Launch of Master Participation Agreements by IIFM and BAFT as new standard documentation

The publication of the two long-awaited master participation agreements mentioned below by the International Islamic Financial Market ("IIFM") in collaboration with the Bankers Association for Finance and Trade ("BAFT") marks another important milestone in the development of standardised template documentation by IIFM:

(a) a template master unfunded participation agreement for trade finance transactions (the "Unfunded Participation Agreement"); and

(b) a template master funded participation agreement for trade finance transactions (the "Funded Participation Agreement").

A participation is an arrangement between two banks/financial institutions whereby: (a) the granting or originating bank/financial institution (as a grantor) offers and (b) the participating bank/financial institution (as a participant) accepts a participation in a trade finance transaction on (i) an unfunded or (ii) a funded basis of an agreed amount.

When a grantor intends to share part of its exposure under an unfunded or funded facility for trade finance transactions with a participant, the Unfunded Participation Agreement and the Funded Participation Agreement (together the "Master Participation Agreements") provide the framework for entering into one or more participation agreements between the grantor and the participant.

IIFM in collaboration with BAFT, the Shari'ah Board of IIFM and Baker McKenzie have worked together with market participants to develop the Master Participation Agreements. Together with the Master Participation Agreements, IIFM has published a structure memorandum and a guidance memorandum covering certain structural and operational aspects of the Master Participation Agreements. The structure memorandum and the guidance memorandum are intended to facilitate the adoption and use of the Master Participation Agreements by potential users.

In line with certain of IIFM's existing standard documentation, the Master Participation Agreements are framework agreements to document multiple unfunded and funded participation transactions between parties. IIFM encourages all potential users of the Master Participation Agreements to undertake their own evaluation and diligence to ensure that these template documents are appropriate for use by them in their particular
circumstances or in a particular transaction and jurisdiction and to ensure that the terms, provisions and conditions of these template documents are appropriate and protect the users' interests in all respects.

The structures involved in, and certain salient features of, both the Unfunded Participation Agreement and the Funded Participation Agreement are explained in further detail below.

1. **AGENCY (WAKALAH) BASED STRUCTURE**

   The Shari’ah principle on which the Master Participation Agreements are based is *wakalah* or agency. An agency relationship needs to be created between the grantor (as agent) and the participant (as principal) prior to entering into a participation transaction. Pursuant to an agency agreement, the participant will appoint the grantor as its agent and the grantor will accept such appointment to act as an agent of the participant in accordance with the terms of the Master Participation Agreements.

   A template agency agreement is provided as an appendix to both the Unfunded Participation Agreement and the Funded Participation Agreement. Before entering into an agency agreement, the parties should consider whether the underlying principal-agent relationship between the participant (as principal) and the grantor (as agent) would raise any local law or operational issues.

2. **PARTIES INVOLVED IN A PARTICIPATION TRANSACTION**

   Parties involved in a participation transaction are generally four and they are as follows: (a) the grantor (or the originating bank/financial institution), (b) the participant (or the participating bank/financial institution), (c) the obligor (or the customer of the grantor which may also include any guarantor and security provider) and (d) the beneficiary of the trade finance facility extended by the grantor and the participant to the obligor (or the supplier of goods/assets to the obligor). The diagram below shows how the parties are connected to each other in a participation transaction:
3. **DIFFERENCE BETWEEN A CONVENTIONAL AND AN ISLAMIC PARTICIPATION**

The table below sets out a few differences between a conventional and an Islamic participation:

<table>
<thead>
<tr>
<th>Conventional sub-participation / participation</th>
<th>Islamic participation</th>
</tr>
</thead>
<tbody>
<tr>
<td>A participant in a conventional participation transaction becomes a creditor of the grantor as the relationship between the grantor and the participant is of a debtor (the grantor) and a creditor (the participant).</td>
<td>Both participant and grantor in an Islamic participation transaction are creditors of the obligor as the grantor acts as the participant’s agent in relation to the participant's share in the participation transaction.</td>
</tr>
<tr>
<td>A participant in a conventional participation transaction takes a credit risk against both (a) the grantor and (b) the borrower. The participant’s return is conditional on the borrower complying with its payment obligations under the loan agreement and on the grantor complying with its payment obligations under the participation agreement.</td>
<td>The participant does not take the grantor’s credit risk in an Islamic participation as the grantor acts as the participant’s agent in relation to the participant's share in the participation transaction.</td>
</tr>
<tr>
<td>In a conventional participation, a participant does not benefit from security or collateral provided by the borrower to the grantor (as lender), unless otherwise agreed.</td>
<td>An Islamic participation is based on an agency relationship such that the grantor enters into the transaction documents with the obligor on its (the grantor’s) own behalf (for its own share in the participation transaction) and on behalf of the participant (as an agent for the participant’s share in the participation transaction). As such, the participant fully enjoys benefits from any security and collateral provided by the obligor to the grantor.</td>
</tr>
</tbody>
</table>

4. **PROCESS FLOW OF A PARTICIPATION TRANSACTION**

4.1 **Unfunded participation**

The Unfunded Participation Agreement contemplates the following process to be followed for entering into an unfunded participation transaction between the parties:

(a) *Unfunded Participation Agreement:* The grantor and the participant will enter into an Unfunded Participation Agreement;

(b) *Agency agreement:* The grantor and the participant will enter into an agency agreement (in a form provided as an appendix to the Unfunded Participation Agreement) pursuant to which the participant will appoint the grantor as the participant’s agent in relation to any unfunded participation by the participant in accordance with the terms of the Unfunded Participation Agreement;

(c) *Unfunded trade finance transaction:* The grantor will agree to provide a trade finance facility on an unfunded basis to the obligor;

(d) *Offer:* The grantor will offer (in a designated form provided as a schedule to the Unfunded Participation Agreement) to the participant to participate in the relevant trade finance transaction on an unfunded basis;

(e) *Acceptance:* The participant will accept (in a designated form provided as a schedule to the Unfunded Participation Agreement) the grantor’s offer to participate in the relevant trade finance transaction on an unfunded basis;
Unfunded transaction documents: The unfunded transaction documents are entered into between the obligor and the grantor (as an agent of the participant for the participant's share in the unfunded participation transaction and on its own behalf for its own share in the unfunded participation transaction);

Sharing fees and commissions: The grantor pays the participant's share of fees and commissions and any other payments upon receipt by the grantor of the same from the obligor; and

Default by the obligor and the grantor's demand for payment from the participant: If the obligor defaults, the grantor will be required to pay the agreed amount to the beneficiary and the grantor will in turn demand payment from the participant for its share in the unfunded participation transaction.

4.2 Funded participation

For a funded participation transaction, the following process is expected to be followed between the parties pursuant to the Funded Participation Agreement:

(a) Funded Participation Agreement: The grantor and the participant will enter into a Funded Participation Agreement;

(b) Agency agreement: The grantor and the participant will enter into an agency agreement (in a form provided as an appendix to the Funded Participation Agreement) pursuant to which the participant will appoint the grantor as the participant's agent in relation to any funded participation by the participant in accordance with the terms of the Funded Participation Agreement;

(c) Funded trade finance transaction: The grantor will agree to provide a trade finance facility on a funded basis to the obligor;

(d) Offer: The grantor will offer (in a designated form provided as a schedule to the Funded Participation Agreement) to the participant to participate in the relevant trade finance transaction on a funded basis;

(e) Acceptance: The participant will accept (in a designated form provided as a schedule to the Funded Participation Agreement) the grantor’s offer to participate in the relevant trade finance transaction on a funded basis;

(f) Funded transaction documents: The funded transaction documents are entered into between the obligor and the grantor (as an agent of the participant for the participant's share in the funded participation transaction and on its own behalf for its own share in the funded participation transaction) whereby the grantor will acquire title to the relevant goods/assets from the beneficiary before the grantor sells/leases the same goods/assets to the obligor;

(g) Demand for payment by the beneficiary and the grantor demands payment from the participant: Upon receiving a demand for payment from the beneficiary, the grantor demands payment from the participant for its share in the funded participation transaction; and

(h) Sharing fees, profits and principal: The grantor pays the participant's share of fees, profits and principal amount upon receipt by the grantor of the same from the obligor.

5. PERMITTED TRADE FINANCE INSTRUMENTS

5.1 Permitted trade finance instruments for unfunded participation

Trade finance instruments which are in compliance with the principles and rules of Shari'ah can be the subject-matter of a participation transaction between the grantor and the participant in accordance with the terms of the Unfunded Participation Agreement. The Unfunded Participation Agreement has included the following as permitted trade finance instruments:
(a) letters of credit issued or confirmed, drafts accepted and deferred payment or negotiation obligations incurred under letters of credit (excluding any discounting arrangement);

(b) confirmations or guarantees of letters of credit;

(c) irrevocable reimbursement undertakings, letters of indemnity, letter of guarantees or similar instruments;

(d) advance payment guarantees; and

(e) performance and bid bonds.

The above is not an exclusive list of Shari’ah compliant trade finance instruments. Any other trade finance instrument which is in conformity with the principles and rules of Shari’ah will be acceptable subject-matter for an unfunded participation transaction under the Unfunded Participation Agreement.

5.2 **Permitted trade finance techniques for funded participation**

A trade finance transaction in compliance with any type of Shari’ah compliant modes of financing (e.g., mudarabah, musharakah, ijarah, murabahah, musawamah, salam, istisna’a and wakalah) is acceptable as the subject-matter of a funded participation transaction under the Funded Participation Agreement.

5.3 **What is not covered in the Master Participation Agreements**

It is evident that only Shari’ah compliant trade finance instruments/techniques can be the subject-matter of a participation transaction between a grantor and a participant. Consequently, any trade finance instrument/technique not in compliance with the principles and rules of Shari’ah will not be acceptable participation transaction under the Master Participation Agreements. The following trade finance instruments are generally perceived not to be in conformity with the principles and rules of Shari’ah:

(a) purchases of claims under letters of credit;

(b) discounts of drafts;

(c) bankers acceptances; and

(d) all instruments dealing with discounting arrangement.

Also, any transaction which involves sale, assignment or transfer of debts is generally not Shari’ah compliant unless such sale, assignment or transfer is at par value and without any discount or premium.

6. **OTHER KEY FEATURES OF THE MASTER PARTICIPATION AGREEMENTS**

6.1 **Justifications for the participant's share in participation service fee and upfront fee**

Both the Unfunded Participation Agreement and the Funded Participation Agreement attach certain conditions for the participant's share in (i) the participation service fee in the case of an unfunded participation and (ii) the up-front fee in the case of a funded participation. In both cases, Shari’ah justification for the participant's share in the relevant fees (paid by the obligor to the grantor) is that the participant is required to render services and such services may include:

(a) examining transaction documents related to the relevant participation transaction and advising the grantor of any discrepancies in such documents provided that any services rendered by the participant shall be directly or indirectly for the benefit of the parties involved in the participation transaction including the obligor; and/or

(b) preparation or issuance of any documents, reports or feasibility studies by the participant related to or in connection with the obligor and/or the participation transaction and the parties
involved in the participation transaction (including the obligor) will be entitled to receive a copy of such documents, reports or studies upon request.

6.2 Amendment and restructuring; assignment and transfer

Both the Unfunded Participation Agreement and the Funded Participation Agreement require the compliance with the principles and rules of Shari'ah with regard to:

(a) any amendment or waiver of any term, any refinancing, any restructuring or re-organisation of the underlying transaction documents entered into between the grantor and the obligor, which are the subject-matter of a participation transaction between the grantor and the participant; and

(b) any assignment or transfer of the rights and obligations by the grantor or the participant under a participation transaction.

Additionally, both the Unfunded Participation Agreement and the Funded Participation Agreement include provisions for "no violation of Shari'ah" and "waiver of payment of interest" as general provisions applicable to all participation transactions concluded thereunder.

6.3 Governing law and jurisdiction

The governing law and choice of dispute resolution forum of the Master Participation Agreements are at the option of the parties, although both templates have been prepared on the assumption that the governing law would be English law and English courts will have jurisdiction along with arbitration at the London Court of International Arbitration or the Dubai International Islamic Centre for Reconciliation and Arbitration. Parties should satisfy themselves as to suitability before choosing the appropriate governing law and dispute resolution forum.

In the case of any conflict between (a) the law of a jurisdiction as the governing law of the Unfunded Participation Agreement or the Funded Participation Agreement and (b) the principles and rules of Shari'ah, IIFM has suggested that the principles and rules of Shari'ah shall prevail.

6.4 Footnotes

Extensive footnotes are included throughout the Unfunded Participation Agreement and the Funded Participation Agreement (including the schedules and annexes thereto) to provide guidance and explanatory information to the users. Such footnotes however do not form part of the terms of the contract between the parties. Accordingly, a clean version of the relevant template, without footnotes, will need to be created before the parties agree and finalise the relevant terms.

6.5 Shari'ah approval

The IIFM Shari'ah Board has approved the Unfunded Participation Agreement and the Funded Participation Agreement after extensive consideration. The approval by the IIFM Shari'ah Board does not however extend to any specific transactions between the parties or to any amendments or additions made to the Unfunded Participation Agreement or the Funded Participation Agreement. It is the ultimate responsibility of each party entering into the Unfunded Participation Agreement or the Funded Participation Agreement to ensure that, to the extent that Shari'ah compliance is relevant to it in connection with its dealings and corporate governance, its use of the documents satisfies its own Shari'ah advisors that the relevant transaction is Shari'ah compliant and that the documents are suitable for, and are being used appropriately in, the context of that particular transaction and the needs of that party.

_Baker McKenzie acted as legal counsel to IIFM in the preparation of the Master Participation Agreements._
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