

UNIVERSITI
KEBANGSAAN
MALAYSIA
National University of Malaysia

Research Center for Islamic Economics and Finance
Universiti Kebangsaan Malaysia
Bangi 43600, Selangor, Malaysia
Fax: +603-89215789
<http://www.ekonis-ukm.my>
E-mail: ekonis@ukm.my

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The Development of Islamic Financial Instruments

Abdul Ghafar Ismail¹
Noraziah Che Arshad²

Islamic Economics and Finance Research Group
School of Economics
Universiti Kebangsaan Malaysia
Bangi, 43600 Selangor D.E., Malaysia

Fax: +603-8921 5789
e-mail: agibab@ukm.my

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¹ Professor of Banking and Financial Economics, Universiti Kebangsaan Malaysia. An earlier version of this paper was presented at The Unisba International Conference for Islamic Economics and Finance, Fakultas Syariah Universitas Islam Bandung 5 January 2009.

² PhD Student, School of Economics, Universiti Kebangsaan Malaysia and Lecturer of Islamic Economics, Faculty of Management and Muamalah, Selangor International Islamic University College.

Abstract

For many years, Islamic finance has been regarded as a niche market by the conventional financial services industry. But the growth and development of finance instruments generally has enabled competitive Islamic financial instruments to be developed. This, combined with the growing affluence of many factors, means it is well worth examining the potential for the development of financial instruments. We examine financial instruments offered by Islamic financial institutions and find that most are initially traditional in nature, but overtime, it becomes sophisticated. The underlying contracts are also changed much and beyond the classical contracts. Therefore, the aim of this paper is to highlight the development of financial instruments. We suggest the establishment of shariah parameter as a pro-active step so that it becomes as guiding principles for any Islamic financial institutions who wish to comply with Shariah principles

JEL classification: G2; K2; K4

Keywords: financial instruments; securitization; risk management; shari'ah parameter;

1. Introduction

The simplest form of relationship between customers and financial institutions could be seen via the money flow to financial institutions, then this money is channeled to customers. This view is considered the majority view of intermediation process. The intermediation process from Islamic perspective, is not only involved money flows but also other in-kind that would, later, be considered as capital. This process also, traditionally, creates financial instruments.

The further growth and development of the Islamic financial services industries would not only depend the money and in-kind flows, but also on the nature of innovations introduced in the industries, sound and prudent regulations, and number of participants. The immediate need is to deploy human and financial resources to develop instruments to manage wealth; perform asset/liability and risk management; perform corporate social responsibility; and introduce public finance instruments.

The number of participants, especially the number of Islamic financial institutions can play a vital role in mobilizing dormant savings and attracting funds that are being intentionally kept at interest-based financial institutions. At the same time, the establishment of such Islamic financial institutions would enable the contracting parties to choose financial instruments compatible with their business needs, social values, and religious beliefs.

In the beginning, the aim in introducing the financial instruments was to offer the traditional banking operation such as deposits and financing. These simple financial transactions were later moved to a more sophisticated Islamic financial instruments. The underlying contracts were also changed much and beyond the classical contracts.

Securitization is a step in the right direction that moves away from the classical contracts or known as sophisticated instruments. However, the scope of securitization, the process of unbundling and repackaging a financial asset to enhance its marketability, negotiability, and liquidity are very crucial. With the expansion of securitization, the customer base of Islamic financial systems will grow as institutional investors, who have access to broader maturity structures, are attracted to the market; and asset or liability management will become a reality. Other strong candidates for securitization include real estate, leasing, and trade receivables because of the collateralized nature of their cash flows. Therefore, the aim of this paper is to highlight the development of financial instruments.

The discussion of this paper will be divided into four sections. Section 2 is introduced to identify the taking stocks of financial instruments from traditional activities to recent one. While section 3 will discuss the creation of shari'ah parameter. Section 4 provides the conclusion of this paper.

2. Taking Stocks from Traditional Instruments to Sophisticated Instruments

The aim of this section is to trace the development of financial instruments from the earlier birth of Islamic financial institutions to the recent one.

2.1 Traditional Activities

Traditionally, most Islamic financial institutions engage in a variety of financial operations. Besides their range of equity, trade financing and financing operations. In addition, Islamic financial institutions worldwide also offer a wide array of wholesale and retail products including loans, partnership investments, foreign exchange transactions, fund transfers, letters of credit, securities safekeeping, investment management and advice, and other banking services. Many are also active in fund management (such trust funds) and takaful. On the liability side, Islamic financial institutions offer a variety of options for depositors. Current accounts are operated on the principles of al-wadiah (safekeeping) and are not remunerated. The purpose is to offer depositors safe custody for precautionary and transaction purposes.

Depositors are provided with cheque-books and can withdraw their funds at any time without any restrictions or conditions. No fees are normally charged. Savings accounts usually involve higher balances and a longer time commitment. Some Islamic financial institutions offer some kind of remuneration, usually left to the discretion of the institution, depending on its profitability. Investment or profit and loss sharing (PLS) deposits linked to mudarabah investments are in theory though not in practice the principal instruments offered to depositors. Islamic financial institutions typically offer a variety of accounts (PLS Deposit Accounts, PLS Special Deposit Accounts, PLS Term Deposit Accounts) with different maturities and withdrawal conditions, and often offer separate account options for the general public and for institutional investors.

In the classical Islamic tradition, the only acceptable loan was the ‘qard hasan’ (literally, ‘good loan’) or interest free loan, and the only common form of deposit was ‘al-wadiah’. Islamic bankers have been able to devise new products and instruments by updating or combining contracts that go back to classical Islam, by creating products that pose no religious objections, or by invoking custom (urf), overriding necessity (darura) or the general interest (maslahah) to justify the creation of somewhat controversial instruments.

2.2 Recent Activities

Overtime, the traditional instruments have changed. Other instruments related to wealth management and risk management and for financing the government are taking stocks.

a. Wealth Management Instruments

Structured deposits have some important characteristics that distinguish them from traditional deposits. In the case of investment deposits, the return and maturity period are variable and fixed, respectively. Structured deposits on the other hand have variable return, and in some cases, variable maturities as well.

Variable return – structured deposits generally provide the possibility of higher return compared to investment deposits. However we should balance this possibility of higher return against the risk of variable return. In some scenarios, we may get lower or no returns at all.

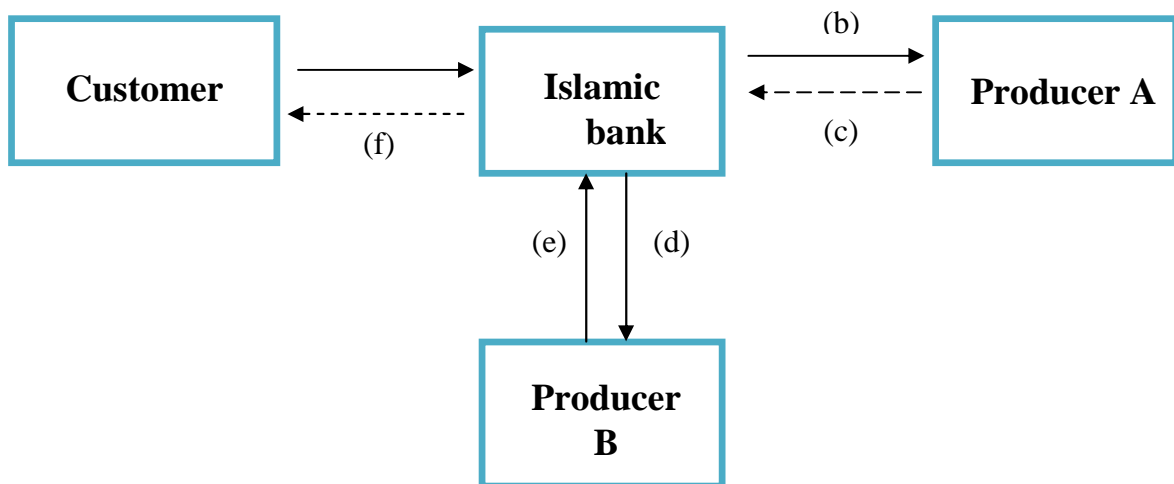
Variable maturities - structured deposits have maturities periods that vary from as short as 2 weeks as long as 10 years. This means that we may not be able to

use our money for other purposes before maturity. Some structured deposits include an agreement that enable the Islamic financial institutions to redeem or “call” the deposits before the maturity date for reason specified in the terms and conditions of our contract. Where a structured deposits callable, we can expect to receive, at a minimum, the full value of our principal. Depending on the circumstances, this early redemption features may benefit us. For example, if we wish to use our money in other ways, we can get back our principal (and possibly, additional return) as soon as redemption occurs. We may, however, be exposed to reinvestment risk. This is the risk of having to invest our money in a low return environment when overnight policy rate (as benchmark) falls.

As shown in Diagram 1, the modus operandi of Mudharabah Structured Deposits involves the following steps:

- (i) Customer as a client transfer the money to Islamic bank under mudharabah contract
- (ii) Islamic bank utilizes the mudharabah deposits to buy commodities by cash
- (iii) Transfer commodities
- (iv) Islamic bank sells the commodity to Producer
- (v) Producer B pay by installment to Islamic bank
- (vi) Pay the profit to customer

Diagram 1: The Modus Operandi of Mudharabah Structured Deposits



Islamic banks normally offer full capital guarantee as well as the potential for upside their links, typically to a basket of international stock indices. According to the diagram 1, customer as a clients and depositors place their deposits or investment RM 50000 with under Mudharabah (this transaction is made in same currency). Assume that maturity period are 5 years to get the return. With the deposits from client, bank use the money to buy commodities from Producer A. The pricing determine by bank depends on commodity price at market. Producer A sold the commodities to bank by cash. Before this transaction occurred, bank should ensure that Producer B would buy the commodities had been bought from Producer A by deferred payment (then, emerged a promise between bank and producer B) because producer B not enough

capital to purchase by cash. This transaction call as a *Wa'd*. Wa'd in Islamic law of transaction's perspective means a promise. The concept of promise is employed in a few modes of Islamic transaction such as in sale contract. In this case Wa'd happened caused by the bank cannot hold he commodity as a their asset. In case, that's why Bank sold the commodities had been bought from Producer A to Producer B. Otherwise bank would bear the loss.

b. Risk Management Instruments

Islamic financial institutions are also exposed to several risks. To avoid such risk, Islamic financial institutions also issue product that is useful for risk management tools. The prominent example of risk management instruments are cross currency swap, and hedging (selling of debt). There is a need for risk-management tools to equip clients with instruments to hedge against the high volatility in currency and commodities markets. In addition, the market lacks the necessary instruments to provide viable alternatives for debt financing.

i. Cross-currency swap³

Swaps have been one of the recent and important innovations in Islamic finance. In its simplest form, a swap consists of an agreement between two entities (called counterparties) to exchange in the future two streams of cash flows which is in a currency swap and in a profit rate swap. If we look in scope a currency swap, these streams of cash flows consist of a stream of profit and principal payments in one currency exchanged for a stream, of profit and principal payments of the same maturity in another currency. However, the principal is never exchanged as it is netted off using the Islamic principle of Muqasah. Therefore, in a profit rate swap they consist of streams of profit payments of one type (fixed or floating) exchanged for streams of profit payments of the other type in the same currency.

The economic purpose of Islamic currency swap is to match funding rates with return rates (from investment), to achieve lower cost of funding, to restructure existing debt profile without raising new finance, or altering the structure of the balance sheet, to manage exposure to interest rate movement as Islamic banks need to compete with conventional banks for market space, and also to deepen Islamic financial market. It is also aimed to protect Islamic banks from fluctuations in earnings and to provide a risk control mechanism.

The challenge, when structuring Shariah compliant products, is to generate cash flows which are at par to conventional products but using established Shariah compliant financing techniques. In the context of Islamic currency swap two simultaneous murabahah transactions, a term and reverse murabahah, are used to generate cash flows.⁴

A murabahah is a sale arrangement whereby bank purchases goods from a supplier and then on-sells them to a counterparty at a deferred price that is marked-up to include the bank's profit margin. This profit margin is deemed justified since the

³ Refer to Ismail and Che Arshad (2009) Islamic Currency Swap. In Ismail and Shahimi (eds) Islamic Financial Institutions and Markets. Kuala Lumpur: Cengage Learning.

⁴ Like other Islamic contracts, contracts in Islamic currency swaps must also be free from any elements of riba (usury), maysir (gambling), Gharar (unnecessary risk) and jahl (ignorance). In addition to these elements, Islamic currency swaps are different from conventional swaps in that they are linked with asset-backed transactions such as Murabahah, wakalah etc.

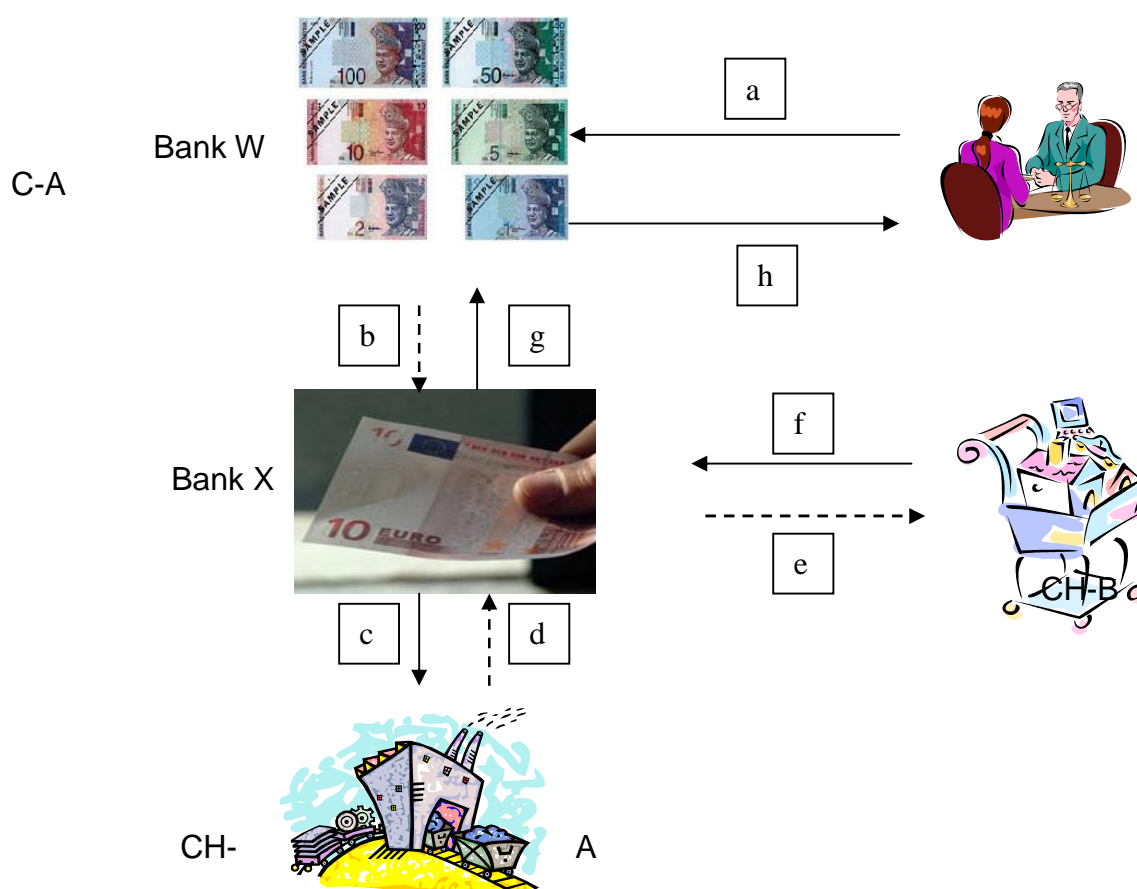
bank takes title to the goods, albeit possibly only briefly, and hence accepts the commercial risk of their ownership.

As such, under the term and reverse murabahah, the parties agree to sell Shariah compliant goods to each other for immediate delivery but on deferred payment terms in different currencies (i.e. use two parallel murabahah to generate corresponding deferred inter-party cash flows in the swapped currencies (Currencies A and B)). This structure, in effect, is not dissimilar to the "parallel loans" structure that was used by institutions in the earliest examples of conventional currency swaps.⁵

Hence, in the following the discussion, we will focus on the stages of swap transactions. It can be divided into three transactions:

Diagram 2

Transaction 1: At Inception



The transactions involve the following steps:

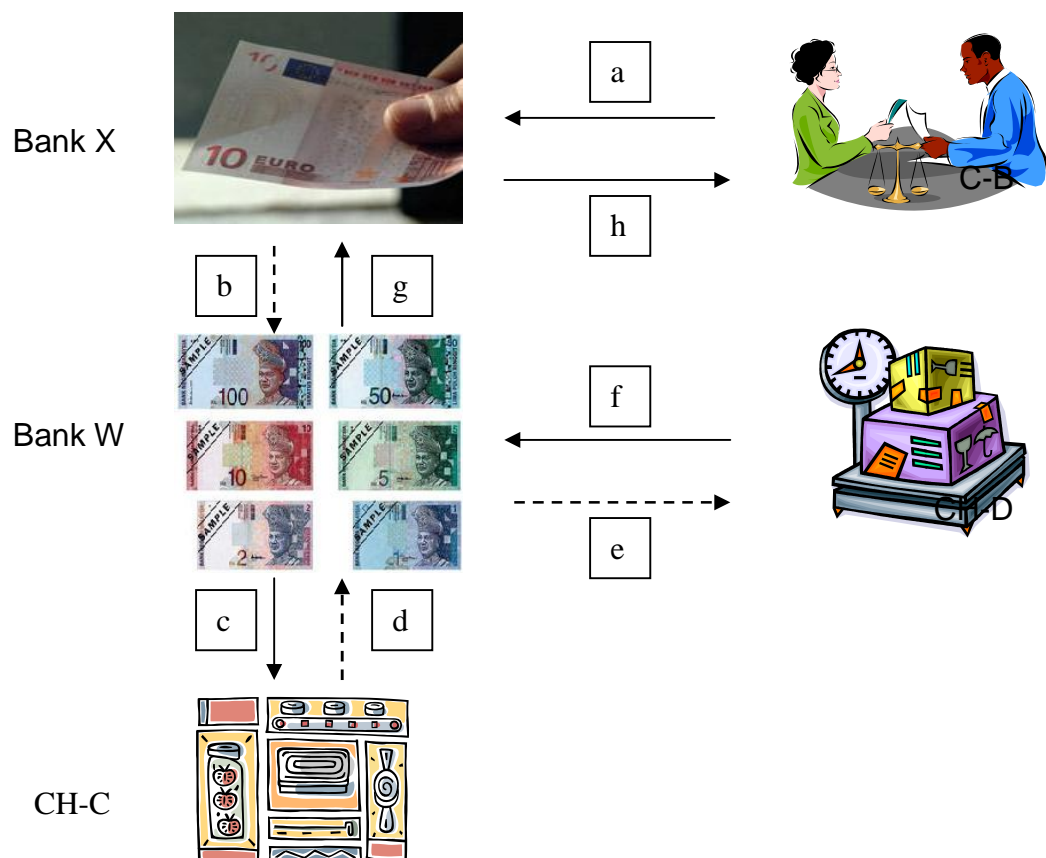
- Client A (C-A) brings money (in RM) and puts as Murabahah deposits in Bank W.
- Bank W appoints Bank X as wakeel to buy commodities from Commodities House A (CH-A) in RM at spot rate and receives commodity. CH-A acts as a seller. CH-A sells commodities on cash basis to Bank X.

⁵ See, Baz and Pascutti (1994)

- c. Bank X pays cash in RM and CH-A receives cash.
- d. Bank X get commodities from CH-A
- e. Bank X sells commodity to Commodities House B (CH-B) for spot delivery on cash basis (or a deferred payment basis) and get profit, i.e., cost in RM plus profit margin.
- f. CH-B pays for the commodities on a cash basis (or a deferred basis payment (Murabahah)). In this transaction, Bank X receives the installment from CH-B periodically.
- g. Bank W receives the cash payment and profit (or the periodical payment) from Bank X.
- h. Bank W makes payments on maturity to C-A.

Diagram 3

Transaction 2:



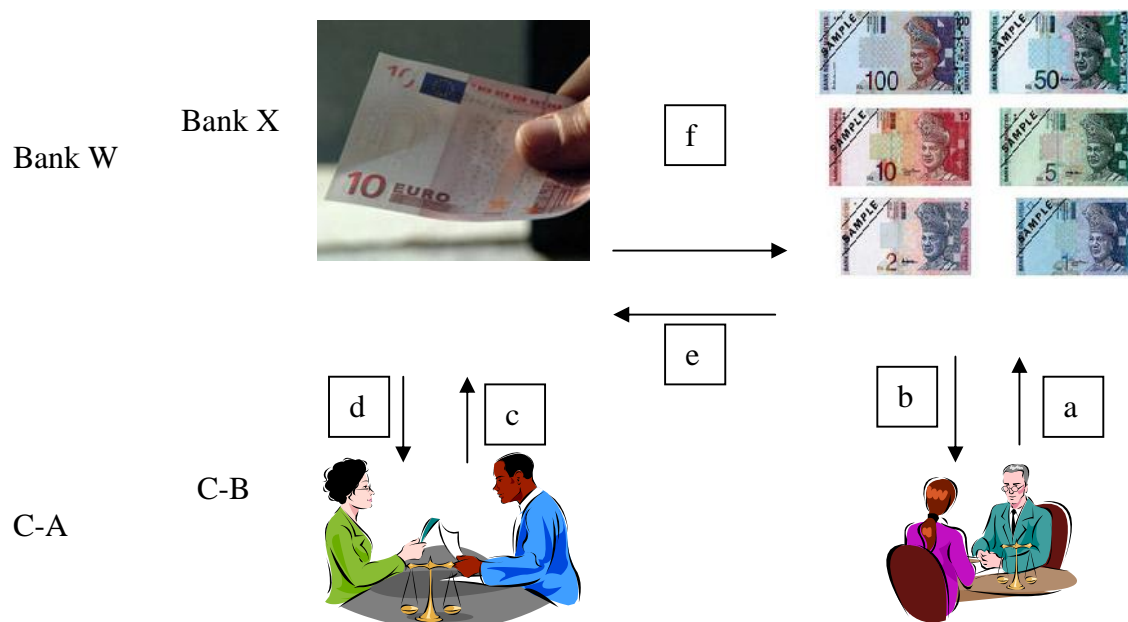
The transactions involve the following steps:

- a. Client B (C-B) brings money (in Euro) and puts as Murabahah deposits in Bank X.
- b. Bank X appoints Bank W as wakeel to buy commodities from Commodities House C (CH-C) in Euro at spot rate and receives commodity. CH-C acts as a seller. CH-C sells commodities on cash basis to Bank W.

- c. Bank W pays cash in Euro and CH-C receives cash.
- d. Bank W get commodities from CH-C
- e. Bank W sells commodity to Commodities House D (CH-D) for spot delivery on cash basis (or a deferred payment basis) and get profit, i.e., cost in Euro plus profit margin.
- f. CH-D pays for the commodities on a cash basis (or a deferred basis payment (Murabahah)). In this transaction, Bank W receives the installment from CH-D periodically.
- g. Bank X receives the cash payment and profit (or the periodical payment) from Bank W.
- h. Bank X makes payments on maturity to C-B.

Diagram 4

Swap Transaction:



- a) At the beginning (or at inception), C-A deals in murabahah transaction with Bank W (as explained in Transaction 1) and, at maturity date, gets payments in RM from Bank W. However, C-A makes a deal with Bank W to get Euro.
- b) At maturity, C-A get Euro at spot rate $RM * SF_X (1 + R_A)$, where SF_X is the spot exchange rate and R_A is rate of return paid by Bank W.
- c) The same also happen to Client-B. At inception, C-B makes a deal in murabahah transaction with Bank X. At maturity, C-B get change her Euro to RM at spot rate $Euro * SF_X (1 + R_B)$. R_B is rate of return paid by Bank X.
- d) At maturity, C-B gets payments in Euro from Bank X but instead, she wants RM.

[Note: To fulfill the demand from their clients, both Bank W and Bank X need to do swap transactions]

- e) Bank W asks Bank X to change her RM into Euro at spot rate (which is equal to $RM(1+R_A)*SF_X$).
- f) While Bank X wants to change her Euro (which is equal to purchase price plus profit or $Euro*S_{FX}(1+R_B)$).

However, if the netting off cannot be done, then, for example, if the required amount of Euro is less than $RM(1+R_A)*SF_X$, as part of the netting off, then Bank W buys commodities from Bank X on deferred basis. To avoid the mismatched amount among each others, bank can set a swap agreement based on the fixed or floating profit rates. It involves the following two stages:

- a) Fixed Profit Rate
Bank W invests RM in Bank X on Murabahah basis at a selling price that comprises both principal and profit margin to be paid upon completion of subsequent transaction. Example, suppose the principal amount intended is RM500,000 and the fixed mark-up is 5.75% for 2 years. The fixed mark-up profit rate amount is payable every 6 months for 2 years ($RM500,000 \times 5.75\% \times 5.75\% \times 180/365 = RM815.24$).
- b) Floating Profit Rate
Just prior to 6 months, Bank W invests to Bank X at a selling price of RM500,000 plus a mark-up based on current profit rate (agreed spread plus current benchmark). Payment of selling price by both Bank W and Bank X is netted-off. The net difference is profit, and is paid to the receiving party as the case may be spelt out in the settlement agreement.

ii. Selling of Debt

Islamic financial institutions bank use murabahah as a sale agreement, whereby the bank discloses the true cost of the assets and then adds a mark-up (m) to sell it at an agreed price to the customer.⁶ However, the mark-up is determined by adding the benchmark i.e. base financing rate plus the spread. Once the contract was set, Islamic financial institutions would receive a constant stream of income through the duration of contract. Therefore, overtime, when the market base financing rate change, then Islamic financial institutions are exposed to interest rate risk. To hedge against the movement of market interest rate, Islamic financial institutions choose to sell off a fraction or all of its sale receivable (murabahah housing contract) to the third party. If Islamic financial institutions sell the debt financing today, during the higher rate of

⁶ Murabahah is an acceptable form of credit sale under Shariah. Similar in structure to a rent to own arrangement, the intermediary retains ownership of the property until the loan is paid in full. Further discussion of this argument can be found in Ismail and Kamil (2008) Debt Selling and Their Impact on the Islamic Bank Value. Paper presented at the Islamic Banking and Finance Conference, The University of Melbourne, in Melbourne, Australia. 20-21 November, 2008

base financing, the Islamic bank has a competitive advantage and may charge a higher mark-up that leads to more generation of income. The payoff from the selling position can then be reinvest by Islamic bank on other lucrative project or provide higher return to depositors.

iii. Re-takaful

Reinsurance based on Islamic principles. It is a mechanism used by direct insurance companies to protect their retained business by achieving geographic spread and obtaining protection, above certain threshold values, from larger, specialist reinsurance companies and pools.

Diagram 5: Re-takaful Models: Mudharabah Model

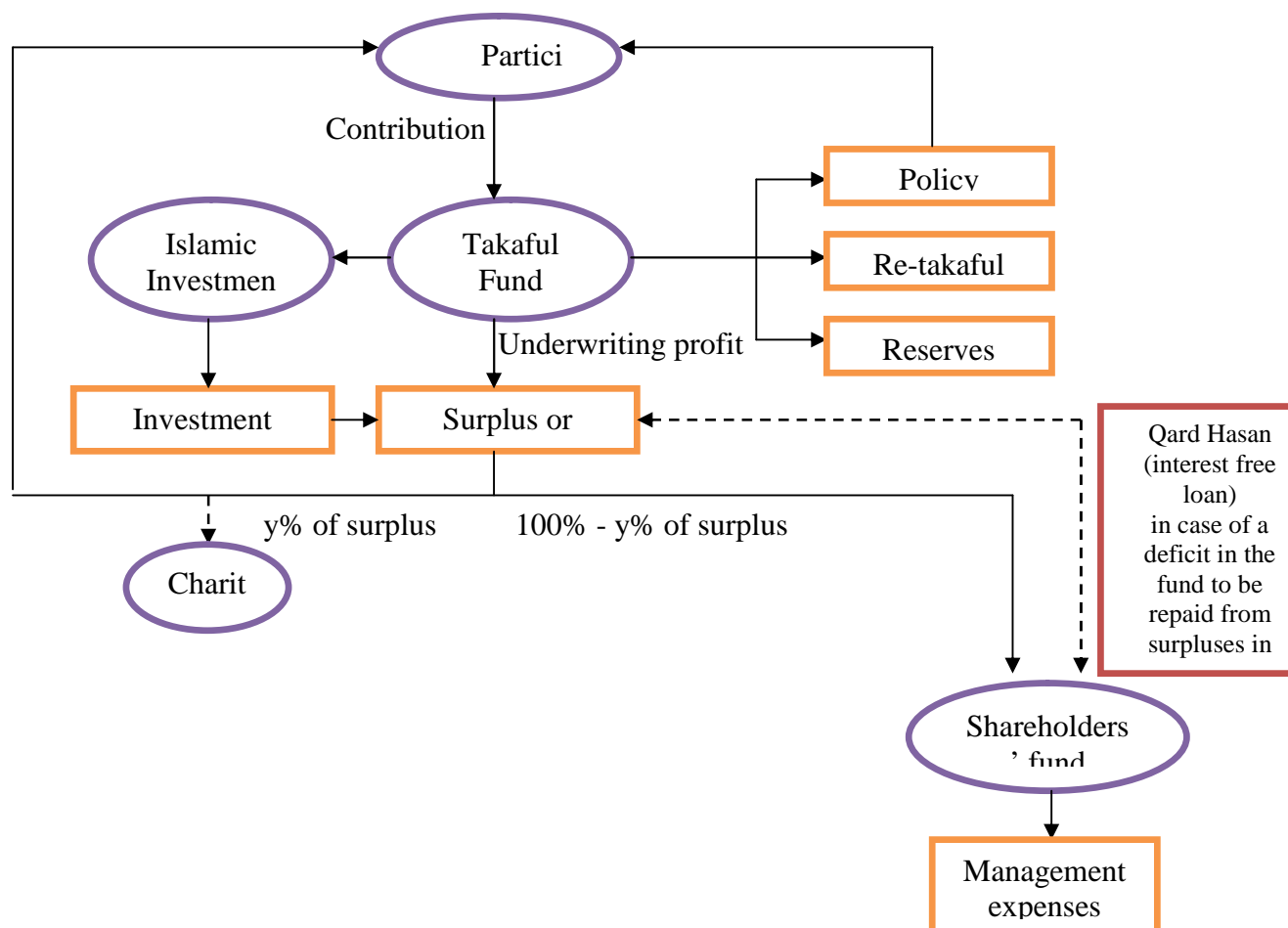
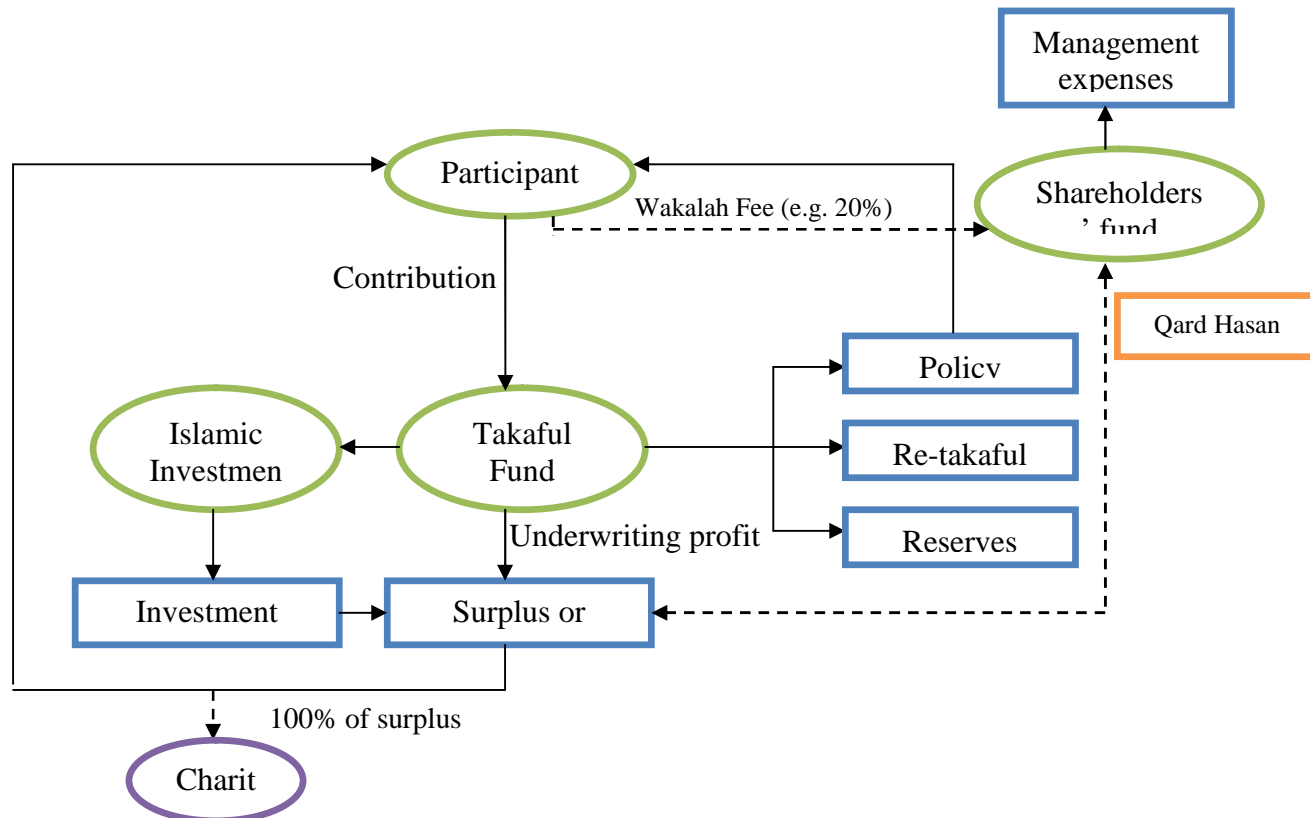


Diagram 5 show The Mudharaba model : is essentially a basis for sharing profit and loss between the Re-takaful operator and the policyholders. The Re-takaful operator manages the operation in return for a share of the surplus on underwriting and a share of profit from investment. This is commonly used in Malaysia. Under the Al-Mudharabah principle, the profit as universally defined by conventional insurance companies, which in the case of general business is taken to mean returns on investment plus underwriting surplus, is then shared according to a mutually agreed ratio between the participants and the operators. Management expenses of the

operator including agency remuneration, if any, shall be borne by the shareholders' fund and not from the Re-takaful funds. Hence, there is a distinct separation between Takaful funds and shareholders' fund.

Diagram 6: Re-takaful Models: Pure Wakala Model



The Wakala model : is a contract of agency, which replaces surplus sharing with a performance fee. The Re-takaful operator in this case acts as an agent (Wakeel) for participants and manages the Re-takaful fund in return for a defined fee. This model is used more in the Middle East region. Whereas, under the Al-Wakalah principle, the paid-up capital is contributed as donation by the shareholders. Therefore, under this principle the shareholders do not expect and probably do not mind for not receiving any returns on the capital donated. However, it is understood this standpoint has changed in view of opinion expressed by certain scholars that the shareholders (operators) in their capacity as managers should also be entitled to share the profit arising from the Re-takaful business.

We would receive a Wakala Fee and a part of the Investment surpluses of the business. Under Malaysian setting, we could also stipulate to receive a part of the underwriting surplus (after reserves). We strive to market the pure wakala solution, following demand of the scholars and being innovative. All Pricing parameters (risk assessment, expense evaluation, scope of cover) are done in a conventional way and then be transferred to a mathematically equivalent Takaful pricing structure.

d. Public Finance Instruments

The Private Finance Initiative (PFI) is a mechanism developed by the Government to raise money to pay for new buildings and services. The PFI is one of the mechanisms that the Government supports for involving the private (business) sector in public sector projects which are grouped under the umbrella title Public Private Partnership (PPP).

Under PFI schemes, a public authority (PA) is established to buy the services of a private company or group of companies in a private consortium to design, build, finance and operate a public facility, such as a school. The private consortium or 'special purpose vehicle' (SPV) is usually made up of a building firm, a finance company and a service provider. The use PFI will facilitate greater participation of the private sectors in the areas of management, operations and maintenance to improve the delivery of infrastructure facilities and public services. The PFI is considered attractive due to several reasons:

- (i) PFI could be used in place of public sector borrowing. The Public Sector Net Cash Requirement (PSNCR), which used to be known as the Public Sector Borrowing Requirement (PSBR), is a measure used to judge the prudence of a government, and keeping it low is attractive to the Treasury, as well as it follows the international standard. Conform with Malaysia style or IMF or the suggested level of budget deficits.
- (ii) There seems to be a belief in government that public sector management is intrinsically inefficient. For schools it is sometimes argued that a PFI scheme can take some of the administrative burden away from teaching professionals by placing 'non-core' functions in the hands of more efficient 'experts' who reduce costs, generate a profit for the contractor and potentially save the budget for education.
- (iii) PFI schemes are also claimed to be attractive because they share 'risk'. In theory, if PFI contractors fail to perform at an agreed standard they don't get paid and the PA can spend the money elsewhere to put things right. How well this can operate in practice depends on the nature of the scheme and the effectiveness of the contract.
- (iv) They are very attractive to a local authority which needs to raise capital to carry out much needed works or provide services and is not allowed to raise the money in any other way (e.t legal). So government policy effectively imposes PFI.

How does the scheme work? It can be developed via the asset backed securities-sukuk (ABS-sukuk) structure involves several following relationships: property owner-special purpose vehicle (SPV), SPV-government, and SPV-investors.

- (i) SPV-property owner

The government (i.e., property owner) sells, as shown by Diagram 7 (number 1) the property (e.g. school building) to SPV (a trust company held by share trustee or also called as PA). SPV pays cash (number 2) to government, then the later uses this proceed to pay the contractor.

- (ii) SPV-government

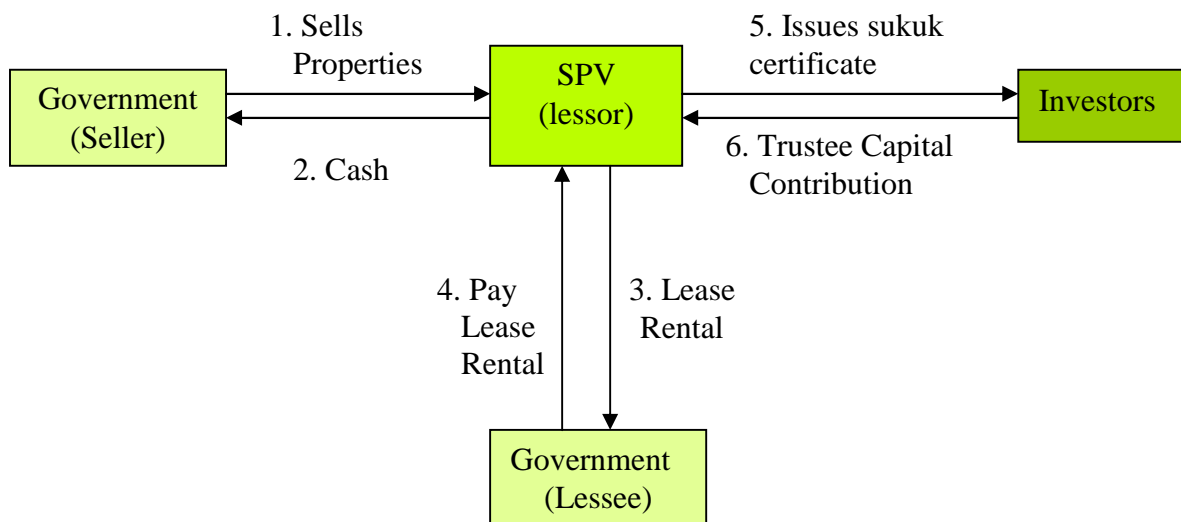
SPV leases properties to government (number 3) on trust for a certain number of years under the Ijarah principles. Government pays (number 4) lease rental to SPV.

(iii) SPV-investors

To finance the buying of properties from government, SPV issues sukuk (trust certificates based on musharakah or mudarabah principles) to investors (number 5). Then, SPV pays periodic distribution (coupon) to sukuk holders (number 6).

At maturity date, the investors redeem their sukuk from sale of properties. However, SPV also has an option to renew lease.

Diagram 7: Sukuk Ijarah Structure



e. Social Welfare Instruments

Islamic financial institutions should also be encouraged to offer social welfare contracts that produce “pahala”. In this perspective, an endowment instrument should be established with funds from the public, which comprises the amount or principal of the endowment. The amount is invested, and the income or the capital gain is used to fund a project or need. The amount remains intact in perpetuity, thereby continuing to generate funds to be used by the recipient. Although, endowments are divided into the following three categories: immovable endowments and cash endowments. But, our focus is on the later.

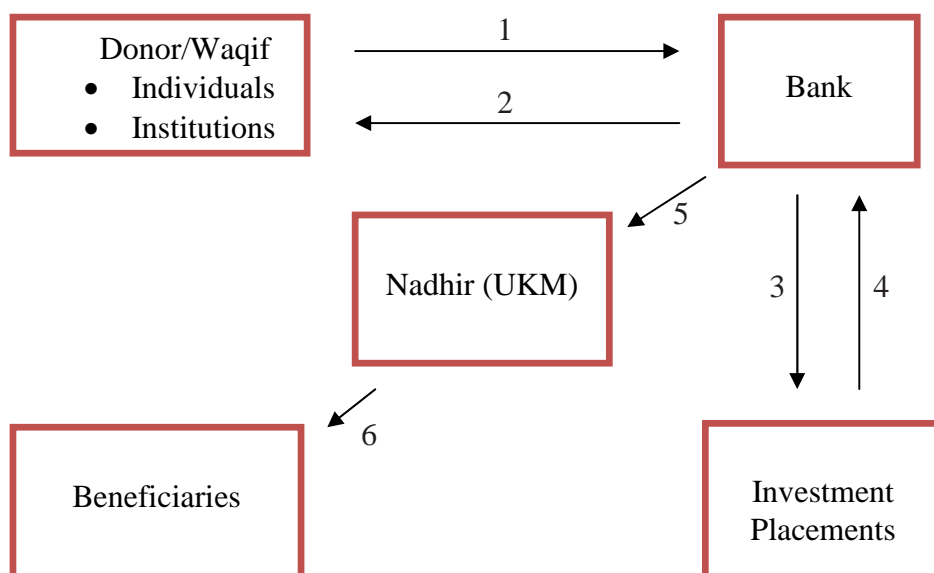
Cash waqf is aimed at mobilizing public funds to be pooled as a waqf asset (financial capital/endowment) to be managed in such a way that it can generate income stream besides maintaining its initial value to grow, or at least to preserve its perpetuity, then the income generated from investing the funds will be distributed to the beneficiaries. Preserving the perpetuity of waqf is a very important character in managing waqf assets, inclusive of cash waqf, because it is an essential characteristic of waqf. In this regard, it is very important to design a basis for valuation of this

financial waqf asset. In addition, due to its financial nature of the asset, it has to take into account of the general price changes, i.e. inflation rates.

The modus operandi of this instruments can be seen in Diagram 8. It involves the following steps:

1. Donors transfer cash to Bank
2. Issuance of Cash Waqf Certificates
3. Placement of Funds
4. In Banks (e.g. Investment Deposits)
5. Structured products (e.g. ILD)
6. Direct Investments
7. Income Flows from Investment
8. Income shared with Nadhir
9. Benefit Distribution to Beneficiaries

Diagram 8: Product Mechanism – Cash Waqf



3. Parameterization of Financial Instruments

There is no absolute authority as to which particular financial practices are allowable under Shariah law, and therefore what constitutes Islamic finance. Banks and other institutes seeking to market Shariah compliant instruments must seek a review of their instruments by shariah scholars who judge each case on its merits. Having said there is no overarching law, there must be a pro-active step, so that it becomes as guiding principles for any Islamic financial institutions who wish to comply with Shariah principles.⁷

⁷ That are (i) There is a prohibition on usury, which is generally interpreted as a ban on interest payments; (ii) Investments in gambling, pornography, tobacco, pig products and alcohol are all forbidden; (iii) Finally, Islamic finance is required to focus on real trade and transactions rather than speculation.

We suggest the creation of shariah parameter for each contract with an additional elements attached to each instruments features. The aims of this suggestion are: (i) in achieving harmonization and convergence in the concepts and application among the shari'ah committee of Islamic financial institutions to avoid contradiction or inconsistency between the rulings and applications by these institutions; and (ii) in helping the developments of shari'ah approved instruments and also in enabling Islamic financial institutions to cope with the developments taking place in instruments and formulas in fields of finance, investment and other banking services.

How could we create the shari'ah parameter? In the following discussion, we will explain the creation process. The content of this parameter includes the following items, as listed in Table 1.

Table 1: Hypothetical Example of Murabahah Deposit

Parameter Items	Purposes
Functions of Products	To execute the real sector economic transactions that facilitate the exchange, sale and trade of goods and services
Objectives of Products	Encourage savings habit
Product Features (i) IFI as wakeel (ii)Maturity	Wakeel for buying and selling
Essential conditions: (i) Wordings (ii) Commodities (iii)Contracting parties Additional conditions for (i): (i) offer and acceptance must correspond and connect to one another (<i>muwafaqah al-ijab wa al-qabul</i>) (ii)offer and acceptance must be made in the same contractual session (<i>ittihad al-majlis</i>). Additional conditions for (ii): (i) existence (ii)deliverability (iii) specification (iv) legality Additional conditions for (iii): (i) must possess complete legal capacity	To create ijab and qabul To identify the subject matter To identify only the qualified and competent person to demonstrate the intention of the parties to conclude a specific contract. the parties are present to agree on something and it ends when they separate physically To determine the legal ownership To avoid the uncertainty whether they can be delivered or not To determine the nature, quality and quantity To determine the commodity that is capable of being traded to execute or discharge his rights and duties

<p><i>((ahliyyah)</i></p> <p>(ii)competent (e.g. puberty and prudence</p>	<p>emanating from the contract that he has entered, i.e., to understand the legal consequences of any contract that he has entered into.</p> <p>To understand the transactions (Art 966 of The Mejelle)s</p>
<p>Legal Documents</p> <p>(i) Master agreement</p> <p>(ii) Supporting agreement</p>	<ul style="list-style-type: none"> • Shari’ah principles clearly translated into legal language • to satisfy the needs of economic agents through various phases of economic activity, right from the purchase or sale of goods, to arrangements for collaterals and guarantees, to arrangements for financing and investment

This parameter, later on, can be used as a way to construct the shariah compliant index which is an important component in auditing. Finally, it is suggested to create a guideline (issued by the central bank) that cover the shari’ah parameter for each financial instruments

4. Conclusions

Islamic financial institutions started their operation with a traditional activities. However, overtime, the clients want the instruments that could be tailored with their needs or the Islamic financial institutions want to offer the special features that can attract the clients. On the other hand, the Islamic law has a set of core contracts, which serve as main principles for designing more sophisticated and complex financial instruments. Therefore, to be on the pro-active side, the Islamic financial institutions should be guided. This guidance could be in the form of shariah parameter introduced by the central bank.