# *Musharakah Product Guide*

| **Policy** | **Person / Function** |
|---|---|
| Accountable Executive | Islamic Banking Division |
| Policy owner | Head of Islamic Banking Division |

| Approved by DAB Governor : | Date ................................... | DAB Board Secretary ................................ |
|---|---|---|

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# 1 INTRODUCTION

## 1.1 PURPOSE

1.1.1 This Musharakah Product Guide ("the Guide") is an integral part of the overall Shariah Governance Framework ("SGF") developed by the Islamic Banking Division ("the IBD") of Da Afghanistan Bank ("DAB"), the Central Bank of the Islamic Republic of Afghanistan and sets out guidance for the application of Musharakah contract to various products and services for use by any Islamic Finance Institution ("IFI"), Islamic Window Operation or an Islamic Unit operating in Islamic Republic of Afghanistan collectively referred to as "the Bank" in developing products and services using the Musharakah contract.

1.1.2 The Guide shall, however, be read in conjunction with other related internal and external policies, manuals and guidelines and specific/general transaction documentation issued by DAB from time to time.

1.1.3 All relevant staff in the Bank are expected to be familiar with the policy and understand their roles and responsibilities with respect to application of the Musharakah contract to various products and services.

## 1.2 REVIEW AND UPDATE OF POLICY

1.2.1 This Guide shall be reviewed periodically by the Head of the IBD of DAB to ensure that it is in line with the leading industry practices and caters to the customer requirements as well as ensure that the Guide is in line with other applicable changes introduced by DAB and other regulatory authorities.

1.2.2 Amendments to the Guide may be required as a result of one or more of the following reasons (not exhaustive):

i. Changes in laws and regulations

ii. Changes in functions and activities of the Banks in the Islamic Republic of Afghanistan

iii. Changes in business processes

iv. Changes in the organizational structure of the Bank

v. Changes in job roles, duties, and descriptions

vi. Any other change, where the management deems necessary to update the Bank's policies and procedures

vii. Any significant modifications arising out of the review shall be recommended by the Head of IBD reviewed by the Supreme Council of DAB and presented to the DAB Shariah Supervisory Board (the " SSB") for their approval.

# 2 OBJECTIVES AND SCOPE OF APPLICATION

## 2.1 OBJECTIVES

2.1.1 The objective of this Guide is to describe the features and the characteristics of the Shariah contract of Musharakah to be referred to by DAB to assist Banks in developing and offering Shariah compliant products which adopt the underlying Islamic contract of Musharakah.

2.1.2 The Guide is a framework which shall ensure that the process of product development and product offerings adopting the Musharakah contract at the Bank is governed by a set of clear guidelines to be adopted by the Bank staff.

2.1.3 The Guide shall outline and communicate the key guidelines for the application of Musharakah contracts to various products and services. More specifically, the primary objectives of the Guide is to:

i. Provide concept and legitimacy of the Musharakah contract under Shariah;
ii. Provide features of the Musharakah contract; and
iii. Provide guidelines on the application of the Musharakah contract.

## 2.2 SCOPE OF POLICY

The Guide applies to the Bank, its subsidiaries and branches.

# 3 GOVERNANCE AND OVERSIGHT

## 3.1 SUPREME COUNCIL OF DAB

3.1.1 The Supreme Council is the authority for approval of the Guide.

## 3.2 HEAD OF IBD

3.2.1 The Head of IBD is the Guide owner providing, in consultation with the Shariah Supervisory Board ("SSB"), the necessary oversight which shall consider the following:

i. ensuring the Guide is in line with the current business strategy, governance framework and business structures;
ii. ensuring that detailed procedures are in place across the Bank to ensure compliance with the Guide;
iii. assisting in providing subject matter expertise, support and technical guidance to the business in accordance with the Service Level Agreements (SLAs) signed with various departments; and
iv. Communicating the Guide to the business units and concerned functions and ensuring it is understood.

3.2.2 The Head of IBD is consulted on dealing with executive decisions and/or actionable issues arising from the Musharakah product offerings process and any deficiencies.

## 3.3 ISLAMIC BANKING DIVISION

3.3.1 The IBD is the Accountable Executive (AE) for the Guide with the head of IBD shall be the Policy Owner.

3.3.2 The IBD assumes oversight and supervisory responsibilities for the framework used in the Musharakah product development, offerings process and ultimate responsibility for the ongoing review and for recommending alterations to the Guide.

3.3.3 Any deviations or exceptions to the Guide must be based on a proposal by the IBD and/or other relevant authorised senior management person, in consultation with the SSB, to the Supreme Council of DAB, who shall approve or deliberate on such exceptions periodically. Any material deviation or exception shall be referred to the SSB for guidance or approval.

3.3.4 The IBD shall review the Guide's validity, relevance and accuracy as and when needed.

# 4 DEFINITION

3.1 '*Musharakah*' is a word of Arabic origin which literally means sharing. In the context of business and trade it means an agreement between two or more parties to combine their assets, labor or liabilities for the purpose of making profits.

3.2 The *Musharakah* contract from the context of modern Islamic Banking, means a partnership where profits are shared according to an agreed ratio whereas the losses are shared in proportion to the capital or investment of each partner. In an Islamic financial institution (bank), a typical Musharakah transaction is between the bank and its clients whereby each party contributes capital to the partnership to establish a new project or to participate in an existing one. Each partner becomes the owner of the project on a permanent or declining basis and shall have its due share of profits. Losses are shared in proportion to the capital contribution.

3.3 Diminishing *Musharakah* or *Musharakah* ending with a transfer of ownership is a partnership contract between two parties on a particular asset which allows one of the partners to redeem the shareholding of another partner through an agreed redemption payment throughout the tenure of the contract.

# 5 LEGITIMACY OF MUSHARAKAH CONTRACT

The legitimacy of the *Musharakah* contract is founded on the basis of the *Qur'an*, the *Sunnah* of the Prophet Muhammad (SAW) and the Consensus of Muslim Jurists.

## 5.1 THE QUR'AN

The following *Qur'anic* verses generally indicate the validity of joint or co-ownership.

5.1.1 *"…but if more than two, they share in a third..." (An-Nisaa':12)*

5.1.2 *"…truly many are the Partners (in business) who wrong each other…" (As-Sad:24)*

## 5.2 THE SUNNAH OF THE PROPHET MUHAMMAD (SAW)

5.2.1 The Narration of Abu Hurayrah

Abu Hurayrah said that: The Prophet SAW said: Allah says: I am the third [partner] of every two partners as long as they do not violate each other. When one of them violates the other, I get out from between them" (Sunan Abu Daud).

5.2.2 The Narration of Abu al-Minhal

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

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

## 5.3 THE IJMA' OF THE MUSLIM JURISTS

5.3.1 This type of partnership has been practised throughout the history of Muslims without objection from the jurists. Ibn Qadamah in Al-Mughni also mentioned that the Muslims are in consensus as to the legality of *sharikah*.

5.3.2 Imam Ibn al-Munzir states in his book *al-Ijma'*: "And they (Muslim jurists) agree on the valid partnership where each of the two partners contributes property like the other partner in dinar or dirham, and comingles the two properties to form a single property which is indistinguishable, and they would sell and buy what they see as (beneficial) for the business, and the surplus will be distributed between them whilst the deficit will be borne together by them, and when they really carry out [as prescribed], the partnership is valid."

# 6 TENETS OF MUSHARAKAH CONTRACT

There are a number of features or principles which are unique and peculiar to this contract. These features include capital, management, profit sharing, loss sharing and business venture.

(i) **Capital**: Both partners contribute a portion of capital which may not necessarily be equal. The contributed capital can be either in the form of cash or assets with an ascribed monetary value;

(ii) **Business Venture**: The project or business must be permissible by *Shariah*;

(iii) **Profit Sharing**: The proportion of profit to be distributed between the partners must be mutually pre-agreed upon inception of the contract;

(iv) **Loss Sharing**: Any losses shall be distributed between the partners according to the capital contribution ratio. However, if the loss is due to the negligence of the managing partner or management team, such losses shall be borne by the respective partner or the management team; and

(v) **Management**: While both partners may undertake the management of the business, if a partner chooses to withdraw from the management to become a sleeping partner, such arrangement is allowed. The partner is also allowed to appoint a third party to manage the business on behalf of the *Musharakah* partnership.

## 6.1 CAPITAL CONTRIBUTION BY ALL PARTNERS

6.1.1. *Musharakah* capital shall be contributed by all the partners for commercial benefit or gain.

6.1.2. Capital invested in *Musharakah* shall be in the form of monetary assets since these assets are liquid in character and provide flexibility as capital. However, it is permissible with the agreement by all partners to provide non-monetary assets as the capital after the monetary values of these assets are determined at a market value or fair value and expressed in currency, to determine the share contribution by each partner.

6.1.3. Debts such as account receivables or loan payables shall not qualify as capital of a *Musharakah*. However, if the debts are inseparable from the non-monetary assets contributed (e.g. net assets of a manufacturing company), such debts shall be measured as part of the capital contribution.

6.1.4. Funds placed with the Islamic financial institution in the form of Qard deposits can be re-invested as capital in a *Musharakah* contract.

6.1.5. Capital in the form of monetary assets denominated in a different currency from the currency adopted in the partnership shall be converted into the agreed currency of the partnership upon conclusion of the contract according to the prevailing or current currency exchange rate.

6.1.6. The capital shall be contributed in one lump sum to the partnership. However, capital can also be contributed in stages as agreed by the parties.

6.1.6 Failure to contribute capital as per the agreed schedule can cause some or all of the contributed capital to be forfeited as agreed in the Musharakah agreement unless agreed otherwise.

6.1.7 The capital invested shall not be guaranteed by any of the partners. However, such capital can be guaranteed by an independent third party who is not related to any of the partners.

6.1.8 An independent third party who provides the guarantee to the capital shall not have a majority ownership or control in any of the partners.

6.1.9 A share of a *Musharakah* capital partnership can be transferred or sold to existing partners or a third party subject to the approval of the existing partners (*Takharuj*).

6.1.10 The *Musharakah* agreement can impose a condition that the redemption of the partner's share of *Musharakah* capital to existing partners shall based on certain agreed terms and conditions.

6.1.11 New partners can enter into the *Musharakah* partnership during the tenure of the existing contract.

## 6.2 MANAGEMENT OF MUSHARAKAH VENTURE

6.2.1 Both partners can participate in the management of the *Musharakah* venture. Alternatively, one of the partners can allow the other partner to manage the *Musharakah* venture.

6.2.2 Notwithstanding the above provision, neither the partners may exercise the right to the management.

6.2.3 Where both partners decide not to be involved in the management of the Musharakah venture, the venture can appoint a third party to manage either on the basis of a management contract (*Wakalah*/*Ijarah*) or a *Mudarabah* contract.

6.2.4 In the case where one of the partners agrees to manage the *Musharakah* venture, he is also entitled to a fixed remuneration for his services as the manager in addition to his share in profit sharing as a partner.

6.2.5 Notwithstanding the above provision, the appointment of the managing partner(s) of Musharakah can be based on an independent contract (i.e.: Wakalah contract) from the Musharakah contract. He may be dismissed as a manager at any point of time without the need to amend or to terminate the Musharakah contract. In this case, the managing partner(s) may earn a fixed remuneration under the Wakalah contract if he has not received any salaries for his services prior to the termination.

6.2.6 Non-managing partners can waive their executive and voting rights relating to the management of *Musharakah* and this shall be specified in the contract.

6.2.7 The managing partner(s) as an agent shall be liable for any loss caused by his negligence or misconduct.

6.2.8 The report by managing partner(s) concerning the profit, loss or impairment of capital shall be deemed to be true and valid unless proven otherwise. In this respect, the management shall exercise due care and diligence in preparing such a report.

## 6.3 PROFIT SHARING RIGHTS

6.3.1 Profit refers to an excess amount after deducting the Musharakah venture's operating cost, expenses and taxes. This refers to the profit on capital employed. Operating cost shall refer to a direct cost that relates to the operating activity whilst non-operating expenses include administrative and other expenses that support the activity of the venture. The behaviour of such cost information is useful to the partners in performance measurement and determining distributable profit.

6.3.2 In cases where financing is specified and meant for a specified project or activities, only expenses that can be identified by the partners or deemed direct expenses to the project shall be deductible.

6.3.3 The profit sharing ratio can either be proportionate to the capital investment ratio or be based on a ratio or percentage which is agreed upon by all partners irrespective of their capital investment ratio. It is not permissible to have profit in the form of a fixed amount as this may deprive the other partner from benefiting from and sharing in the profit.

6.3.4 Notwithstanding the above provisions, it is preferable if the ratio of profit for the sleeping partner not exceeding the ratio of the managing partner.

6.3.5 Subject to certain conditions, a lump sum amount of profit can be specified if it does not deprive the other partner from benefiting from and sharing in the profit.

6.3.6 The profit sharing ratio can be revised either subject to the mutual consent of the partners or subject to a certain benchmark agreed upon by the partners as the case may be.

6.3.7 Essentially, the profit, if it is in the form of a percentage cannot be linked to the capital investment amount. However, a profit sharing ratio can be ultimately translated into a fixed percentage based on the capital investment amount provided there is no possibility that one of the partners will be deprived from the profit irrespective of the amount of the profit.

6.3.8 Profit can be distributed from actual or realized profits through the sale of assets of the *Musharakah* partnership (*al-tandid al-haqiqi* / *al-fi'li*).

6.3.9 Any allocation of funds to any partner prior to actual profit realisation (al-tandid al-hukmi) shall be rationalized at a later stage. The partners shall then reimburse the amount they have received in excess of the rationalised profit, if applicable.

6.3.10 During the *Musharakah* contract period, the partners can mutually agree to set aside a portion of the profit as a reserve or for any other purpose.

6.3.11 If the reserve fund is distributable to the partners, equitable claims by the partners shall be specified.

6.3.12 It is not permissible to one partner guarantees the profit, either in full or partial, of another partner in *Musharakah*.

6.3.13 However, a third party which has no majority ownership or control of any partners can guarantee the profit to the *Musharakah* venture subject to certain conditions.

## 6.4 LOSS SHARING

6.4.1 In *Musharakah*, the capital contributed and not recovered by a partner shall be deemed as loss of capital. Loss of capital may be attributed to a number of factors such as capital impairment, non-performance of venture invested in, negligence or misconduct of another partner.

6.4.2 Loss shall be shared on *pari passu* basis among the partners and in accordance with each partner's capital contribution.

6.4.3 It is not permissible for any of the partners to have special treatment or preference over the others in the case of loss bearing.

6.4.4 The loss to the partners shall be limited to the capital contribution of each partner.

6.4.5 It is permissible for a partner to agree, without any prior condition, to undertake the responsibility of bearing the loss of another partner at the time such a loss is realized.

6.4.6 A third party can undertake to bear the loss of a partner subject to similar conditions on capital guarantees.

6.4.7 The loss due to the breach of stipulated conditions or negligence shall be borne entirely by the negligent partner.

### 6.5 PARTNERSHIP BUSINESS VENTURE

6.5.1 Business ventures of *Musharakah* can be in various sectors including but not limited to trading, plantation, construction, manufacturing, investment and services.

6.1.2 All business ventures of *Musharakah* shall be Shariah compliant.

## 7 MUSHARAKAH MUTANAQISAH

7.1 The transfer of share capital in a diminishing *Musharakah* can be executed in a single payment or in instalments.

7.2 The transfer of share capital in a single payment can be made by way of a sale at the market value of a share or at a price to be agreed upon either at the time of acquisition or at the time of entering into this contract.

7.3 Bank may request its customer to give a unilateral binding promise (*Wa'd*) to the Bank to purchase the Bank's equity share either on a lump sum or instalments basis at a market value or at a fair value or at any price to be agreed upon either at the time of entering into this partnership or at the time of acquisition of these shares

7.4 In the event of a customer's default to acquire the Bank's equity share, the Bank is entitled to terminate the *Musharakah* contract and proceed with recovery action.

7.5 The Bank may recover the unredeemed capital from the proceeds of the disposal of the jointly owned asset to a third party.

7.6 Should the proceeds from the disposal be insufficient to cover the loss, the Bank may have recourse to the customer for the outstanding balance. In the case where the customer is insolvent, the Bank shall bear the loss of capital.

7.7 In the event of a surplus from the disposal of the proceeds, the surplus shall be distributed between the Bank and the customer according to their capital contribution ratio.

## 8. ENHANCED FEATURES TO FACILITATE MUHARAKAH

### 8.1 ORIGINATION AND EXECUTION OF MUSHARAKAH AGREEMENT

8.1.1 A valid *Musharakah* contract shall be concluded by an offer and acceptance between the partners either personally concludes the contract or they can appoint an agent / trustee to conclude the contract on their behalf.

8.1.2 Parties to a *Musharakah* contract shall have the legal capacity to enter into a contract and not be restricted by any law to invest.

8.1.3 Upon the disbursement of the capital by the Bank, both partners' rights to the profit and liability to losses are established.

8.1.4 Any term or condition mutually agreed upon without violating Shariah principles shall be binding on both the partners.

## 8.2 TERMINATION AND DISSOLUTION OF MUSHARAKAH AGREEMENT

8.2.1 Partners can mutually agree to terminate the contract at any point in time unless stated otherwise in the *Musharakah* contract.

8.2.2 A Musharakah contract shall terminate upon expiration of the agreed date or specified tenure of the contract, even though the venture is still in progress unless the partners mutually agree to extend the partnership.

8.2.3 A *Musharakah* contract shall cease to exist if the completion of the business venture is mutually agreed upon to end the partnership.

8.2.4 A *Musharakah* contract can be terminated if a considerable portion of the capital is impaired. Such impairment can arise from losses due to extenuating circumstances that hinder the partnership to continue for the remaining period or from being a going concern.

8.2.5 Essentially, the bankruptcy of a partner or any restriction imposed on a partner shall render the *Musharakah* contract terminated unless another arrangement has been agreed upon by all the partners in the *Musharakah* agreement

8.2.6 The demise of one of the partners shall lead to the termination of a *Musharakah* contract. However, the partners can agree to continue with the contract in accordance to certain procedures as documented in the *Musharakah* contract.

8.2.7 Upon the termination of the *Musharakah* contract, *Musharakah* assets shall be liquidated.

8.2.8 Liquidation of the partnership assets can be actual or constructive.

8.2.9 In the case of an actual liquidation, the assets shall be sold at market value and the proceeds of the sale shall be used as follows:

a) Payment of liquidation expenses.
b) Payment of financial liabilities that are owing to the partnership
c) Distribution of the remaining assets, if any, among the partners in proportion to their capital contribution.

8.2.10 Pre-contracting costs incurred to conclude *Musharakah* contract such as Bank to conduct technical and feasibility studies of the financial viability *Musharakah* venture can be charged subject to the customer's consent.

## 8.3 MUSHARAKAH AGREEMENT

8.3.1 Amendments and variations to the *Musharakah* agreement can be affected at any time throughout the tenure of the contract on all issues subject to the consent by all partners.

8.3.2 The *Musharakah* agreement can specify that any amendment to the agreement is valid by a specified approval process such as a majority vote or a decision by the management board.

8.3.3 Any amendment to the loss sharing ratio which differs from the capital contribution ratio is not permissible under all circumstances

8.3.4 The *Musharakah* contract shall enable the partner to withdraw capital and thus is not bound to maintain the capital throughout the agreed period unless it is stated otherwise in the *Musharakah* agreement.

## 9. CUSTODIAN OF THE DOCUMENT

This Product Guide shall be under the safe custody of the Islamic Banking Division ("IBD") of DAB. Any changes to this Manual shall be made by the IBD with prior consultation with the SSB, as reviewed by the DAB Executive Board and upon approval by DAB Supreme Council. A copy of the amended Guide shall be made available to all stakeholders and SSB members for reference and implementation.

## 10. EFFECTIVE DATE OF THE DOCUMENT

The Effective date of this guide is the ______ day of ______________ 20___