New product documentation for Wiqayah Min Taqallub As'aar Assarf (Islamic Foreign Exchange Forwards)

Today marks the latest 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 two template product documents for Wiqayah Min Taqallub As'aar Assarf (Islamic Foreign Exchange Forwards), each 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 templates for Mubadlatul Arbaah (profit rate swaps) and Himaayah Min Taqallub As'aar Assarf (Islamic cross currency swaps). Today sees the publication of two template product documents for Wiqayah Min Taqallub As'aar Assarf (Islamic Foreign Exchange Forwards) (IFXs), thereby responding to the needs identified by market participants to facilitate access to and hedging in respect of foreign currencies.

Two versions of the IFX templates are available for use: both of which are Wa’ad-based (or undertaking-based), whereby a promissory party may exercise the other party’s Wa’ad on an exercise date, leading to the exchange of a first currency amount for a second currency amount (both of which are calculated by reference to a pre-agreed rate) on the relevant settlement date.

Copies of both IFX templates (together with the TMA, the profit rate swap templates and the Islamic cross currency swap templates) can be obtained at www.isda.org and www.iifm.net.

1) A recap on TMA DFT Terms Agreements and Transactions

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 Designated Future transaction are provided for in a DFT Terms Agreement, which is evidenced by a "DFT Terms confirmation". In the context of the IFX templates, each Wa’ad constituted in an undertaking provided by a party under the IFX terms and conditions is a DFT Terms Agreement, the signed undertaking would be the "DFT Terms confirmation". The exchange of currencies on a settlement date under the terms of such undertaking will be

Key issues

- Two different Wa’ad structures for IFX trades
- Exercise Condition under Two Wa’ad Structure
- Wa’ad leading to Sale Transaction for exchange of currencies
- Features of the template IFX terms and conditions
the "Designated Future transaction".

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". In the context of the IFX templates, the signed offer and acceptance pursuant to an undertaking would constitute 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 template documents, two structures for IFX

Two versions of the IFX templates have been published, as follows:

- one version where only one party is the buyer who grants the Wa'ad in favour of the other party (the "Single Wa'ad Structure")
- another version where each of the parties grants a Wa'ad in favour of the other party (the "Two Wa'ad Structure"), and a party's right to exercise the other party's Wa'ad is subject to an exercise condition being satisfied on the exercise date

The availability of both versions of the IFX templates is in response to Shari'ah preferences by some market participants for each party's Wa'ad to be separately documented, as well as a reflection of the existing use of single Wa'ad structures by other market participants.

3) Use of Wa'ad leading to a Transaction for the exchange of currencies

Both versions of the IFX templates are structured as terms and conditions which would be applicable to all IFX trades between two parties: each time an IFX trade is entered into, a Wa'ad (or undertaking) is granted by the buyer (in the case of a Single Wa'ad Structure) or by each party (in the case of a Two Wa'ad Structure) under which the undertaking party agrees to enter into a future transaction for the exchange of currencies at a pre-agreed exchange rate as set out in the relevant Wa'ad.

Therefore, although the parties will execute a set of IFX terms and conditions at the start of a trading relationship which involves IFX trades, a further agreement (and associated documentation) is required in order to execute an IFX trade and thereby create a DFT Terms Agreement.

4) Single Wa'ad Structure IFX

With a Single Wa'ad Structure IFX, only the buyer-party (the "Buyer") grants a Wa'ad in favour of the seller-party (the "Seller") at the outset of a trade, a form of which is set out in Annex 1 of the Single Wa'ad Structure terms and conditions.

The Buyer's Wa'ad will be exercisable and exercised by the Seller on a given exercise date through the Seller delivering to the Buyer an exercise notice together with an offer. Following the Buyer's acceptance of such offer, the parties will enter into a Sale Transaction under which the Buyer will transfer a second currency amount in the second currency in exchange for transfer of a first currency amount in the first currency by the Seller. Forms of the offer and acceptance are set out in Annex 3 of the Single Wa'ad Structure IFX terms and conditions.
The operation of the *Wa’ad* and the resulting Sale Transaction under a Single *Wa’ad* Structure IFX is illustrated in Figure 1. The overall documentation architecture across the TMA and the Single *Wa’ad* Structure DFT Terms confirmations is illustrated in Figure 2.

### 5) Two *Wa’ad* Structure IFX

With a Two *Wa’ad* Structure IFX, each party grants a *Wa’ad* in favour of the other party at the outset of a trade, forms of which are set out in Annexes 1 and 2 (respectively) of the Two *Wa’ad* Structure IFX terms and conditions. Accordingly, two unilateral and independent *Wa’ads* will be granted in respect of each IFX trade.

The exercise of a party's *Wa’ad* on a given exercise date is conditional upon the satisfaction of the exercise condition (the “Exercise Condition”) set out in the undertaking party's *Wa’ad*. As only one party's *Wa’ad* may be exercisable on an exercise date, the Exercise Conditions in a pair of *Wa’ads* relating to an IFX trade are mutually exclusive. The Exercise Condition in:

- Party A's *Wa’ad* is that the Spot Rate is less than or equal to the Forward Rate
- Party B's *Wa’ad* is that the Forward Rate is greater than the Spot Rate

The Spot Rate is determined by the Calculation Agent (who will usually be one of either Party A or Party B) and is expressed as an amount of the second currency per one unit of the first currency as of the exercise date. The Forward Rate is set out in each party’s undertaking, expressed as an amount of the second currency per one unit of the first currency.

As the Spot Rate and the Forward Rate in a party's *Wa’ad* are always expressed as an amount of the Second Currency per one unit of the First Currency, the Exercise Condition is always different across both *Wa’ads* in a Two *Wa’ad* Structure IFX trade.

Accordingly, even though there are two *Wa’ads* per IFX trade, only one *Wa’ad* will be exercisable and there will only be one Sale Transaction under each pair of *Wa’ads*.

Upon satisfaction of the Exercise Condition in a party's *Wa’ad*, that party's (the Buyer's) *Wa’ad* will be exercisable and exercised by the other party (the Seller) on a given exercise date by the Seller delivering to the Buyer an exercise notice together with an offer. Following the Buyer's acceptance of such offer, the parties will enter into a Sale Transaction under which the Buyer will transfer a second currency amount in the second currency to the Seller in exchange for the transfer of a first currency amount in the first currency by the Seller. Forms of the offer and acceptance are set out in Annex 4 of the two *Wa’ad* Structure IFX terms and conditions.

The operation of the *Wa’ad* and resulting Sale Transaction under a Two *Wa’ad* Structure IFX is illustrated in Figure 3. The overall documentation structure across the TMA and the Two *Wa’ad* Structure DFT Terms confirmations is illustrated in Figure 4.
Figure 3: Two Wa’ad Structure – Wa’ad and Sale Transaction

By its Wa’ad, the Undertaking Party (a Buyer) undertakes to purchase the First Currency Amount in the First Currency for an agreed Second Currency Amount in the Second Currency on the settlement date from the Exercising Party (a Seller) IF the Exercise Condition under its Wa’ad is satisfied on an exercise date and the Exercising Party exercises that Wa’ad by notice on an exercise date.

**Exercise Date**

- If the Exercise Condition in Party A’s Wa’ad is met (which means it will not be met in Party B’s Wa’ad), Party A’s Wa’ad is exercisable by Party B:

**Sale Transaction after exercise of Wa’ad on a settlement date**

- Under Party A’s Wa’ad:

- Under Party B’s Wa’ad:

*Note: the First Currency and the Second Currency under each party’s Wa’ad are the reverse of each other across the pair of Wa’ads which comprise an IFX trade under the Two Wa’ad Structure.*

Figure 4: Two Wa’ad Structure – documentation architecture

- Master Terms
- Tahawwut Master Agreement
- IFX Terms and Conditions
- Undertaking by Party A
- Undertaking by Party B
- Exercise Notice
- Sale Transaction
6) Other features of the IFX templates

Definitions

In line with the other TMA product templates published to date, the IFX 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 hedging market, as well as those which are specific to the Wa’ad structure of the IFX product.

Footnote guidance

Also in line with the other TMA product templates published to date, extensive footnotes are included throughout the IFX templates 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 IFX terms and conditions as well as the terms of their DFT Terms Agreements.

Transaction terms

The forms of IFX trade specific undertakings (i.e. a “DFT Terms confirmation” for the purposes of the TMA) set out in Annex 1 of the Single Wa’ad Structure IFX terms and conditions and Annexes 1 and 2 of the Two Wa’ad Structure IFX terms and conditions contains line items for specific terms to be completed on the Trade Date (e.g. Exercise Date, Settlement Date, First Currency Amount, Second Currency Amount, Business Day, etc.), as agreed between the parties upon entry into the relevant DFT Terms Agreement for an IFX trade. The form of undertaking is intended to be extracted, completed and used by the parties when they wish to enter into an IFX trade and a form of undertaking may be used multiple times for multiple IFX trades after a set of IFX terms and conditions is executed between the parties.

As mentioned earlier in the context of the Exercise Conditions under the Two Wa’ad Structure, the Second Currency Amount and the Second Currency in a party’s undertaking is always the currency which the Undertaking Party needs to pay.

Related confirmations – Two Wa’ad Structure

The DFT Terms confirmation for one Wa’ad of an IFX trade under the Two Wa’ad Structure should identify the DFT Terms confirmation for the other leg as being related to it, as a “Related Party [A]/[B] Undertaking”.

Other annexed pro-forma documents

A form of Exercise Notice is included in the IFX templates and is set out at Annex 2 of the Single Wa’ad Structure IFX terms and conditions and Annex 3 of the Two Wa’ad Structure IFX terms and conditions. The form of Exercise Notice is intended to be extracted, completed and used by the Exercising Party (the Seller) when it wishes to exercise the Undertaking Party’s (the Buyer’s) Wa’ad (or undertaking) on an Exercise Date. This form is not to be completed upon entry into the DFT Terms Agreement at the outset of an IFX trade.

A form of Offer and Acceptance (i.e. a “Confirmation” for the purposes of the TMA) is included in the IFX templates and is set out at Annex 3 of the Single Wa’ad Structure IFX terms and conditions and Annex 4 of the Two Wa’ad Structure IFX terms and conditions. This form is intended to be extracted, completed and used to document entry into each Sale Transaction (i.e. a “Transaction” for the purposes of the TMA) after the exercise date. This form may also be used multiple times after a set of IFX terms and conditions is executed between the parties and is not to be completed upon entry into the DFT Terms Agreement.

Once completed and executed, the Offer and Acceptance will constitute a Confirmation for the purposes of the TMA and the Sale Transaction that it confirms will constitute a Transaction under the TMA.

Gharrar

To provide certainty of subject matter (the principle of gharrar under Shari’ah), the parties should agree and describe in detail the relevant Sale Transaction contemplated in each DFT Terms confirmation to an IFX trade at the outset of that IFX trade (i.e. by filling in the missing information – in particular the First Currency Amount, the Second Currency Amount and, for Two Wa’ad Structures, the Spot Rate and the Forward Rate – in the form of undertaking(s) of the template DFT Terms confirmation as part of the DFT Terms Agreement) and, prior to entry into a Sale Transaction, the Offer and Acceptance.
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 Undertaking Party 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 Undertaking Party 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 IFX templates after extensive consideration, it is always the responsibility of each of the parties entering into the IFX terms and conditions and each IFX trade 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 transaction is Shari‘ah compliant
- that the documents are suitable for, and are being used appropriately in, the context of this particular hedging transaction.

Contacts

Habib Motani
Partner
T: +44 20 7006 1718
E: habib.motani@cliffordchance.com

Qudeer Latif
Partner
T: +971 4 503 2675
E: qudeer.latif@cliffordchance.com

Tim Plews
Partner
T: +966 11 481 9770
E: tim.plews@cliffordchance.com

Cheuk Yin Cheung
Senior Associate
T: +971 4 503 2722
E: cheukyin.cheung@cliffordchance.com
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