall be] according to the goals and will of the two partners and in light of the characteristics and planned structure.

3. It is permissible to pledge to buy the partner's shares at a nominal value or any predetermined value as well as to request a guarantee from the partner in the

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I will do so,' the guarantor will not be liable for anything until the debtor dies. That is because he appointed the period of his liability.

See Shams al-Dīn Muḥammad ibn Muḥammad al-Ḥaṭṭāb, *Taḥrīr al-Kalām fī Masā'il al-Iltizām*, edited by Abd al-Salām Muḥammad al-Sharīf. Beirut: Dār al-Gharb al-Islāmī, 1st edn. 1404H/1984 CE, p. 265.

[179] *Al-Mawsūʿah al-Fiqhiyyah al-Kuwaytiyyah*, 42, p. 10-11.

diminishing partnership that is based on *shirkat al-milk*. As for partnership based on *syirkat al-aqd*, the purchase undertaking to redeem should be as per market value or the price agreed at the time of the transaction.

4. It is permissible to make the sale contract contingent, in the interest of the two contracting parties, upon a condition appropriate to the contract that achieves a legitimate purpose, since the principle in contracts is that they shall be executed sooner or later.

5. Diminishing *mushārakah* or *mushārakah* that ends with ownership transfer can be used to finance or invest in a commercial activity such as working capital financing for small and medium-sized companies.

CHAPTER 5
THE APPLICATION OF *MUSHARAKAH*: PROPOSED INNOVATIVE INSTRUMENTS

5.0 INTRODUCTION

This chapter explores and discusses the variations of business models and financial instruments for Bank Rakyat to adopt towards implementing *Musharakah* on its business operation.

5.1 BUSINESS MODEL TOWARDS MUSHARAKAH ADOPTION

Noting that *Musharakah* requires several considerations and adjustments on Bank Rakyat operation to undertake as a means of an alternative to debt-based financing there are two (2) business models to be explored. Two potential business models are: -

1) Investment Account (IA): Bank Rakyat to offer *Musharakah* financing via IA;
2) Venture subsidiary: Bank Rakyat to set up a subsidiary that offers *Musharakah* Financing;

In both models, *Musharakah* concept can be used to finance Small- & Medium-Enterprises (SMEs) through unincorporated joint-venture agreement and Islamic Redeemable Convertible Preference Shares (RCPS-i).

MODEL I: Investment Account (IA)

The IAs are specific accounts in which its funds are not guaranteed by the bank such as Current Account/Savings Account (CASA) and deposit products. The following excerpt from BNM guideline on IA provides the insight on IA.

The Islamic Financial Services Act 2013 (IFSA) distinguishes investment account from Islamic deposit, where investment account is defined by the application of Shariah contracts with non-principal guarantee feature for the purpose of investment. Notwithstanding this, the IFSA provides adequate legal basis to support the further strengthening of investment account operation that provides appropriate protection to investment account holders (IAH) whilst ensuring financial stability of the Islamic financial system. Under the IFSA, the priority of payment for investment account upon liquidation of the Islamic financial institution (IFI) is treated separately from Islamic deposit, in accordance with the rights and obligations accrued to the IAH. There are two types of IA that has been outlined by BNM: -

1) Restricted investment account (RA), refers to a type of investment account where the IAH provides a specific investment mandate to the IFI such as purpose, asset class, economic sector and period for investment;

2) Unrestricted investment account (UA), refers to a type of investment account where the IAH provides the IFI with the mandate to make the ultimate investment decision without specifying any particular restrictions or conditions.

Musharakah contract can be applied in both RA and UA of Investment account.

IA allows Bank Rakyat to fund any projects or companies without impacting Bank's risk parameter as IA is considered a separate fund to Bank's proprietary or CASA. Under IA, Bank acts as a regulated channel to properly funnel deposit from IA depositor to the specific SMEs while not assuming performance risk of the SME projects. Since IA is a different asset class than CASA, there will require many adjustments on Bank's operation and accounting reporting, which most Banks in Malaysia including Bank Rakyat has already adopted towards IA implementation. However, most if not all IA implementation in Malaysia has been on other Islamic finance contracts not *Musharakah*. Therefore, in order to implement *Musharakah* contract within the existing IA framework, the Banks need to make further adjustment on their operation, reporting and oversight.

As a simple illustration of applying *Musharakah* financing for IA, suppose a company has an indicative profit of 12% per annum from the business activity. A profit-sharing ratio of 5:7 between the bank & IA account holders will translate to 7% annual returns to the account holders while Bank Rakyat will get 5% for managing the investments. This is as shown in Figure below.

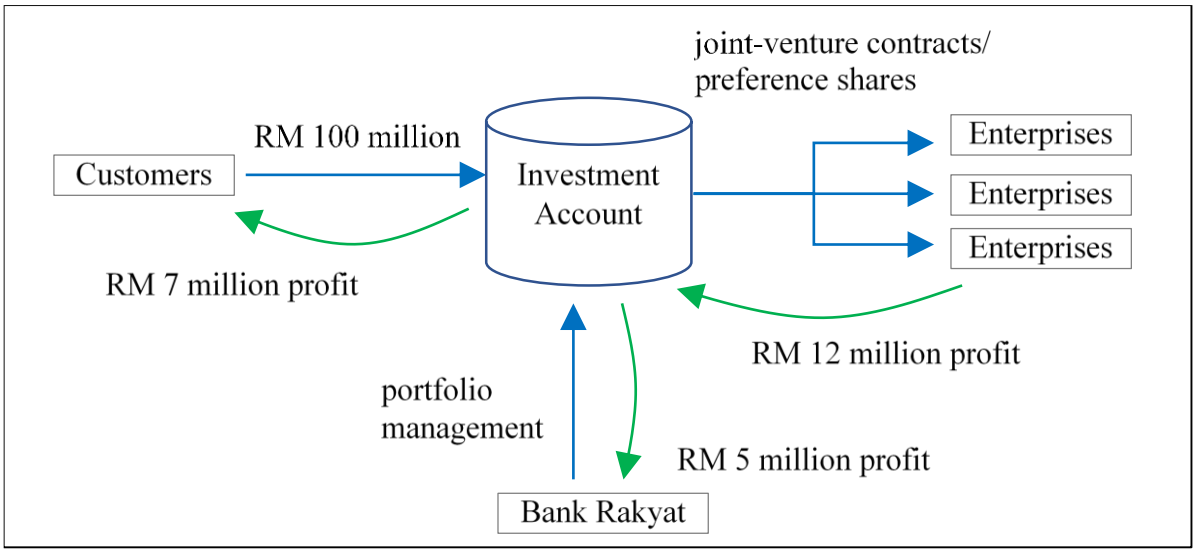

Figure I: Musharakah Financing via IA

MODEL II: Venture Subsidiary

Musharakah undertakings can be carried out by a subsidiary on behalf of the bank. For this, the bank sets up its own SPV, e.g., Bank "X" *Musharakah* Venture (BMV), to directly handle joint-venture operations. Should the bank want to make the join-venture to be their subsidiary, this would require the bank to hold more than 50% ownership of BMV, as well as provide the capital for the BMV's activities. BMV in turn uses this capital to directly finance the ventures.

The contracts involved in BMV's venture is as shown in Figure II. The Musharakah contract can be at either at the fund management level or the financing level or even both. Note as well that BMV does not necessarily have to solely serve the bank as the investor. BMV can also serve other investors, who would have similar profiles to the bank i.e., other banks. If BMV services many banks, it can also work as a coordinator on syndicated financing for a large project.

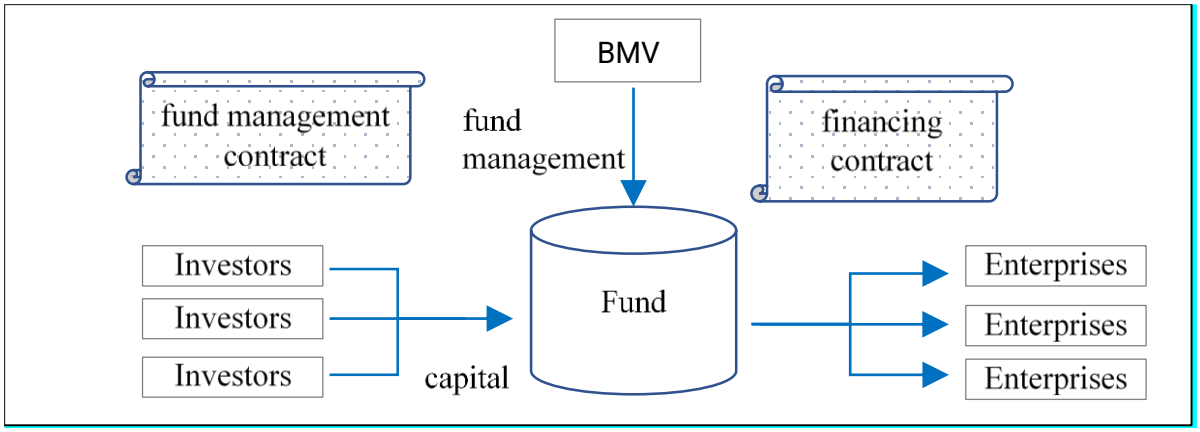

Figure II: Musharakah financing in Venture Subsidiary (BMV)

As an SPV of the bank, BMV can follow risk management principles that harmonizes with what the bank uses, with some tweaks, for simplicity. In this way, reporting communication will be simpler and match to the investor needs.

Exit strategies should be specified so that at the end of the Musharakah contract, investors understand how they are going to be compensated. By default, assets are returned accordingly to cover the contributed capital. The surplus profit is to be divided according to the Profit-Sharing Ratio (PSR) determined in the contract. In certain situations, options can be added so that the investors also get shares in place of dividend pay-out. This allows investors continuous participation in the venture. For example, if RCPSi were used for financing, instead of liquidizing them, they could be passed on directly to the investors, and they can decide to convert them into common shares. Where dividends are to be paid out, BMV can specify in the contract to be quarterly, half-yearly or otherwise to meet investors' preferences.

5.1.1 GENERAL COMPARISON BETWEEN THE TWO MODELS

Table I:
Summary comparison between Subsidiary Venture and Investment Account

	Musharakah via Subsidiary Venture	*Musharakah* via the IA
Capital Risk	150% capital charges on the amount invested in the subsidiary	None.
Accounting	Consolidated at group.	Not on the bank's books.
Liquidity	Dependent on the bank's capital.	Dependent on customer take-up.
Business Setup	New specific team to be established. More flexibility in exploring business models.	Key management team already in existence. BNM approval required for IA operations

Referring to the Table I above, several aspects are to be evaluated between the two models.

i) Risk Capital: under Bank Negara Malaysia (BNM) regulations, the initial investment to BMV will incur 150% capital charges. This is because it is deemed as an equity investment by the bank. On the other hand, under IA framework under BNM, any venture or project financed by IA will not affect the bank capital charge.

ii) Accounting: Accounting for BMV's investments will be consolidated at the bank group level, since the bank will be the major controlling shareholder with more than 50% ownership. With the IA however, they would be treated separately from the bank's.

iii) *Musharakah* Financing Liquidity: The source of funds for *Musharakah* financing from BMV will be limited by capital injection from the bank. BMV could also take upon debt financing from the bank (or any other financial institution) to implement this. As sources of funds from IA comes directly from account holders, the amount of capital that can be raised depends on their contribution.

iv) Musharakah Operations Business Setup: as a separate entity, BMV will not be encumbered by BNM regulations faced by banks and so, will have more freedom in undertaking new, innovative business models for Musharakah financing. For IA implementation, the key human resource within the bank is already in existence. However, setting up BMV will require a whole new team running a business model different from the bank's banking core functions. It involves developing different processes, standards and systems, which is not implementable as a simple 'cut-and-paste' method. This exposes the bank to implementation risks. In contrast, launching a new IA product will have to get approval from BNM. This requires the bank to adapt existing Standard Operating Procedures (SOP) and technology to BNM's regulations on IA products.

5.1.2 CONSIDERATIONS FOR MUSHARAKAH FINANCING

(i) Project Kick-off, Tenure, and Maturity

Although Musharakah financing has a lot of potential, there are items which need to be examined. One of them is the starting of the project. Were a new venture to be created, there will be an initial period whereby money to be raised cannot be deployed until sufficient funds are committed to and due diligence has been completed. However, this scenario is commonplace in any equity funding, even in the Initial Public Offering (IPO) of shares in the stock market. Usually, a subscription deadline is set before allotment of shares and transfer of funding actually starts to take place. Until then, subscription funds are kept in escrow and remain unproductive.

In IA, this can be avoided because a portfolio URIA is offered instead. This allows short-term investments to take place before the subscription deadline reaches. Also, if the bank has confidence in certain projects that are offered but they still fail to raise enough interest, the bank can arrange for other independent parties to act as a back stop to pick-up any shortfall in subscriptions. For projects offered through BMV, this characteristic is usually just tolerated. Limited partners in VCs are sophisticated investors and should understand that funding does not happen on day 1 of committing capital.

(ii) Investment Account (IA) Cannibalizing of Other Deposits & the CASA Ratio

As IAs are expected to give higher returns than CASA or other deposits, there is concern that IAs will cannibalize these other deposits. From the arguments of some bankers, this should not be a concern as CASA depositors "are seeking equivalent products and not investments". Although studies need to be identified to confirm this view, to date, there is no well-known case of significant CASA flight amongst commercial banks due to this.

(iii) Customer Dispute Resolution on Performance

Earlier on, it is mentioned that the understanding of IA holders on the fund's performance reports should be taken into serious consideration. This is important to protect the bank's reputation as uninformed investors will simply blame the bank if results are not up to their expectations. Hence, reports should have clarity and not be open to misinterpretation. The bank (or BMV) has to clearly outline a 'course of action' as well as an 'exit strategy' in the event that there occur lapses in performance. In Black Swan events – such as when the Movement Control Order (MCO) was issued by the Malaysian government – many SMEs found themselves in troubled waters, if there is no plan on how to handle situations like these, similar ventures would be simply written off.

(iv) The Practice of Smoothing (Manipulating) Returns in IA

According to paragraph 13.5 of BNM's policy document on IA, smoothing practices such as Displaced Commercial Risk (DCR) are prohibited. This has been made on the basis that the spirit of profit-sharing will be lost in engineering returns in this manner. However, there is no prohibition that outside the initial contract, IA holders or BMV investors may arrange their own separate CASA accounts to manage surplus and shortfalls from their own target returns of the venture. This is because there will be no contention or ambiguity on ownership of the income.

5.1.3 CAPITAL REQUIREMENT BY BANK NEGARA MALAYSIA (BNM)

The initial investment amount by the bank intended for *Musharakah* financing will be substantially effected by the Capital Requirement set forth by Bank Negara Malaysia (BNM), hence it is impertinent to be notified of the differing effect it holds. In order to adopt the subsidiary venture model, the initial investment amount by the Bank will be greatly affected by the capital requirement that related to it. As direct investment by the bank will be considered as an equity transaction, a substantial capital charge will be applied to the initial investment amount. This will lead to a reduced amount of capital the BMV can hold for funding purposes. The BMV will then have to rely on supplementary funding to make up the difference.

In adopting the Investment Account model, the capital charge does not apply as the book keeping is considered separate. This allows for the initial capital size allocated for *Musharakah* financing to remain and financing activities can continue more seamlessly moving forward. A comparison case study of the two capital charges is as depicted in the Table II.

Table II: Capital Charge Requirement on Both Models

Bank's Book		Investment Account	
Bank Capital	100 Million	Bank Capital	100 Million
Musharakah Loan	50 Million	Musharakah Loan	50 Million
Musharakah Capital Charge	150%	Musharakah Capital Charge	0%
Final Bank Capital	25 Million	Final Bank Capital	100 Million

5.2 GUIDELINE FOR MUSHARAKAH ADOPTION

We shall now examine some of the key conditions and factors which will shape the relevance and potential impact of an effective implementation of *Musharakah* as in investment instrument for Islamic Banks in Malaysia. From the review of theory combined with the assessment of empirical evidence, it is very much apparent that certain conditions need to be in place in order for the financial instrument to be positioned for the best benefit the investor and the economy.

5.2.1 SUITABLE PROJECT OR ASSETS TO BE FINANCED VIA MUSHARAKAH BY ISLAMIC BANKS

Suitable projects for Musharakah financing should have quick turnover in nature. Their ability to realize returns in the short-term gives assurance of project viability. This narrows down the prospective investable companies to be amongst SMEs that has business maturity with a proven business model and strong revenue streams to support the return of investment projections. For businesses with cyclical nature, the business operation should have a proven cycle in generating income. A high inventory turnover indicates good sales. An example would be a second-hand car dealership which can close sales within 6 months.

Income-generating assets are an attractive investment. They generate consistent stable income over time with medium to low levels of business involvement. Popular assets invested by Banks are real estate properties, and real estate investment trusts (REITs). It is vital to differentiate income-generating assets from non-productive assets. Non-productive assets may hold value and even appreciates in value over time, but it does not generate a consistent income.

5.2.2 TECHNOLOGY INTERVENTION

Investors have recently adopted certain technological tools to streamline and expedite certain steps in the assessment process. Such is the use of filtering systems that act as the first line of assessment to identify the right prospects. These tools may either operate as a self-test assessment or guided assessment, either of which, it functions by filtering out the bulk of the unqualified prospects whilst providing the investors with all of the necessary information regarding the company at a fraction of the time and work otherwise needed. The automation and scalability of these technology tools within the process, allows for a more efficient operational process and higher work output. The objective and data-driven nature of these tools also eliminate any human error or influence to the investment decision as well as making the process traceable for monitoring and management.

A common existing practice within banks is also to utilise certain technological systems in the processing, managing, monitoring, and keeping records of the whole investment process. These systems are usually curated specific to the intended processes and SOPs required by the bank, in order to comply to the bank's governing

guidelines and policies. These tools also function to expedite the processes and minimise any human error that may occur during each step of the processes. Albeit all of these technological tools will inevitably incur a substantial investment from the banks upfront, it is a given requirement for banks to fulfil in any new financial operation set-up.

5.2.3 PERFORMANCE EVALUATION

Since any investment made is not without its risks, investment diversification is crucial to off-set any one risk by investing in multiple companies in hopes that any one of those companies will provide a high return to make up for any loss that the other companies would incur. Investors' appetite for risk is taken into proper consideration but also with the understanding that accruing too little risk may not allow the returns to reach the targeted value, hence investment diversification helps to secure high enough return with mitigated risks.

With that, performance of the investment account is most suited to be evaluated as an investment portfolio. As a portfolio, the investment progress is generally determined by the value of the overall portfolio and not on each single investment. This reflects the concept of off-setting certain risks by the wins of a single or two investments within the portfolio. In the case that the portfolio is showing decreased value, the investor may choose to multiply its diversification into new different sectors and markets. Individual shares that are under-performing are sold in order to generate the capital needed to make a new investment whilst still maintaining the asset allocation size for the investment account.

In measuring investment performance, a series of methods can be used. Here are some concepts to consider when evaluating the performance of your investments including yield, rate of return and capital gains and losses.

5.2.4 PORTFOLIO MANAGEMENT

A diverse portfolio is pertinent to securing the bank's loss distribution as well as to stagger the generated income in order to ensure a consistent flow of income across the multiple sources. Building and managing the investment portfolio is generally executed by a professional licensed portfolio manager, an investor may also choose to manage its investment portfolio in-house. In either case, the ultimate goal is to maximize the investments' expected return within an appropriate level of risk exposure. Whether to rely on a third-party portfolio manager with proven experience or to execute it in-house generally rely on which case is most efficient in its process and cost-effective to the investors. The investment portfolio first has to be managed by a professional licensed industry certified manager. Levels of competency and certification will differ and may change throughout the process according to the fund size managed. Acquiring these certifications and licenses incurs cost to the whole project.

Portfolio management requires the ability to weigh strengths and weaknesses, opportunities and threats across the full spectrum of investments. The choices involve trade-offs, from debt versus equity to domestic versus international and growth versus safety. This indicate an advantage experienced portfolio managers may have since they are already experts in the operational best practices, seasoned in market behaviours and trends, as well as well-connected with market players for invaluable inside information and high-value networking. It takes more than just qualifications to remain relevant and up-to-date with the changing market events. Third party portfolio managers also operate as a separate entity from the investors, thus their networking and marketing activities in attracting prospects can afford to be more aggressive without jeopardizing any conflict with investors' internal policies or the Bank's. Any media presence that the third party may have within the market can also benefit the investors and should be leveraged.

Suitability of the project/investee should also be considered; as certain business sectors may appear as a niche sector thus is more suited to be assessed by an entity that is already experienced within that niche. For example, most technology intensive companies are only considered and assessed for investment by venture capitals that expertise in angel-investing in technology-based start-ups whilst conventional investment firms would generally avoid such firms due to their lack of knowledge in the specific niche. Some countries have even embarked on this approach in developing its local entrepreneurial ecosystems by accessing an external venture capital.

5.3 CONTRACTUAL RISK MITIGATION

As *Musharakah* ventures have no fixed-return, agency problem is a high concern. Proactive measures can be arranged within the contractual terms to avoid problems. This should be based on the key steps of a framework that identifies, analyses, evaluates and treats risk. Specific monitoring procedures can be incorporated into these terms to ensure progress reports are submitted regularly and consistently.

5.3.1 CONDITION PRECEDENT

Condition precedent is the legal term that stipulates the definition of certain conditions that must occur or be carried out by either party in order for the contract to progress towards completion. A conditions precedent has to be fulfilled after the agreement is executed but before or prior the closing of transactions. Certain condition precedent can be waived in the case whereby the condition is not related to the transaction given this waiver is justified and acceptable to the investor. If, however any condition precedent is not fulfilled within its stipulated time, then although the agreement is executed, the investor may cancel the agreement prior to transaction.

Condition precedents are commonly covering compliance, approvals from the regulating authorities, prescription by the Article of Association, commonly agreed terms, act to verify equity "cleanliness" and safeguard investors' investment decision.

It also verifies any line and process of approval or sign-off of the equity transferred that needs to be followed to ensure there is no contestation to the equity and that it can be distributed without worries of litigation. Additionally, the investor is allowed to carry out the due diligences, particularly the legal and accounting ones.

It specifies measures to avoid fraud such as holding ownership of assets in trust or stipulating actions to ensure proper management of the venture is observed. Condition subsequent can be included as an exit clause when certain events indicate that business continuity of the venture is deemed suspect – such as death of a partner. Rights and obligations of parties in early dissolution of a Musharakah partnership can be outlined from the beginning to avoid lengthy legal disputes and challenges.

5.3.2 SUBSEQUENT CONDITION

In the case where a promise is not delivered or a certain situation has taken place, condition precedent act to outline the following actions to be in force. The purpose of a condition precedent in an investment agreement is first and foremost to protect each party from accruing any loss due to the Bank each of contract. The clause will alleviate both parties of any liabilities and its previous responsibilities within the contract, and to maybe also compensate the other party for the Bank's each of contract. Subsequent precedent also protects investors remaining assets, information and data, as well as outline the consecutive actions to be taken regarding the dissolution of the agreement in a manner that is beneficial to both parties.

6.0 TRANCHE

Tranches are a collection of securities that are separated and grouped based on various characteristics and sold to investors. Tranches are executed during a process called securitization. It allows for original investor to free up its capital and increase liquidity whilst offering opportunities for new investors to invest.

Disbursements of funds can be drawn down in stages to observe proper use. For example, in a construction project, the first tranche would be released to purchase fixed assets. Subsequent tranches would then be released at different stages of operations, with revenue growth being monitored as performance indicators.

7.0 POST-FINANCING MONITORING

After the closing of an investment, the company's progress is monitored to oversee both its financial and business performance. Investment agreements should lay out the specific financial and impact metrics with the frequency of reporting. Through a consistent and informative reporting system set up, an investor is able to identify the targeted efforts to take and how to work with the company, leveraging on the investors' skills, expertise, and network to achieve its financial and growth targets.

Depending on the type of investor, a passive investor may be interested in receiving reports on business growth and recent success milestones whilst an active investor may be interested to review both the financial and business progress on top of identifying indicators of problems. A seasoned active investor will most likely be able to detect small issues before it becomes a predicament to the company. All this monitoring is done to reduce the risk of the investment made and ultimately maximise the returns.

8.0 ESCROW

As the risk on capital invested remains, another method investor can practice is setting up an escrow account to ensure the funds invested is disbursed and will be utilised correctly by the company. Escrow accounts are commonly used to ensure a secure transaction for high-value ticket until both parties have fulfilled their respective requirements. Establishing an escrow account reinforces the investments to be a low risk and performance-driven investment.

Setting up an escrow account functions to manage the uncertainties between parties to deliver on their end of the agreement. It also provides protection during transaction. It allows the investors to remain in control of the funds by disbursing the funds to the company in stages upon completion of set deliverables. The investors also have the option to hold back or block further funding to the company in the case the milestone completion is not up to par with what was pre-agreed in the investment agreement together. Other risks that is mitigated via having an escrow account is the uncertainty whether the company will manage the funds accordingly to meet the target growth and protection against suspicious activity in fund transfers. Disbursement of the funds in a staggered manner once a milestone is achieved helps to maintain the progress of the company in a timely manner and not lose its momentum for progress.

9.0 IMPLEMENTATION PLAN

9.1 IN-HOUSE

In the case of Investment Account, as a suggested roadmap to implement Musharakah financing, the bank can start off incrementally by developing in-house SOPs to target rolling out URIAs. This is because of its flexibility to attract customers in terms of tenure as well as its flexibility for the bank to manage the funds. Target customers would be those who will be more comfortable relying on the bank's expertise to make decisions.

Trial runs to simulate customer experiences can be done for some period by internal teams to learn and improve SOP. This would include external-facing processes such as enhancing reporting formats for customers, where getting actual feedback from the general public on the trial run reports can assess if they are suitable for public consumption.

IAs are to be treated as investments rather than deposits, there may be discoveries of different priority needs in execution. For example, internal team skillsets may evolve from the focus of credit analysis to growth analysis, though it should not be a big leap, since the bank's IA offerings should still remain very much lower risk than non-retail banking investments.

Similarly, in the case of Subsidiary Ventures, the bank can exist as the sole customer/investor in the beginning. Although the BMV would be more flexible to finance higher risk targets than what the bank can on its own, it would be prudent to start off with those similar to the bank's existing portfolio. This is so that the SOP developed in BMV can be allowed to mature first, while growing the portfolio of target ventures as well as the pool of investors. As the pool of investors increase, BMV can start to work with other VCs to finance more types of ventures within the preferred sector and build-up expertise. Conclusively, building the necessary SOPs and developing in-house talents will take a longer time and higher initial investment on part of the bank.

9.2 CO-MANAGE

The bank can also work with an independent financial intermediary that are expert matters and seasoned skillset to manage the specific projects i.e., Venture Capital (VC). Granted that the 3rd party will also need to abide by the Shariah requirements in order to manage *Musharakah* financing model, utilising a separate 3rd party entity with its own set of market presence and business acumen allow for more flexibility and efficiency in the overall processes.

In this nature of collaborative venture, distribution of roles and responsibilities of each party has to be clearly outlined and clarified amongst both parties, each role also attached to its fair compensation in terms of income distribution gained from the project. For this to be effectively structured, the bank should have a clear investment and monitoring processes prior to approaching any 3rd party for collaboration.

Considering this collaboration as being novel practice to some banks, a practical and pragmatic way of approaching this may be by allocating the processes related to fund raising, project identification, due diligence, and fund distribution to the more experienced and skilled VC whilst the bank may be put in charge of post-financing monitoring of the investees and projects. Over time, once the bank has developed its own capacity for building and managing its own portfolio, if the resources allocation is beneficial to the bank, the bank can later opt to do this in-house.

In comparison to building it in-house, collaborating with an experienced third-party VC may just make the *Musharakah* adoption more seamless in terms of operations, processes and possibly shorten the duration for each step of the processes.

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