

Evaluation of Musharakah Financing, Standards, Country Cases, Major Obstacles and Solutions

—A Study of Islamic Finance Partnership Methods

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Abstract

Islamic finance products and services directly reflect the real economy. The main reason they are not based on the appreciation of money, however, could be sales (murabahah, salam, istisna), leasing (Ijarah), investment (wakala), partnership methods (musharakah, mudarabah), or other asset-backed instruments (sukuk). Even though sales via leasing-based financing are widely used, partnership methods (musharakah, mudarabah), which are necessary for the real economy and growth, account for only a small share of total financing. This study aims to analyze musharakah (capital partnership) financing with all aspects, regulations, standards, country cases, and why this method is not used as expected. The answers show that there are no specific differences between countries in rules and practices; however, the reasons behind comparatively lower musharakah financing are the same. To channel resources directly into production and investment, possible risks need to be reduced, control mechanisms strengthened, and the human resources empowered.

Keywords

Musharakah Financing & Obstacles, Islamic Finance Musharakah Standards, Islamic Finance Partnership Methods

1. Introduction

Islamic finance products and services are different from conventional ones. The primary reason is that all financing products are interest-free and backed by assets, sales, trading, investments, projects, and the real economy rather than by pure money transactions. As a result, products and services directly affect the real economy.

These transactions could be on sales methods (murabahah, salam, istisna), leasing methods (Ijarah), investment methods (wakala), partnership methods (musharakah, mudarabah), or other asset-backed methods (sukuk). However, while some products (murabahah, ijara, tawarruq) are widely used, some others (musharakah, mudharabah) are not preferred as expected (Demirtaş, 2024a). The partnership methods (musharakah, mudharabah), which support projects and investments, are essential to the real economy and growth but account for only a small share of total financing. This study aims to analyze one partnership method, musharakah structure, regulations, country cases with data, and the reasons why this financing method is rarely used.

In this study, the first section explains what musharakah is and the main differences between other partnership methods, mudarabahah, from musharakah. Musharakah is coming from the word “sharaka”, which means partnership, share, participate, or be a partner. Musharakah (capital partnership) differs from other partnership methods, mudarabah (labor-capital partnership), in that each partner contributes cash or in-kind capital. The profits resulting from the partnership are shared according to the initially agreed profit-sharing ratios, while losses are shared in proportion to the parties’ capital contributions.

The second section discusses international regulations and standards on musharakah and how countries implement them in practice. AAOIFI and IFSB are the major regulators in the international arena, and they are generally principle-based rather than rule-based.

The third section analyses the financing structure of 11 major countries, the distribution of the products, and the musharakah position. The data show that Islamic countries widely use sale-based murabaha; however, the share of partnership products, musharakah (capital partnership), and mudarabah (capital-labor share), is less preferred. The asset-based and buy-and-sell structure of murabahah makes these products less risky and more practical in the Islamic financial system. Today, approximately 50 percent of total fund allocations and transfers are done in this way. On the other hand, the average is only 13 percent for musharakah.

The fourth section examines why musharakah financing is not widely used and the significant obstacles to its implementation in practice. The results reflect seven major causes that affect the musharakah rates in general.

This article shows how the musharakah financing framework, standards, country cases, and the reasons behind lower ratios as a whole. Results are generally the same across countries, and corrective steps should be taken to support real economies and growth.

2. What Is Musharakah?

Musharakah (capital partnership) is a partnership agreement between two or more people in which each party contributes cash or in-kind capital of a determined value. Musharakah comes from “sharaka,” which means sharing and mixing the shares of two or more parties to make them interchangeable (Yustiardhi

et al., 2020).

Musharakah (capital partnership) differs from mudaraba (labor-capital partnership) in that each partner contributes cash or in-kind capital. The profits resulting from the partnership are shared according to the initially agreed profit-sharing ratios, while losses are shared in proportion to the parties' capital contributions. In contrast, Mudaraba is a partnership in which one party contributes capital, and the other contributes labor. In this partnership, profits are shared according to the initially agreed-upon profit-sharing ratios, as in Musharakah, while monetary losses accrue solely to the capital owner; the laborer's losses are attributed to their labor.

Musharaka, a funding method in Islamic banking, is used in some project financings and investments through the Islamic bank's involvement in the project. However, because banks are not established or specialized in the business, they delegate management to someone with expertise in the project rather than taking a direct role. In this financing method, the Islamic bank assumes the risk of losses or issues arising from project partners, while also providing the opportunity to generate high returns and directly contribute to the national economy and employment.

3. Standards and Regulations on Musharakah

Musharakah standards could be divided into national and international standards. International sides AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions) is one of the not-for-profit organizations that issues standards for the Islamic finance industry. The standards are on Shari'ah, accounting, auditing, ethics, and governance. Even though the standards are followed and used in over 45 countries, they are not rule-based; instead, they are principle-based, which means national authorities have the option to comply with them. However, there are no significant differences in practices regarding the major rules across countries. National standards are generally prepared by the leading authorities in each country, taking into account the basic rules of Islamic finance, country-specific procedures, and references to international standards. For that reason, AAOIFI is one of the central organizations that all countries use to understand the standards. This section explains how characteristics of musharakah products in the AAOIFI standards are classified. Another international organization is the IFSB (Islamic Financial Services Board), which has published standards that also shape the practices of Islamic products and services. The last section of this article explains how capital adequacy ratios and risk weights should be classified for musharakah under the IFSB standard.

Contractual companies are explained under the headings of companies (Sharikat al-Inan (contractual partnership), Sharikat al-Wujuh partnership (creditworthiness or reputation partnership), and contemporary partnerships (joint-stock, collective, limited partnership, partnership established for a special business, and decreasing musharakah) which are discussed and whose rules are explained in Is-

lamic law.

AAOIFI standards divide partnerships into two categories: traditional Fiqh-nominated partnerships, based on Sharikat al-Aqd (contractual partnership), and modern corporations. A contractual partnership involves two or more individuals who own common assets and their proceeds resulting from an inheritance, a will, or other circumstances. A contractual partnership is a partnership in which two or more individuals contribute capital and share profits or losses. Contractual partnerships fall into three categories: Sharikat al-Inan (contractual partnership), Sharikat al-Wujuh partnership (creditworthiness or reputation partnership), and Sharikat al-Amal (vocational partnerships and partnerships for undertaking difficult work or accepting jobs). Some view musharakah contracts as belonging to a contractual partnership, that of Sharikat al-Inan.

3.1. The Structure of the Sharikat al-Inan Company

A partnership established by two or more partners, each contributing a certain amount of capital. In this type of partnership, each partner has the right to dispose of the owner's capital. The profit rate in the partnership is determined by agreement, and in the event of a loss, the partners bear the loss in proportion to their capital (AAOIFI, n.d.b, SS12).

- A company is established at the request of each partner and with the consent of the others. If necessary, it is registered with a written agreement and official record. The purpose of the partnership must be stated in this document or in the articles of association.
- Traditional interest-bearing banks and other parties can also be included in the partnership. However, a guarantee must be obtained that the capital and transactions will be subject to the terms and conditions.
- The terms of the contract and the profit rates can be changed by agreement at any stage of the partnership. However, losses must be paid in proportion to their capital.
- The conditions regarding the capital to be contributed to the partnership are the same as the general rules. General rules also apply in cases such as intent, fault, and liability for compensation.
- As a rule each management partner has the authority to buy, sell, receive, deliver, deposit, pledge, take pledges, claim and respond to receivables, acknowledge debts, be involved in lawsuits, legal and judicial proceedings related to partnership, return purchased goods due to defects, lease, transfer, and borrow, all transactions required by trade and customary practices. The approval of the other partners is required for lending, making donations, or making dispositions that do not generate returns or are harmful.
- Partners may, by agreement, delegate the management and administration of the company to one or more of the partners. In this case, the partners can not participate in the company's management. An external manager may be appointed to manage the company, and a fee is paid to offset company expenses.

The manager may also be paid a bonus from the company's profits. However, if a share of the profits is allocated to the manager, the manager will be considered a laborer and will therefore not pay an additional fee. The partner assuming management under the partnership agreement can not receive a separate fee, but a higher percentage of the profit share may be determined. If a contract is drawn up independently of the partnership agreement, this partner may be paid separately. If the partnership resigns, the partnership agreement remains in effect.

- The rules and flexibility regarding profit distribution and sharing in the event of the company's liquidation are the same as the general rules. It is not permissible for the articles or profit distribution rules in the partnership agreement to contain any clause or condition that would violate the principle of profit sharing. If such conditions are included in the contractual articles, the contract is void.
- A company is terminated upon the termination of the partnership term, the partners' agreement to dissolve the company before the term expires, or, in the case of partnerships established for a specific business/project, the actual liquidation of the company's assets by selling them. In the event of liquidation, the company's assets are sold at market value. Liquidation expenses are paid first. The company's financial liabilities are met from the proceeds of sales. The remaining company assets are distributed among the partners in proportion to their shares.

3.2. Musharakah Rules in the AAOIFI Standard (AAOIFI, n.d.a, SS4)

- The offer and acceptance, the two parties, and the subject matter of the contract (funding and business) must be clear in the contract.
- The contract does not have a specific form; it can be tailored to the purpose. It can be written or verbal.
- Partners must have the capacity to grant and receive power of attorney.
- The capital contribution can be cash, gold, silver, or their equivalent. The capital can be in the form of goods, property, equipment, etc., or intangible rights such as mortgages and patents. Some schools of thought argue that different capitals can be mixed without granting any privileges to the partners, while others say it should be cash-only, and still others claim that capitals should not be combined.
- The contributed capital is considered a single fund, and each partner has the authority to dispose of their assets and engage in Musharakah activities. No partner can guarantee another partner's capital, but they may be required to provide a guarantee in the event of negligence.
- The fundamental rule for Musharakah is that all partners participate in the work to be done. No partner is permitted to try to exclude another from the business. However, there are no requirements for equality in work. It has been deemed appropriate that the partner who undertakes the work be given a greater

share of the profits. A partner who is required to perform work beyond their job description may hire external workers and may request a fee if they work independently. The partner responsible for the work cannot borrow or lend without the other partners' approval.

- Profit must be measurable. If not, its liquid value and distribution must be clarified in the contract. The profit to be paid to the partners must be proportional to the total profit and based on the capital contributed. It is stated that the profit can be agreed upon between the partners and distributed according to the work performed. If the profit exceeds a certain amount, the excess can be distributed to any partner. It is also possible to send the profit to third parties, such as charities. Loss sharing is determined to be based on capital contribution.
- The musharakah agreement can be terminated upon the termination, death, or depletion of the partnership's capital.

3.3. Diminishing Musharakah (AAOIFI, n.d.b, SS12)

- One partner undertakes to purchase the shares of the other gradually and acquires the entire ownership of the project under consideration.
- Shares are bought and sold between the partners after the partnership is formed. However, in this partnership, there should be no stipulations regarding the purchase and sale of shares; the purchase commitment should be made through a promise independent of the partnership. It is not permissible to stipulate the other in either the partnership or the sale contract. However, it is acceptable for any partner to make a binding promise to transfer share ownership gradually. The share sale must be for the agreed-upon amount based on the prevailing market price. The sale is not permissible at nominal value.
- In this partnership, general provisions regarding companies, especially Shari'at al-Inan companies, must be applied. It is not permissible to include a clause in the contract granting either party the right to withdraw their share of the company's capital.
- It is not permissible to impose insurance or maintenance costs on only one partner.
- Each partner must contribute a share of the company's assets. This share can be cash, a movable or immovable property with a monetary value. The parties bear losses in proportion to their shares. This is also taken into account when a share transfer occurs.
- The share of the company's profit or income that the partners will receive must be determined at the outset. It is permissible for the profit share ratio to differ from the partners' share ratio, to remain constant even if the share ratio changes, or to vary with the share ratio. However, the principle that the loss-bearing ratio should be proportional to the company's shareholding can not be changed in any way.

One of the general rules in Musharakah agreements is the principle of profit-

and-loss sharing. The profit-sharing ratio is clearly determined by the agreement of all partners at the time of the Musharakah agreement. This ratio may be proportional to the partners' participation shares, or it may be a different ratio. The profit-sharing ratios specified in the contract may be adjusted by mutual consent of the parties for the duration of the partnership agreement. No profit guarantee is given in favor of any partner, and no partner may be deprived of their share of the profits. In Musharakah, it may be agreed that if a certain profit amount is reached, any profit exceeding this amount will belong to one or more partners or to the company's employees. Partners share in losses in proportion to their share of capital. This can not be agreed otherwise.

The management of a partnership is a right held by all partners who hold a share in the capital. Therefore, each partner may actively participate in the company's management if they so desire. However, there is no legal impediment to partners delegating the management of the partnership to one or more individuals, either by agreement or by decision, or to appoint a third party. The essence of musharaka is that all partners undertake management. However, only one or more partners may assume management of the company with the consent of the other partners. In this case, they are considered to be acting as principals in their own activities and as agents for the partners. The managing partner may continue this fiduciary duty without receiving any compensation, or, according to the majority of Islamic jurists, they may also perform it in exchange for an additional profit agreed upon by the parties with their consent (PBAT, 2025, SS.7).

4. Distribution of Funds and Musharakah Ratios

This section analyses data from 11 countries to determine the average distribution of products and country cases. Musharakah products have been preferred less than other products, such as mudarabah, commodity murabahah, and Ijarah. **Figure 1** shows the composition of the average product distribution for 11 countries in the banking sector, including Islamic banks and Islamic windows funding options. Total musharakah financing is an average of 13 percent, while 8 percent is diminishing musharakah. On the other hand, murabahah funding dominates the sector, accounting for 50 percent of total products.

Figure 2 includes the distribution of murabahah and musharakah funding in the country. The data show that preferences for mudarabah and commodity mudarabah funding are widely adopted across all countries. However, only four countries (Pakistan, Indonesia, Afghanistan, and Malaysia) are using musharakah in higher portions, while in Pakistan and Indonesia, the sector is dominated by musharakah.

Countries use two types of musharakah in practice. In a normal musharakah contract, shares remain stable; on the other hand, diminishing musharaka provides partners with the option to sell their shares to the other party in time. **Figure 3** shows the diminishing musharakah portions via musharakah fundings. The data clarifies that Pakistan highly uses diminishing musharakah in total, and Indonesia.

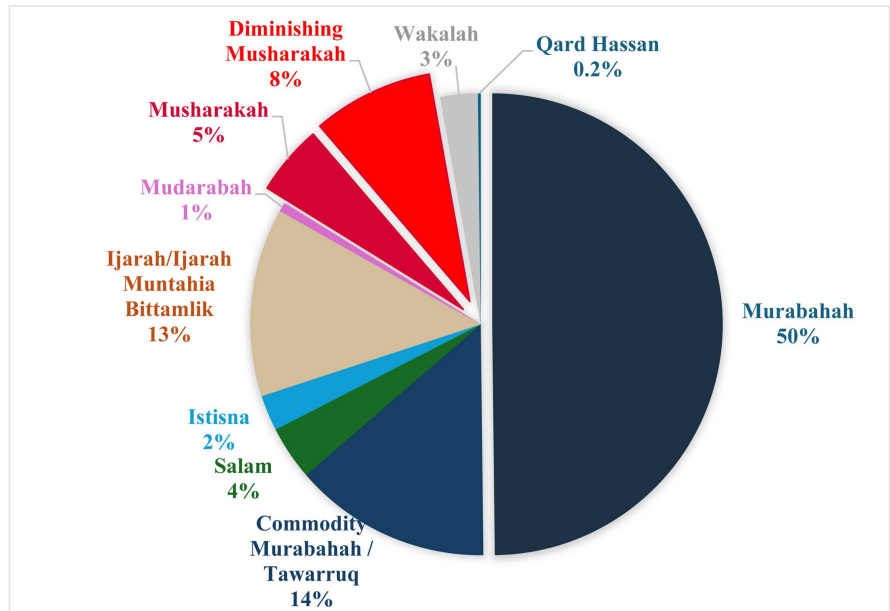


Figure 1. Average distribution of funding products in 11 countries (Percent) (Sources: IFSB Data of 2024).

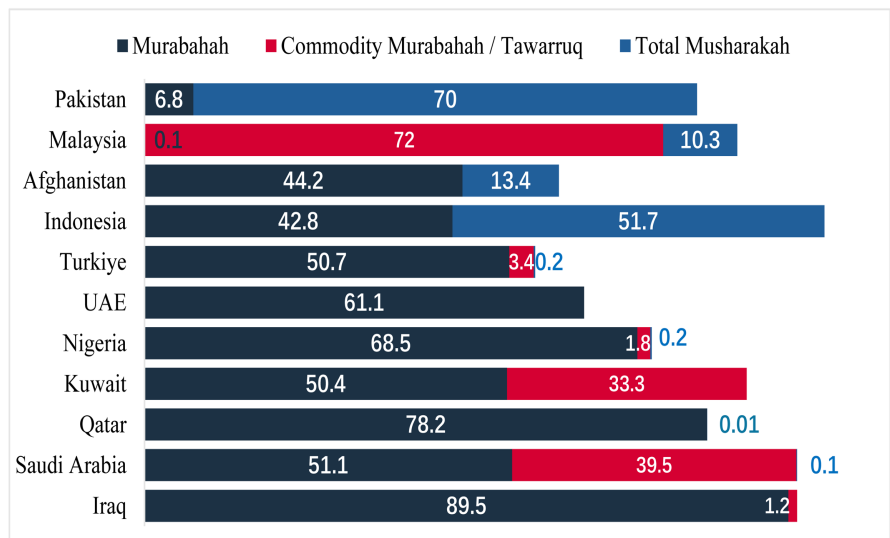
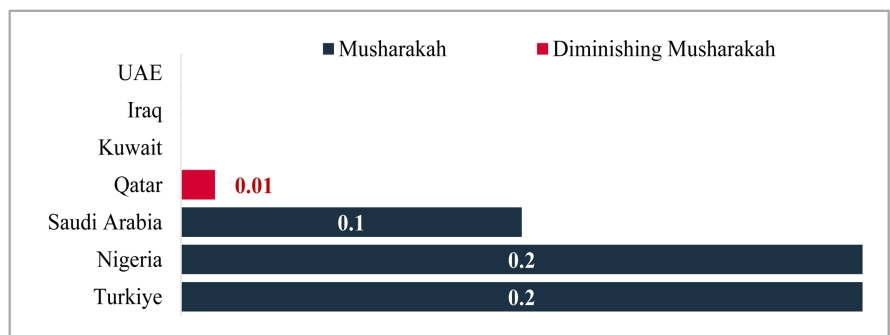


Figure 2. Distribution of murabahah and total musharakah fundings (Percent) (Sources: IFSB Data of 2024).



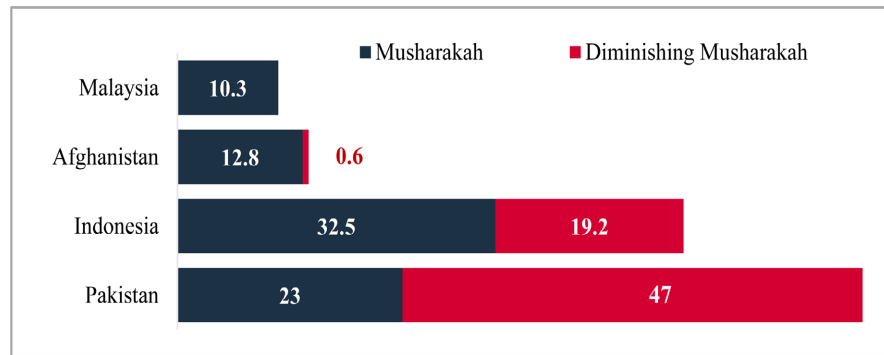


Figure 3. Distribution of musharakah fundings (Percent) (Sources: IFSB Data of 2024).

5. Why Is Musharakah Financing Not Widely Used?

Islamic finance fund collection and allocation methods differ from those of conventional banks, mainly because they are based on trade, asset-backed, real production, or project financing. The previous section's data show that murabahah, including commodity murabahah, is widely preferred over partnership methods, musharakah, and mudarabah. Murabahah is a sales method that provides profit by buying or selling goods. On the other hand, musharakah via mudarabah financing is a project and investment financing method based on partnerships. In other words, these financing methods are directly supported by the real economy, production, and growth. However, although Islamic banking and the Islamic finance sector could directly support the development of the real economy and channel capital into it, many countries are less likely to prefer them (Demirtaş, 2024b). This part analyses the reasons behind this reality.

- **Musharakah Financing Is Perceived as Riskier than Others**

The subjects of the musharakah financing are mainly projects and investments. As a result, the possibility of loss or profit, and the rate of return, cannot be clearly determined in the decision process. These contracts are based on both parties' capital contributions, so in the event of a loss, banks are liable for the initial capital share. On the other hand, the aim of guaranteed profit and the avoidance of unexpected or higher losses makes banks more selective about these products (Yustiardi et al., 2020; IFSB, 2021).

- **Monitoring and Evaluation Costs**

In some cases, selecting a productive and profitable project or investment requires high evaluation, operational, and monitoring costs for banks. The need for comprehensive analysis and specialization in selection and operational matters is another reason for banks to select musharakah financing (Abedifar et al., 2013; Khan & Bhatti, 2008; Yustiardi et al., 2020).

- **Principal-Agent Problem**

Even though musharakah contracts are designed for all parties' capital contributions, banks play no role or specialty in the execution of financed projects and investments. For that reason, reporting the process, results, losses, and profits is in Musharik's hands. Principal-agent problems occur when the specialized part-

ner on a project or investment misrepresents the process, costs, and actual profit or loss (Beck et al., 2013; Dar & Presley, 2000; Khan & Bahetti, 2008; Sarker, 2001; Abdul-Rahman et al., 2014; Louhichi & Boujelbene, 2016).

- **Credit & Capital Risks and Regulations**

According to Basel capital requirements, banks must maintain a minimum capital adequacy ratio to avoid a risky balance sheet composition. As a result, all credits are arranged by risk category, and risk-weighted assets are classified accordingly. IFSB standard explains the musharakah risks and the reason behind the risk-weighted amount as follows:

“As a partner in a musharakah contract, the IIFS is not entitled to a fixed rate of return and thus exposed to variable profits generated by the partnership, which are shared on a basis as agreed in the musharakah contract, whereas losses are to be borne by the IIFS and its partners according to their respective ratio of invested capital. Therefore, the IIFS is exposed to entrepreneurial risk of an active partner that manages the partnership and business risks associated with the underlying activities and the types of investments or assets of the partnership.” (IFSB, 2021)

Musharakah financing requires 400% risk-weighted assets as entrepreneurial risk capital for a project; four times the capital must be set aside. According to the IFSB standard, this ratio applies to a private commercial enterprise undertaking business ventures other than trading in foreign exchange, shares, and commodities. If the musharakah is based on an ijarah or murabahah subcontract, then the risk-weighted ratio could be 100 percent (Ariffin et al., 2009; Khan & Habib, 2001; Misman, 2012; Alandejani & Asutay, 2017).

- **Challenges of Providing Guarantee.**

The possible risks of entrepreneurial financing force banks to get collateral from customers before financing. Higher collateral amounts compensate for potential risks and, in some cases, help ensure the business does not use credit. Financing can not be provided in cases where the client profile, which starts with a capital requirement, makes it difficult to offer guarantees above the required financing amounts (Rahman & Nor, 2016; Yustiardi et al., 2020).

- **Reluctance of Sharing Profit & Possibility of Low Return.**

In a profit-loss-sharing contract, both parties aim to maximize profit. In this condition, while customers are reluctant to share their actual profits, banks expect to guarantee profits and protect the principal. The possibility of loss and low returns leads both parties to other products, such as murabahah, ijarah, etc., rather than partnership-based (musharakah, mudharabah) financing (Rosly & Zaini, 2008; Khan et al., 2020).

- **The Need for Specialists and Human Resources.**

Selecting and monitoring the process of a project or investment for musharakah financing requires special knowledge and human resources. The multifaceted nature of investment and project channels necessitates human resources with varying levels of expertise, which in turn requires different organizational structures and costs for banks (Khan et al., 2020).

6. Conclusion

Islamic finance products and services directly affect the real economy. The main reason is that not all transactions are based solely on the appreciation of money; they also involve tangible assets or investments, which is significant. These transactions are on sales methods (murabahah, salam, istisna), leasing methods (Ijarah), investment methods (wakala), partnership methods (musharakah, mudarabah), or other asset-backed methods (sukuk). Even though sales and leasing methods are widely used, partnership methods (musharakah and mudarabah) account for only a small share of total financing. This study aims to analyze musharakah (capital partnership) financing with all aspects, regulations, musharakah standards, country cases, and why this method is not used as expected.

The first section explains what musharakah is and its primary characteristics. Musharakah (capital partnership) comes from the word “sharaka,” which means sharing, and makes them interchangeable. Compared to mudarabah (labor-capital partnership) financing, both partners contribute capital and are responsible for losses in proportion to their capital contributions. Even though profits could be shared in the same ratio, the partners may decide on other ratios as well. This method is used for projects and investment financing.

The second section focuses on the basic standards and regulations behind the musharakah financing logic. AAOIFI and IFSB publish the major international standards on this subject. These standards are generally principle-based rather than rule-based. However, many countries follow the rules, use the main principles, and share the same basic perspectives. Musharakah is derived from the structure of Sharikat al-Inan companies, which are partnerships established by two or more partners who each contribute a certain amount of capital. In this type of partnership, each partner has the right to dispose of the owner’s capital. AAOIFI standards 4 and 12 explain how musharakah via diminishing musharakah contracts should be arranged and operated.

The third section analyzes data from 11 country cases. The data show that Islamic countries predominantly use sale-based murabahah (approximately 50 percent on average), and that only 13 percent of total financing comes from musharakah. On the other hand, some above-average countries (such as Pakistan) prefer diminishing musharakah, in which one party sells its share to the other over time.

The fourth section examines why the musharakah financing ratio remains low on average across total financing. Many researchers working on this subject find that the main reasons behind this issue are generally the same. Musharakah financing is perceived as riskier than other financing options; high monitoring and evaluation costs and principal-agent problems are the primary reasons for selecting any investment or project. Because of the credit risks, the required capital and risk weights for this financing are high (400 percent) and, in some cases, require high collateral to protect customers. Expectations for high profit also make customers reluctant to explain the actual profit, and to guarantee the return, murabahah and ijarah-based financing are preferred. In addition, evaluating and mon-

itoring the musharakah financing process requires high-quality human resources, an understanding of Islamic finance, and specific projects or investments.

In conclusion, this study aims to examine musharakah financing in all aspects and the reasons why this financing method accounts for only a small percentage of total funding. The answers show that there are no specific differences between countries in standards and regulations; however, the reasons behind lower ratios remain the same. In summary, to channel resources directly into production and investment for economic growth, it is evident that possible risks need to be reduced, control mechanisms strengthened, and human resources empowered.

Conflicts of Interest

The author declares no conflicts of interest regarding the publication of this paper.

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