



BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

**DRAFT SHARIAH PARAMETER
REFERENCE 5: *ISTISNA'* CONTRACT**

(SPR5)

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TABLE OF CONTENTS

SECTION 1: BACKGROUND AND PREAMBLE.....	1
SECTION 2: PURPOSE AND SCOPE.....	2
SECTION 3: DEFINITION.....	3
SECTION 4: LEGITIMACY OF THE <i>ISTISNA'</i>	
CONTRACT.....	3
4.1 The Sunnah of the Prophet Muhammad (SAW).....	4
4.2 The Consent of the Muslim Jurists.....	4
SECTION 5: FEATURES OF THE <i>ISTISNA'</i>	
CONTRACT.....	4
5.1 Binding Nature of <i>Istisna'</i> Contract.....	5
5.2 Asset.....	5
5.3 Price and Mode of Payment.....	7
5.4 <i>Istisna'</i> Work.....	11
5.5 Delivery.....	12
5.6 Enhanced Features of the Contract.....	15
5.7 Parallel <i>Istisna'</i>	17
GLOSSARY.....	21

SECTION 1: BACKGROUND AND PREAMBLE

1. In essence, *Istisna'* is a contract to manufacture, build or construct assets to be delivered to the purchaser. Generally, it refers to the production of materials into finished products by a manufacturer or contractor at the request of a customer. The use of an *Istisna'* contract enables flexibility to the purchaser to specify the required asset in accordance to his needs and made payment based on agreed terms. In the context of modern financial practice, the construction and manufacturing financing facilities have been structured by Islamic financial institution (IFI) based on the contracts of *Istisna'*, parallel *Istisna'* and combination of *Istisna'* and *Ijarah Mawsufah fi Zimmah*.

SECTION 2: PURPOSE AND SCOPE

2. The Shariah contract parameter for *Istisna'* is aimed to become true source of reference on the nature and features of *Istisna'* contract for the Islamic financial services industry, and to facilitate the consistent implementation of *Istisna'* contract in Malaysia. Specific definitions and the basis for its legitimacy are described to facilitate the understanding of the Shariah contract requirements. The features identified in this parameter shall serve to assist the Islamic financial services industry to identify, understand, apply and distinguish the contract from other prevailing contracts in the industry.
3. The features identified and described in this parameter are extracted from the text of fatwas opined by the Shariah boards or committees of financial authorities and institutions. For each of the fatwa on a particular conditionality, activity, situation or context relating to the contract, the underlying concepts and principles are deduced and synthesized to guide the development of the Shariah parameter.
4. The features outlined in this parameter may serve as a general guidance for application of an *Istisna'* contract. Any practices of the IFI which are not specified in the parameter can be conducted as long as they do not contradict the features as outlined in the parameter.
5. This parameter also takes into consideration relevant mechanisms and contracts such as *Wakalah*, *Kafalah*, *Rahn*, *Wa'd*, *Urbun* and *Ijarah* where applicable and these are identified and proposed as secondary features.

SECTION 3: DEFINITION

6. The word *Istisna'* means requesting someone to construct, build or manufacture an asset.
7. Technically, *Istisna'* is an agreement to sell to a customer a non-existent asset that is to be manufactured or built according to the agreed specifications and delivered on a specified future date at a predetermined selling price.
8. For the purpose of this parameter, the technical definition is adopted in financial transaction undertaken by IFI and its customer where the latter requests the IFI to manufacture, construct or build specified assets and deliver it to them upon completion.

SECTION 4: LEGITIMACY OF *ISTISNA'* CONTRACT

9. The legitimacy of the *Istisna'* contract is founded on the basis of the Sunnah of the Prophet Muhammad Peace Be Upon Him (PBUH), and the consensus of the Muslim Jurists (*Ijma'*). *Basis of legitimacy of Istisna'*

4.1 THE SUNNAH OF THE PROPHET MUHAMMAD (PBUH)

10. Nafi' reported that Abdullah ibn 'Umar has reported to him that the Prophet Muhammad (PBUH) has requested for the manufacturing of a golden ring for him. The narration provides basis for the permissibility of *Istisna'*.

Sunnah of the Prophet Muhammad (SAW)

4.2 THE CONSENSUS OF THE MUSLIM JURISTS

11. *Ijma'* constitutes a juristic basis for the legality of *Istisna'*. *Istisna'* is also legally recognized by established Shariah bodies such as the International Islamic Academy of Fiqh which is under the patronage of the Organisation of the Islamic Conference (OIC).

SECTION 5: FEATURES OF THE *ISTISNA'* CONTRACT

12. The essential elements of the *Istisna'* contract are:
- i) Legal capacity of contracting parties;
 - ii) Offer and acceptance; and
 - iii) Subject matter of the contract must be lawful which includes the works and asset specification.

13. The principal features of *Istisna'* derived from the essential elements of the contract are :
- i) Binding contract;
 - ii) Asset of *Istisna'*;
 - iii) Price of *Istisna'*;
 - iv) *Istisna'* work; and
 - v) Delivery of the *Istisna'* asset.

5.1 BINDING NATURE OF *ISTISNA'* CONTRACT

14. The *Istisna'* contract entered by both seller and purchaser to manufacture or construct specific asset that conforms to the agreed specifications, price, place of delivery and payment modes shall be binding on both parties. *Binding contract on both parties*
15. The purchaser may refuse to accept delivery of the asset, if it did not meet the agreed specifications. *Non-binding contract for non-conforming asset*
16. The seller in the *Istisna'* contract shall be liable for any defects of the *Istisna'* assets as well as its merchantable quality. The seller shall not exempt himself from any defects liability during the construction and warranty period. *Seller's liability for defect*

5.2 ASSET

17. The *Istisna'* assets refer to finished products that will be manufactured or constructed as ordered by customers. *Nature of Istisna' assets*

18. The manufacturing or constructing the *Istisna'* assets shall be executed based on the specification stipulated in the agreed contract in order to avoid any uncertainties. *Detailed specifications of Istisna' assets*
19. The *Istisna'* assets may represent homogeneous assets which are commonly traded or a customised product, which will be manufactured by the seller. *Common and customised assets*
20. Both contracting parties may agree on certain degree of deviation or tolerance in terms of expected level of accuracy in meeting the agreed specification, which is in line with the acceptable market practice. *Degree of deviation of Istisna' assets*

Illustration 1: Deviation of *Istisna'* Asset Specification

A motor engine to be re-assembled with new parts delivered by a manufacturer is specified by the customer in a manner that the engine should not have a variance of more than 0.5% from the expected capacity and performance. When the engine was delivered and tested by the customer it was found that it varied at 0.1% from the expected capacity and performance. Hence the engine is accepted and the *Istisna'* contract is completed.

21. The assets to be manufactured or constructed shall be specified but not identified with reference to the physical form of the intended assets. *Specified not identified assets*

Illustration 2: Specified but not Identified Asset

A customer requested an automobile company to manufacture a car with certain specifications such as engine power, automation and design. This is a valid *Istisna'* contract. In a situation when the car can be identified with specific physical items, such as chassis and engine numbers, the *Istisna'* contract is not applicable because such identifications indicate that the car is already in existence.

22. The seller may acquire *Istisna'* asset from third party who has the capability to manufacture or construct the asset provided that the purchaser did not specifically require the *Istisna'* work to be performed by the seller himself.
23. The asset and the purpose of manufacturing and construction shall be Shariah compliant.
24. Warranty terms may be specified by the parties in an *Istisna'* contract to safeguard the interest of the purchaser against defects and to ensure necessary maintenance work is carried out after the asset is delivered.

Istisna' assets for Shariah compliance purpose

Specified warranty terms

5.3 PRICE AND MODE OF PAYMENT

25. The price of *Istisna'* assets shall be determined upon the execution of the contract. The agreed price concluded may take into consideration the warranty, after sales services and length of delivery period.

Price determination

Illustration 3: Inclusion of Additional Benefit in Price Consideration

A customer specified to the manufacturer that assets produced based on *Istisna'* contract shall include warranty of one year as well as after sales service. In this regard, the *Istisna'* financing amount may include the additional warranty charge that is built into the price, after taking into account the responsibilities of the manufacturer to provide both warranty and after sales service for one year.

26. The requirement to disclose the production cost by the seller is not mandatory in *Istisna'*. The selling price may be determined based on the direct and/or indirect costs of *Istisna'*. *Contract cost*
27. The price of the asset shall not be determined and concluded on the basis of *Murabahah*.

Illustration 4: No *Murabahah* on *Istisna'*

A customer has entered into an *Istisna'* contract with an IFI requesting the IFI to undertake the office renovation for the customer. The IFI has quoted the *Istisna'* sale price consisting of the cost of renovation plus 10% mark-up. This is not a valid *Istisna'* contract as the cost is not yet certain at the time of concluding an *Istisna'* contract. This will render the *Istisna'* sale price uncertain.

28. The variation in the selling price shall not be associated with the extension of payment period. However, variation in price may be allowed arising from mutually agreed variations in the specification of the *Istisna'* by both manufacturer and purchaser. *Revision of Istisna' sale*

29. The purchaser shall not be entitled to claim from the seller any reduction of *Istisna'* sale price due to reduction of construction/manufacturing cost. However, the manufacturer may decide to waive (*Ibra'*) part of the selling price based on its own discretion. *No entitlement to claim on cost reduction*
30. The price consideration for the assets to be manufactured or constructed may be in the form of money, services or in-kind. *Form of price consideration*

Illustration 5: Price in the Form of Money, Services or In-Kind

A developer obtained concession rights from the government to develop a government land into a township that comprises 30% residential units, 20% commercial and 50% government offices with a total value upon completion at RM100 million to be completed in two years. The required Islamic financing is estimated at RM80 million to develop the government land which is valued at RM20 million. Upon completion of the project, the developer has the right to lease the commercial premises and government offices for RM10 million per annum as lease rental for 10 years, while the residential properties will be sold by the developer on behalf of the government after 10 years. Both the government and commercial offices will be handed over to the government. In this case, an *Istisna'* contract is concluded between the developer and the government based on the concession right to develop and lease the commercial government properties and to sell the residential properties. The consideration of the *Istisna'* purchase price payable to the developer by the government is in the form of the concession right and rental payment out of leasing commercial premises and government offices to the lessee.

31. The *Istisna'* sale price may be paid on the spot, progressive or deferred payment in the form of installments or bullet payments. *Flexible payment modes*

32. A down payment (*'urbun*) may be paid subject to a mutual agreement. The seller may forfeit the down payment if the purchaser breaches or terminates the contract. *Down payment*

Illustration 6: Down payment for *Istisna'* Financing

A customer requested the IFI to construct a building on his land. The IFI undertook to develop the building by drawing up another contract with a contractor who undertook to construct the project within a stipulated time. The IFI, however, stipulated that the customer must pay 10% of the total price as a down payment and the amount would be forfeited in the event the customer terminates the contract before the construction begins. The balance is to be paid by the customer in monthly installment. Should the customer withdraw from the *Istisna'* contract, the IFI may forfeit the down payment.

33. When both parties have agreed on an *Istisna'* contract but yet to be signed, the seller may claim for compensation of the cost incurred if the purchaser decided not to proceed with the signing of the contract. *Compensation for rescinded contract*
34. Additional costs and expenses arising from meeting any specific legal requirement which is not specified in the contract may be imposed on the purchaser provided that those expenses are not within the liabilities of the seller. *Additional cost not specified in the contract*
35. The purchaser may promise to share with the seller some of the trading profits arising from the sale of an *Istisna'* asset when it is sold to a third party. *Promise to share trading profit of *Istisna'* contract*

5.4 **ISTISNA' WORK**

36. Work to build, construct, transform, convert or process the assets to be manufactured or constructed may be performed directly by the seller and/or by third party. *Work performance by the IFI or third party*

Illustration 7: Parallel Istisna' between a customer, an IFI and a third party

An agricultural production company would like to appoint a manufacturer to produce and supply fertilizers according to the company's specifications. So as to finance the supply of the fertilizers, the company entered into an *Istisna'* contract to seek financing from an IFI, and the IFI subsequently entered into a parallel *Istisna'* contract with the manufacturer. The IFI advances payments to the manufacturer for the purpose of producing the specified fertilizers, which will ultimately be delivered to the company. The company may settle the *Istisna'* purchase price to the IFI on installment basis as agreed under the *Istisna'* contract.

37. The *Istisna'* work shall be undertaken according to the agreed schedule as stipulated in the contract. *Work schedule*
38. Subcontracting of *Istisna'* work to a third party is allowed unless specified otherwise. *Subcontracting*
39. The contract may incorporate a clause to provide an option for the purchaser to take control of the project and the right to recourse to the seller for all expenses to complete the asset if the seller (contractor) failed to follow the schedule agreed upon in the contract. *Power to take control of the incomplete project and recourse to the contractor*

40. *Istisna'* work may be scheduled into phases to facilitate the progress payment to be made according to the completion of each phase. *Phases of work*
41. A third party may be appointed to provide additional professional services related to the project. The engagement of the additional services and fees are to be specified and mutually agreed in a separate contract. *Additional consultancy services and fees*

Illustration 8 : Fee for a Third Party

A feasibility study conducted by an IFI found that the proposed property to be constructed is at a site which is below sea level and prone to flooding. The contractor is required to engage an expert to evaluate the need for a retention pool and the appropriate drainage to make the project viable. The *Istisna'* financing agreement may state that the additional costs to higher a third party, are to be borne by a specified party as agreed in a separate agreement.

42. The seller may undertake to provide certain maintenance services post delivery of the asset. *Maintenance post delivery*

5.5 DELIVERY

43. The time of delivery shall be determined and agreed by both parties. *Determination of time of delivery*
44. Delivery may be performed through actual or constructive delivery which enables the purchaser to take control of the asset. *Delivery may be actual or constructive*

45. The seller who fails to observe timely and effective delivery of the manufactured asset as stipulated in the contract shall be liable for damages as well as for any penalty clause specified in the contract. *Timely and effective delivery*
46. Purchaser, in person or through an agent, should accept the *Istisna'* assets according to the agreed specifications and delivery schedule. The manufacturer is discharged from any liability associated with losses suffered arising from the failure of the purchaser to accept the delivery of the completed *Istisna'*. *Duty to accept asset delivered based on agreed specifications*
47. The purchaser may accept the delivery of *Istisna'* assets prior to the agreed delivery date without any price revision. Unless agreed otherwise, the payment obligation will take effect upon acceptance of the manufactured assets. *Early delivery of asset based on agreed specifications*
48. In the cases of late delivery of the assets without a valid reason, the manufacturer shall be liable for damages and subject to any penalty specified in the contract. *Late delivery of asset based on agreed specifications*

Illustration 9 : Penalty for Late Delivery

Assets specified by the customer is produced by the manufacturer and financed by an IFI based on *Istisna'* valued at RM40,000. Due to a breakdown in the factory, the assets were delivered one month later than the agreed date. According to the agreement a penalty of 6% per annum is imposed for any delay. The manufacturer is thus liable for damages suffered by the customer and to pay a penalty of $RM200 = (0.06/12) \times 40,000$.

49. In the case of delivered assets that are not in accordance with the agreed specifications, the customer has the right to reject them. In such a situation, both parties should mutually agree on settlement terms such as the new selling price and disposal of the assets to other buyers in the market. *Delivery not according to specifications*
50. The purchaser may reject the delivery of incomplete manufactured assets. However, the purchaser may claim ownership of the incomplete assets. *Rejection of asset and right to title*
51. The manufacturer should not stipulate in the contract a liability waiver for defects to avoid liability for incomplete delivery. *No liability waiver for incomplete delivery*
52. The purchaser shall accept the delivery of the assets according to the agreed specifications. In event that the purchaser fails to accept such delivery, it will render the following: *Failure by purchaser to accept delivery*
- i) appointment of the seller as an agent to hold the assets in trust;
 - ii) the seller while holding the assets in trust may charge the purchaser any additional cost relating to safekeeping of the assets; and
 - iii) the liability of holding the assets rests with the purchaser unless there is negligence or misconduct by the seller.

53. The *Istisna'* contract may incorporate a clause providing the seller to act as an agent to the purchaser in disposing the assets at fair market value or at a mutually agreed price, should the purchaser fails to accept the delivery within the reasonable time. In this regard, the sale proceeds shall be used to pay any outstanding amount due to the seller. Any surplus shall be refunded to the purchaser. *Appointment of the seller as agent to sell the asset on behalf of the purchaser*
54. The manufactured asset shall be delivered to the purchaser either by the seller or an authorized agent. The liability of the seller is discharged upon acceptance of delivery by the customer/purchaser. *Delivery and receipt of the asset*

Illustration 10 : Delivery Through Approved Distributor

A manufacturing company with its own approved distributorship is contracted to produce assets. Assets manufactured were then delivered to the customer through the distributor. The liability of the company is discharged upon acceptance of delivery by the purchaser.

5.6 ENHANCED FEATURES OF THE CONTRACT

55. Upon acquiring ownership of the asset, the purchaser may appoint the seller via a separate *wakalah* contract with or without consideration to sell the asset to other parties. *Manufacturer as agent to sell the asset to third party*
56. It is permissible to obtain a security for the financing of an *Istisna'* contract such as mortgage, pledge, '*urbun* (down payment), takaful coverage, security deposit and other acceptable security mechanism. *Security in Istisna'*

57. The *Istisna'* asset may be mortgaged or pledged as a security for the payment of the outstanding *selling price* amount or for any other financial obligation due from the purchaser. *Istisna' asset as security of payment*
58. An IFI (purchaser) and the manufacturer (seller) under an *Istisna'* agreement may enter into a separate forward lease agreement under which the manufacturer leases the manufactured asset from the IFI with an option or undertaking to purchase provided that the ownership remains with the IFI until the asset is sold. *Forward lease with an option or undertaking to purchase by the manufacturer*

Illustration 11: Forward Lease during *Istisna'* Period

An oil and gas company needs to build a new oil refinery factory for further expansion. The cost of the construction is valued at RM500 million. The company may ask the IFI to finance the construction. Under this arrangement, the IFI may request the company to build this refinery factory at RM500 million which is payable during the progress of the construction. This money can be used to finance the construction of the factory. Simultaneously, the company will undertake to lease the asset by paying an advance rental of RM1 million per month under a forward lease arrangement as the asset is still under construction. The company is given the option to purchase the completed asset at predetermined price or at a price to be determined later.

59. Pursuant to paragraph 58, in the case where an *Istisna'* contract is combined with a forward lease, the purchase price payable to the seller may be set-off against rental payment payable under the forward lease contract. *Payment in the form of set-off*

Illustration 12 : Forward *Jjarah* and *Istisna'* Financing

An IFI entered into a two year *Istisna'* contract to provide financing to a property developer to build a government office complex valued at RM10 million. The IFI requested the developer to build the complex under this contract and subsequently entered a forward lease agreement with the developer for a monthly rental of RM50,000 payable to the IFI for a period of two years with an option for the developer to purchase the asset at the end of the lease tenure. At the end of two years, RM1.2 million of lease payment was received by the IFI. Should the developer exercise the option to purchase the asset at a concluded price of RM11.2 million, the RM1.2 million worth of rental may be set-off against the purchase price. Hence, the amount payable to the IFI is RM10 million.

5.7 PARALLEL *ISTISNA'*

60. Any variation of contract performance due to force majeure, may be made through an agreement between the contracting parties. This may result in loss sharing, partial cancellation of contract, deferment of performance, and reduction of obligation of the affected party.

Variation of contract due to force majeure

Illustration 13 : Variation of Contract Due to Force Majeure

An *Istisna'* contract provided by an IFI to manufacture car components is secured by a fixed charge on the manufacturer's equipment. During the production period, the factory was flooded affecting the industry site. Production was delayed and the quality of production affected. The customer, the IFI and the manufacturer may settle outstanding issues affecting damages and liabilities through an agreement between the contracting parties.

61. *Istisna'* may be structured in the form of parallel *Istisna'*. *Parallel Istisna'* consists of two series of separate *Istisna'* contracts whereby the first *Istisna'* contract is between the ultimate purchaser (customer) and the seller (IFI), who is responsible to deliver the specified asset to the purchaser. The contract shall not stipulate that the seller (IFI) is to be the manufacturer. This enables the seller (IFI) to enter into a second *Istisna'* contract with a third party who will be responsible to manufacture or construct the asset and deliver it to the IFI for subsequent delivery to the ultimate purchaser (customer) in the first *Istisna'* contract.

Illustration 14 : Parallel Istisna'

A customer wants to purchase a property under construction from a developer and seeks financing from an IFI. In order to facilitate the financing to the customer, the IFI enters into an *Istisna'* contract with the customer for the sale of the property for a price of RM500,000 payable in 5 years. Subsequently, the IFI enters into another separate *Istisna'* contract with the developer of the property for a price of RM400,000 with progress payments paid to the developer during the two years construction period. Consequently, the IFI will earn RM100,000 as profit from the sale of *Istisna'* asset to the customer.

62. The IFI as the seller shall not be obliged to give discount to the customer/purchaser if the actual manufacturing costs are lower than the specified costs or when the IFI obtained a discount from the manufacturer.
- No obligation on the seller to give discount in parallel Istisna' should the seller obtained a discount from the ultimate manufacturer*

63. Pursuant to paragraph 61, each party in a parallel *Istisna'* is bound to undertake the work and the payment as the case may be. The obligation of each party shall not be dependent on the others' obligations.

Binding nature of a parallel Istisna'

64. The IFI purchase price shall be agreed between the IFI and the manufacturer, and the IFI selling price shall be agreed between the IFI and the customer.

Price in parallel Istisna'

65. If the purchaser has executed a sale and purchase agreement with the ultimate seller (developer/manufacturer), the said agreement has to be terminated prior to the execution of the *Istisna'* contract with the IFI.

66. The IFI may appoint the ultimate purchaser as an agent to supervise the manufacturing/construction process to ensure that the items produced conform to contractual specifications.

Appointment of customer/purchaser as agent

Illustration 15: Appointment of an Agent

Due to the frequent occurrence of property development failure in meeting satisfactory standards, a customer (the ultimate purchaser) insisted that he has to be appointed as an agent of the IFI to monitor and appraise the quality of the property development. In this regard, a separate contract of agency which appoints the customer to undertake quality assurance assessments may be executed to monitor the project development on behalf of the IFI.

67. The IFI may purchase the *Istisna'* assets from the manufacturer or contractor under the second *Istisna'* contract and sells the asset to the customer in the first *Istisna'* contract.

IFI as the seller in parallel Istisna'

68. In the case of project abandonment, the manufacturer is liable to compensate the damages incurred by the purchaser.

GLOSSARY

Terms	Definition
<i>'Urbun</i>	Earnest money.
Actual Delivery	A state where an asset is physically delivered to another party together with the right to control it.
Constructive Delivery	- A state where the right to control an asset is delivered to another party but not in the physical forms; or - Delivery that is inferred to have taken place from the conduct of the parties (such as when one transfers a title to another) involved in a transaction, even if the physical delivery did not take place.
Direct Cost	Costs or expenses incurred to directly enable the acquisition of goods by the IFI and delivery of the goods to the customer.
Forward Lease	Lease of specified future usufruct of an asset which is not in existence at the time of contract.
<i>Ijarah</i>	A contract between a lessor and a lessee in which the lessor being the owner of the property allows the lessee to enjoy the usufructs of the property at agreed terms on the rental and period of lease.
Indirect Cost	Costs or expenses indirectly incurred and not directly chargeable to a specific acquisition project or task.
<i>Istisna'</i> Asset	Subject matter of the <i>Istisna'</i> contract which shall be an asset to be manufactured or constructed and is able to be transformed, processed, converted or changed to meet the purchaser's specifications.
<i>Istisna'</i> Purchaser	A party known as <i>mustasni'</i> who orders for an asset to be built, constructed or manufactured in accordance with the specifications agreed in an <i>Istisna'</i> contract.
<i>Istisna'</i> Seller	A party known as <i>soni'</i> who receives orders for an asset to be built, constructed or manufactured in accordance with specifications agreed in an <i>Istisna'</i> contract. However in parallel <i>Istisna'</i> , the seller in the first <i>Istisna'</i> contract is not the ultimate manufacturer and becomes a purchaser for the second <i>Istisna'</i> contract.

<i>Kafalah</i>	A contract of guarantee in which one party guarantees the fulfillment of a claim or performance of an obligation which is due to another party in a case of default. Synonym: <i>dhaman</i> .
<i>Murabahah</i>	A contract for buying and selling assets whereby the price which includes a profit margin is agreed upon by both parties (the purchaser and seller).
<i>Rahn</i>	Pledge or collateral.
<i>Wakalah</i>	A contract where a party authorizes another party to act on behalf of the former as long as he is alive.
