

New product documentation for *Himaayah Min Taqallub As'aar Assarf* (Islamic Cross Currency Swaps)

Today marks a further step in the development of standardised documentation for the Islamic finance industry with the publication by the International Swaps and Derivatives Association, Inc. (ISDA) and the International Islamic Financial Market (IIFM) of template product documentation for *Himaayah Min Taqallub As'aar Assarf* (Islamic Cross Currency Swaps) designed to be used with the ISDA/IIFM *Tahawwut* Master Agreement.

The ISDA/IIFM *Tahawwut* Master Agreement ("TMA") was published in early 2010, followed by the two sets of *Mubadalatul Arbaah* templates for profit rate swaps. The publication today of the template product documentation for *Himaayah Min Taqallub As'aar Assarf* (Islamic Cross Currency Swaps) ("ICRCS") marks another milestone for ISDA and IIFM in meeting the needs identified by market participants both to access and hedge foreign currencies.

The ICRCS templates are a pair of *Wa'ad*-based (or undertaking-based) documents involving a "two sales" structure, whereby each party can exercise the other party's *Wa'ad* on a payment date, generally leading to sales and purchases of assets across both *Wa'ads* on a given payment date.

Clifford Chance acted as legal counsel to ISDA and IIFM in the

preparation of the TMA and the ICRCS templates.

Copies of the ICRCS templates (together with the TMA and the profit rate swap templates) can be obtained at www.isda.org and www.iifm.net.

1) The TMA context

It will be recalled that the TMA is a master agreement that contains the general terms and conditions agreed between the parties and under which parties may enter into "Transactions" and/or "DFT Terms Agreements" relating to "Designated Future transactions".

The TMA draws a distinction between "Transactions" that have been entered into between the parties and "Designated Future transactions" that will or may be entered into between the parties in the future. This is an important distinction which is key to the different close-out mechanisms

which apply to these two types of arrangement.

The terms of a Transaction are evidenced by a "Confirmation". The terms of a Designated Future transaction are provided for in a DFT Terms Agreement, which is evidenced by a "DFT Terms confirmation".

Key issues

- Islamic Cross Currency Swap templates
- *Wa'ad* leading to *Murabaha*: two sales structure
- Features of the templates
- *Shari'ah* issues to consider

Once a Designated Future transaction is, pursuant to a DFT Terms Agreement, entered into between the parties, it becomes a "Transaction" under the TMA and should be documented using a "Confirmation".

A failure to enter into a Designated Future transaction when required to do so in accordance with a DFT Terms Agreement is an Event of Default under the TMA.

2) Two legs of an ICRCS

The ICRCS templates comprise two **DFT Terms confirmations**, one relating to Party A's payment (and asset purchase) leg of an ICRCS; the other relating to Party B's payment (and asset purchase) leg of an ICRCS. A form of **Confirmation** is provided in Annex 2 to document the Transaction that will be entered into pursuant to the terms of each DFT Terms Agreement.

In the conventional swap market, a cross currency swap, consisting of two legs (typically, in Currency A and Currency B), will be treated as a single transaction and documented by a single confirmation. In the case of a *Wa'ad*-based ICRCS, however, instead of using a single document for both legs, there is a *Shari'ah* preference for the *Wa'ad* (or undertaking) for one leg to be clear and distinct from, and not combined with, that of the other leg. Therefore, to document the ICRCS, two separate template DFT Terms confirmations have been prepared, one for each leg.

3) Use of *Wa'ad* leading to *Murabaha Sale*

The ICRCS templates use a *Wa'ad* (or undertaking) structure, as is now increasingly common in Islamic finance transactions.

Fig 1: Exercise of *Wa'ads*

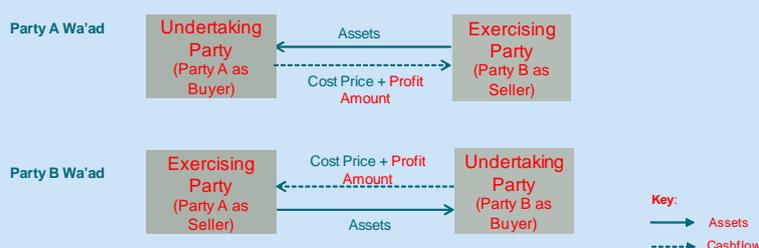
Wa'ad in each leg of ICRCS

Each DFT Terms Agreement contains a *Wa'ad* granted by one party to the other (by "**Undertaking Party**" to "**Exercising Party**"), as illustrated in Figure A below.

- In the DFT Terms Agreement for the Party A payment leg, Party A is the Undertaking Party.
- In the DFT Terms Agreement for the Party B payment leg, Party B is the Undertaking Party.

By its *Wa'ad*, the Undertaking Party undertakes to purchase *Shari'ah* compliant assets at an agreed price from the Exercising Party, if the Exercising Party exercises the *Wa'ad* by notice on an Exercise Date.

Transaction upon exercise of *Wa'ad* on a Purchase Date



A *Wa'ad* is an undertaking or promise made by one party (the Buyer of assets) to the other party (the Seller of assets) that, if required by the Seller (usually called exercise of the undertaking or *Wa'ad*), the Buyer will fulfil its promise, in this case, to enter into a *Murabaha* (or sale and purchase) contract under which it will buy from the Seller an agreed quantity of agreed *Shari'ah* compliant assets at an agreed price (or agreed formula for calculating a price) on the relevant exercise date.

The *Wa'ad* is contained in Paragraph 10 (*Buyer's Undertaking*) of each template DFT Terms confirmation.

If and when the Buyer's *Wa'ad* (or undertaking) is exercised by the Seller on an Exercise Date, the Buyer is required to purchase specified assets under a *Murabaha* contract with the Seller and execute a *Murabaha* Asset Sale Confirmation.

A *Murabaha* Sale entered into between the parties constitutes a Transaction under the TMA.

The mechanics of the *Murabaha* Sale are set out in Paragraph 11 of each template DFT Terms confirmation, with Annex 2 providing an agreed form of *Murabaha* Asset Sale Confirmation to evidence and contain the operative provisions of the *Murabaha* Sale.

A diagram of the Transactions which take place under each party's *Wa'ad* is shown in Figure 1.

4) Two Sales Structure

The ICRCS templates adopt a "two sales" structure, meaning that, for each Calculation Period in relation to the ICRCS, the two *Wa'ads* set out in the DFT Terms confirmations granted by each party will, respectively, be exercisable and exercised against the Buyer by the Seller. Therefore, **two Murabaha Sales** will be entered into between the parties; one in relation to Party A's payment leg and one in relation to Party B's payment leg. Accordingly, there will be **two asset-flows** and **two cash-flows** between the parties in relation to each Calculation Period.

A product description has been included in Part 1 of the relevant template DFT Terms confirmations describing how the Two Sales Structure should work.

The overall documentation architecture across the TMA and the ICRCS DFT Terms confirmations is illustrated in Figure 2 below.

5) Profit Types for Murabaha Sales

The ICRCS templates allow the parties to make an initial exchange of a fixed amount of one currency against a fixed amount of the second currency at the start of an ICRCS, with a further final exchange of a fixed amount of that currency against a fixed amount of the second currency at a later date (such as upon maturity or an early termination date).

The payment by one party to the other of such initial exchange amount or final exchange amount is achieved through exercise of its *Wa'ad*, where the profit element of the purchase price applicable to the *Murabaha Sale* would be equal to the initial exchange amount or the final exchange amount respectively. Therefore, the profit calculation formula for *Murabaha Sales* entered into under a *Wa'ad* would need to distinguish between the initial exchange amount or final exchange amount and the periodical payment amounts. The ICRCS templates provide for a number of "Profit Types" which can be specified in Paragraph 13 of each template DFT Terms confirmation in relation to each Purchase Date.

"Profit Type 1"

Profit Type 1 relates to the initial exchange amount and the final exchange amount payable by a party as the profit element of the purchase price of the *Murabaha Sale* taking place on the first Payment Date of the ICRCS.

"Profit Type 2 – Fixed Profit Rate"

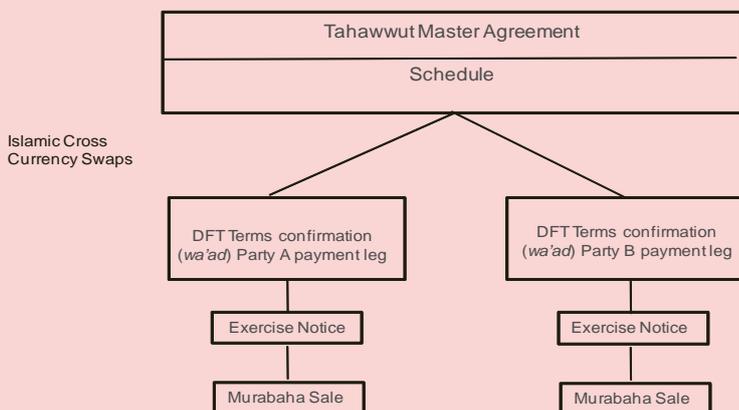
Where the periodical payments under an ICRCS are calculated on the basis of a fixed rate, Profit Type 2 – Fixed Profit Rate refers to the profit element of the purchase price of the *Murabaha Sale* taking place on the relevant specified Payment Dates.

"Profit Type 2 – Floating Profit Rate"

Where the periodical payments under an ICRCS are calculated on the basis of a benchmark rate (plus a spread), Profit Type 2 – Floating Profit Rate refers to the profit element of the purchase price of the *Murabaha Sale* taking place on the relevant specified Payment Dates.

There is also the flexibility to specify a combination of the "Profit Types" above in Paragraph 13 of a template DFT Terms confirmation in respect of a Payment Date. For example, "Profit Type 1 *plus* Profit Type 2 – Floating Profit Rate" to denote the payment of the final exchange amount on the last Payment Date of an ICRCS.

Fig. 2: Two Sales Structure



6) Other features of the DFT Terms confirmations

Transaction terms

Each template DFT Terms confirmation (at Part 3) contains line items for specific agreed terms to be completed on the Trade Date (e.g. Effective Date, Business Day, Purchase Dates, Payment Dates, Buyer, Seller, etc.), as agreed between the parties upon entry into the relevant DFT Terms Agreement.

Related confirmations/legs

The DFT Terms confirmation for one leg of an ICRCS should identify the DFT Terms confirmation for the other leg as being related to it, as a "Related DFT Terms confirmation".

Annexed pro-forma documents

A form of **Exercise Notice** is included in each DFT Terms confirmation at Annex 1. The form of Exercise Notice is intended to be extracted, completed and used by the Seller when it wishes to exercise the Buyer's *Wa'ad* (or undertaking) on an Exercise Date. This form may be used multiple times over the term of the ICRCS and is not to be completed upon entry into the DFT Terms Agreement.

A form of **Murabaha Asset Sale Confirmation** (i.e. a "Confirmation" for the purposes of the TMA) is included in Annex 2 of each DFT Terms confirmation. This form is intended to be extracted, completed and used to document entry into each *Murabaha Sale* (i.e. a "Transaction" for the purposes of the TMA). This form may also be used multiple times over the term of the ICRCS and is not to be completed upon entry into the DFT Terms Agreement.

Once completed and executed, the *Murabaha Asset Sale Confirmation* will constitute a Confirmation for the

purposes of the TMA and the *Murabaha Sale* that it confirms will constitute a Transaction under the TMA.

Footnote guidance

Extensive footnotes are included throughout the template DFT Terms confirmations to provide guidance to the parties (in particular in respect of the some important *Shari'ah* considerations) but these do not form part of the terms of the contract between the parties.

As a practical and drafting matter, a new clean version of the relevant template, without footnotes, may be created before the parties agree and finalise the relevant terms of their DFT Terms Agreement.

Shari'ah compliant assets

Only *Shari'ah* compliant assets that are suitable as the subject matter of a *Murabaha Sale* may be sold by Buyer to Seller. "**Shari'ah compliant assets**" are defined in Part 2 of the template DFT Terms confirmations as being "*any asset or assets which comply or are consistent with the principles of the Shari'ah and which, for Shari'ah purposes, are suitable as the subject matter of a Murabaha Sale*". (By way of example, gold is not generally regarded as constituting *Shari'ah* compliant assets for these purposes.)

To provide certainty of subject matter, the parties should agree and describe in detail the relevant assets in each DFT Terms confirmation relating to a leg of the ICRCS (i.e. by filling in the missing information in Part 3 of the template DFT Terms confirmation as part of the DFT Terms Agreement) and the *Murabaha Asset Sale Confirmation*. The expectation is that different types of assets will be specified in the two legs of the ICRCS.

Definitions

The ICRCS templates contain terminology that will be familiar to those with a derivatives background or knowledge of ISDA documentation. However, some new terminology has been introduced to make the document more accessible to those parties who may not have a detailed knowledge of the terminology used in the conventional derivatives market.

Agency/brokerage

The template DFT Terms confirmations anticipate that the parties may wish to appoint an agent or broker to deliver, buy, sell or receive delivery of assets on its behalf. In these cases, the views of *Shari'ah* advisers should be sought to ensure that the use of the agent/broker and the relevant agency/brokerage procedures in the context of the particular ICRCS transaction do not fall foul of restrictions such as the prohibition on *Bai Al Inah*.

Execution as a Deed

The usual practice in the Islamic finance market is that an English law governed *Wa'ad* (or undertaking) is evidenced or confirmed using a deed and, therefore, the DFT Terms confirmations provide for the Buyer to enter into a DFT Terms Agreement as a deed. The parties will need to satisfy themselves as to the correct form of execution block to be used by the Buyer to ensure that the DFT Terms Agreement is properly executed as a deed.

7) *Shari'ah* approval

While IIFM's *Shari'ah* Board has approved the ICRCs templates after extensive consideration, it is always the responsibility of each of the parties entering into the ICRCs to ensure that, to the extent that *Shari'ah* compliance is relevant to its dealings and corporate governance, its use of the documents in the context of the transactions which it enters into satisfies its own *Shari'ah* advisers that the relevant hedging transaction is *Shari'ah* compliant and that the documents are suitable for, and are being used appropriately in, the context of that particular hedging transaction.

Clifford Chance acted as legal counsel to ISDA and IIFM in the preparation of the TMA and the ICRCs templates.

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