



Risk Management in Islamic Finance

Risk Middle East

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Hedging Requirements of IFI's



- Islamic banks are exposed to business risk just as conventional banks
 - obligor
 - market
 - liquidity
 - currency
 - operational

- Risk generates unexpected losses and hedging restricts the impact of such losses

Hedging Requirements of IFI's



- Derivatives
 - In conventional, risk is separated from asset; and traded separately which leads to speculation
 - Islamic hedging instrument is based on real economic activity and real balance sheet items (asset or liability)

- Islamic hedging argument
 - Against – causes volatility, represents speculation, zero sum game and may involve no real economic transaction
 - For – permissible if derivatives involve the actual transaction and do not cause injustice to anyone

Hedging Requirements of IFI's



- Islam permits freedom of contracts provided it is free from Riba and Gharar
- The objective of risk management does not raise Shari'a issue, infact not to hedge a risk is similar to speculation or gambling
- Instrument used for hedging may call for debate
 - ❑ Currency Risk – currency swap
 - ❑ Profit – fixed vs floating

Hedging Requirements of IFI's



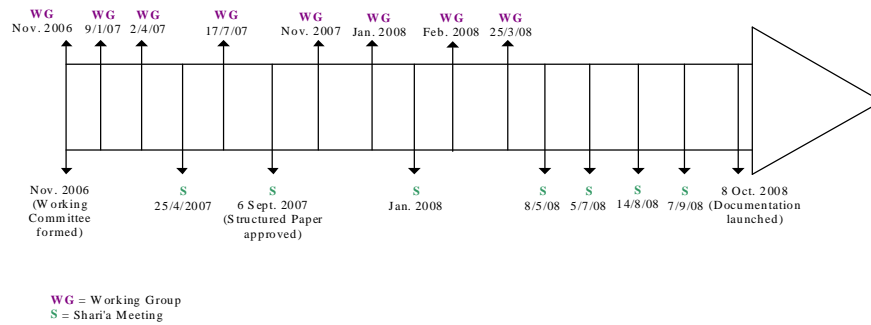
Structuring Derivatives – Themes to consider

- Risk – market vs credit
 - ❑ Early conventional derivatives focus was on market risk (price risk of underlying assets)
 - ❑ Lately conventional derivatives focus shifted to credit risk eg: CDS, CDO and Credit-linked notes (default risk)
- Legal
 - ❑ Governing jurisdiction, threshold, enforceability of contract, collateral, margin and credit support
- Documentation
 - ❑ Master agreement governing the relationship b/w two parties, credit support/collateral document and definition/product template

Standardization of Documentation in Islamic Finance



Project Time-line for IIFM Master Agreement for Treasury Placement (MATP) – first globally standardized Master Agreement in Islamic Finance



ISDA / IIFM Tahawwut (Hedging) Master Agreement



The Purpose and Value of the Agreement

- Provides the market with standardised master documentation for hedging products
- The Master Agreement is a new market document. In preparing it we have sought to
 - comply with Shari'a requirements
 - be consistent with other market standard documentation where practical

ISDA / IIFM Tahawwut (Hedging) Master Agreement



The Purpose and Value of the Agreement cont...

- It aims to facilitate netting and thus net risk management
 - ❑ recognition of the Master Agreement for regulatory capital purposes is an objective, although conditions such as jurisdictional recognition of netting will also need to be satisfied and the structure of the Agreement may need to be explained to the regulators

ISDA / IIFM Tahawwut (Hedging) Master Agreement



The Scope of the Agreement

- The Agreement is a master or framework agreement
- Sets out general terms on the basis of which the parties can enter into individual transactions
- By entering into the Master Agreement, the parties will agree, inter alia:
 - ❑ The identity and location of the parties
 - ❑ The governing law
 - ❑ Certain basic representations to be given to each other
 - ❑ The events of default and early termination events, the occurrence of which will permit early termination; and
 - ❑ In the event of early termination how early termination shall be processed and effected, the objective being to minimize the loss caused by early termination to both parties
 - ❑ Whether dispute resolution will be through the courts or arbitration

ISDA / IIFM Tahawwut (Hedging) Master Agreement



Net Risk Management

- If certain events occur, it is in the interests of the parties to early terminate the Master Agreement and the transactions entered into under it and to minimize the loss that either will suffer as a result of the early termination by netting or setting off the respective obligations of the parties to each other
- This ability to early terminate and net out on early termination
 - ❑ allows each party to limit its credit risk on the counterparty
 - ❑ helps in enabling the parties to calculate their exposure to each other on a net basis
 - ❑ is the basis on which the regulatory capital treatment can be discussed with the regulators

ISDA / IIFM Tahawwut (Hedging) Master Agreement



Key Features

- Shari'a Compliant Uses
 - ❑ In border sense the transactions entered into under the Master Agreement should only be for the purpose of hedging actual risks of the relevant party. Transaction should not be for the purpose of speculation and must be real transactions involving the actual transfer of ownership of real assets i.e. actual risk and real settlement
- Governing Law
 - ❑ The governing law will be English or New York law, though as the case with ISDA conventional document the counterparties will be able to chose the relevant law

ISDA / IIFM Tahawwut (Hedging) Master Agreement



Key Features cont...

- Netting Arrangements
 - ❑ The netting of transactions will be based on Muqasa principle and it is dependent on the product structure institutions will be using. Generally, for example in case of PRS, the product involves Murabaha and Wa'ad and will result into two sets of transactions i.e. concluded which could be Murabaha and future transactions based on promise or Wa'ad.
- Early Termination
 - ❑ The early determinations events will be fully defined in Agreement and will cover:
 - A party fails to pay or deliver when obliged to do so
 - A party fails to comply with its other obligations
 - Cross default
 - Insolvency
 - Change in taxation
 - Illegality or force majeure
 - Merger and negative impact on credit risk or rating


About IIFM



IIFM is an international development institution established and supported by the central banks/regulatory authorities of Bahrain, Brunei, Indonesia, Malaysia, Sudan, Pakistan, Dubai International Financial Centre and the Islamic Development Bank, Saudi Arabia. It is further strengthened by the involvement of a number of regional and international financial institutions as its members.


The objective of IIFM is to take part in the establishment, development and promotion of the Islamic Capital and Money Market (ICMM).

IIFM's primary focus lies in the advancement and unification of the Islamic Financial Services Industry's documentation, wider market products, processes, infrastructure and recommendations for the enhancement of ICMM globally.




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Financial Market

About IIFM



- Market driven standard setting body with regulatory heritage
- Addressing the standardization needs of the IFSI
- Providing universal platform to market participants through 'Global Working Groups' for the development of ICMM
- Shari'a harmonization in documentation, wider market products & processes

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About IIFM

IIFM Standardization Initiatives

- IIFM Master Agreements for Treasury Placement (MATP) – completed
- IIFM Tahawwut (Hedging) Master Agreement – advanced stage
- Repurchase and Collateralization prospects – under consideration
- Other initiatives

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