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Tahawwut Master Agreement & Product Schedules Standardization

ISLAMIC PROFIT RATE SWAP, CROSS CURRENCY & FX SWAPS STRUCTURES

Meeting with IIFM Shari'ah Advisory panel & Banks on 8th November 2010 @10 AM - Central Bank of Bahrain

Manama
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1. INTRODUCTION

Islamic banking and finance is still in dynamic mode. The availability of Islamic hedging products is imperative for the industry to compete with its conventional counterparts and more importantly to hedge risks arising from exposures such as currency, rate of return mismatches etc.

In the case of Islamic hedging, there have been encouraging developments by industry players in introducing different product structures with different mechanisms, resulting in global perspective for the Islamic Financial industry. For example, after more than three years of concerted efforts and resources put in by the market participants, IIFM Board of Directors, TMA Execution Team and most importantly the honorable scholars on IIFM Shari'ah Advisory Panel, IIFM has set On 1st March 2010, a new milestone by jointly publishing the ISDA/IIFM Tahawwut Master Agreement (TMA). This Agreement is an essential building block which will lead the way in further development of the Islamic hedging segment, which is necessary to mitigate risk commonly found in Islamic financial transactions.

The Tahawwut Master Agreement is a framework document that provides a globally standardized early termination and closeout mechanism and other legal & Shari'ah provisions for privately negotiated and widely accepted Islamic hedging products. The Agreement is designed to facilitate the risk management function of Islamic financial institutions including providing a legal framework which in due course will enable the industry to address regulatory capital requirements.

Since launch, the TMA has been accessed by approximately 300 financial institutions. A number of banks have informed IIFM that they are going through their internal approval process involving credit, operations and shariah, bilateral negotiations which will lead to transactions under TMA.

2. MARKET FEEDBACK ON TMA, RECOMMENDATION AND PROPOSED STRUCTURES

Islamic Financial Institutions who wish to document Shari'ah compliant hedging transactions may do so by entering into the Tahawwut Master Agreement, which contains general and specific terms and conditions that govern the most widely used and accepted Islamic hedging transactions, together with further shorter documentation for each transaction in the form of a confirmation, each confirmation being entered into at the time the commercial terms of such transaction are agreed.

Based on industry requirements for mitigating risk and with a view to wide Islamic market acceptance, the following products are considered essential and required by Islamic financial institutions as well as institutions offering Islamic services:

(1) Islamic Profit Rate Swap and

(2) Cross Currency or FX Swap.

Based on market feedback on the TMA, the recommendation by the banks is to consider standardization of the above mentioned essential hedging or risk mitigation products. In order to achieve this noble goal, the guidance of the honorable scholars is imperative. IIFM is fully aware that it is compulsory to meet the core Shari'ah requirements for its global projects and initiatives by adopting best practices in this respect as set out in its Shari'ah Charter. Therefore, swaps products must be exclusively for hedging purposes. They may only be used for hedging activity aimed to protect an asset from adverse change, such as an unexpected and undesirable change in the value of an asset. This recognises that Islamic swaps cannot be used for speculative activity to generate a profit, as is sometimes the case in conventional finance. In connection with these matters, the role of the IIFM Shari'ah Advisory Panel is very relevant.

The IIFM Shari'ah Advisory Panel is entrusted with the duty of advising, directing, reviewing and supervising the IIFM initiatives and projects, in order to ensure all aspects of its projects are in accordance and compliance with Shari'ah principles. Moreover, it also responsible for providing Shari'ah expertise and guidance on all IIFM projects at the earliest stages of developing it to its launch, particularly in regard to documentation and structuring to ensure compliance with the general Shari'ah principles. The following are proposed structures:

3. ISLAMIC PROFIT RATE SWAP (IPRS)

3.1 Definition

An Islamic Profit Rate Swap is an agreement to exchange profit rates between a Fixed Rate Party and a Floating Rate Party and is implemented through the execution of a series of underlying contracts to trade certain assets in accordance with Shari'ah principles.

3.2 Objective of IPRS

The Islamic Profit Rate Swap seeks to achieve Shari'ah compliance through using Murabaha transactions: the parties enter into Murabaha contracts to sell Shari'ah compliant assets for immediate delivery but usually on deferred payment terms. Two aspects should be noted in Islamic Profit Rate Swap transactions*:*

3.2.1 Murabaha are used either to generate the fixed payments (comprising a cost price and a fixed profit element) and separately to generate the floating payments (comprising a cost price and a floating profit element) or payment date one Murabaha may be entered into so as to generate the cost price and the difference between the fixed profit element and the floating profit element.

3.2.2 An Islamic profit rate swap may also be structured through the use of Wa'ads (unilateral promises) whereby each party undertakes to enter into Murabaha transactions and thereby to "swap" relevant fixed and floating rate payments at some particular point of time in the future or each party undertakes to enter into Murabaha transactions where (if the party is the fixed rate payer) the profit it pays is the amount by which the fixed rate exceeds the floating rate, or (where the party is the floating rate payer) the profit it pays is the amount by which the floating rate exceeds the fixed rate.

4. EXAMPLES OF ISLAMIC PROFIT RATE SWAP STRUCTURES

4.1 Base Information:

- Party A – Fixed Profit Payer at a rate of 2%
- Party B – Floating Profit Payer at a rate of LIBOR +1%
- 5 Year IPRS
- Annual Payments
- USD
- Spot Delivery Settlement is two days after the day the trade is entered into (trade date)

4.2 Murabaha based structure #1

(As practiced in the market based on Spot Sale & Differed Payment)

4.2.1 On the Trade Date (which is Effective Date minus 2 Days)

(a) A agrees to purchase Shari'ah compliant commodity from B for spot delivery and deferred purchase price payment. The purchase price is cost price plus 2%. On the Effective Date the commodity is sourced by B from a broker and delivered spot to A. A will pay the purchase price on the first anniversary of the Effective Date. A sells the commodity on the Effective Date to another broker and realises the cost price.

(b) B agrees to purchase a different Shari'ah compliant commodity from A for spot delivery and deferred purchase price payment. The purchase price is cost price + (LIBOR +1%). LIBOR is determined on the Trade Date before the purchase is agreed. The commodity is sourced by A from a broker and delivered spot on the Effective Date to B. B will pay the deferred purchase price on the first anniversary of the Effective Date. B sells the commodity on the Effective Date to another broker and realises the cost price.

(c) A agrees with B that A will enter into similar Murabaha purchases (where the purchase price will be cost price plus 2%) with B on each of the first, second, third and fourth anniversary of the Trade Date.

(d) B agrees with A that B will enter into similar Murabaha purchases (where the purchase price will be cost price plus (LIBOR + 1%)) on each of the first, second, third and fourth anniversary of the Trade date.

(e) The agreements between A and B to enter into Murabaha in the future are DFT Terms Agreements. The Murabaha between A and B under which one agrees to purchase commodity from the other are Transactions.

4.2.2 On the first anniversary of the Trade Date:

(a) A agrees with B to purchase Shari'ah compliant commodity from B at a purchase price equal to cost price +2% with spot delivery of the commodity on the first anniversary of the Effective Date (i.e. 2 days after) and payment of the purchase price is deferred to the second anniversary of the Effective Date.

(b) B agrees with A to purchase Shari'ah compliant commodity from A at a purchase price equal to cost price + LIBOR + 1% (LIBOR here being LIBOR as of the day which is the first anniversary of the Trade Date) with spot delivery of the commodity on the first anniversary of the Effective Date (i.e. 2 days later) and payment of the purchase price is deferred to the second anniversary of the Effective Date.

4.2.3 On the first anniversary of the Effective Date

(a) A pays B the deferred purchase price of the Fixed Rate IPRS Murabaha entered into on the Trade Date (Cost price + 2%))

(b) B pays A the deferred purchase price of the Floating Rate IPRS Murabaha entered into on the Trade Date (Cost price + LIBOR + 1%)

(c) The parties may agree to set off the payment due in (a) against the payment due in (b), so that only the net balance is paid

4.2.4 This procedure in 4.2.2 and 4.2.3 is repeated at the end of years 2, 3 and 4. At the end of year 5, only the deferred purchase prices for the Murabaha entered into on the 4^{th} anniversary of the Trade Date are paid. No new Murabaha are entered into.

4.3 Murahaba based structure – #2

(As practiced in the market based on spot delivery & spot payment)

4.3.1 On the Trade Date (Effective Date minus 2 days)

(a) A agrees with B that on each of the first, second, third, fourth and fifth anniversary of the Trade Date, A will enter into a Murabaha with B under which A will purchase a commodity from B for spot delivery against spot payment of the purchase price. In each case the purchase price will be cost price + 2%.

(b) B agrees with A that on each of the first, second, third, fourth and fifth anniversary of the Trade Date, B will enter into a Murabaha with A under which B will purchase a commodity from A for spot delivery against spot payment of the purchase price, the purchase price being the cost price plus LIBOR plus 1%, with LIBOR being in the case of the first Murabaha, the LIBOR rate on the Trade Date and in the case of the second, third, fourth and fifth Murabaha, the LIBOR rate on the relevant anniversary of the Trade Date.

(c) On the first anniversary of the Trade Date A enters into a Murabaha with B under which A purchases commodity from B deliverable spot two days later by B on the first anniversary of the Effective Date and for which the purchase price (cost price + 2%) will be payable spot on the same date.

(d) On the first anniversary of the Trade Date, B enters into a Murabaha with A under which B purchases commodity from A deliverable spot two days later by A on the first anniversary of the Effective Date and for which the purchase price (cost price + LIBOR + 1%) will be payable spot on the same date.

(e) On the first anniversary of the Effective Date, B sources the commodity from its broker and delivers it to A and A pays the purchase price of cost price plus 2%.

(f) On the first anniversary of the Effective Date, A sources the commodity from its broker and delivers it to B and B pays the purchase price of cost price + LIBOR + 1%.

(g) The parties may agree to set off the payment due in (e) against the payment due in (f), so that only the net balance is paid.

4.4 Islamic Profit Rate Swaps may also be structured using a combination of Wa'ad (which will take the form of purchase undertakings (or promises to purchase)) and Murabaha agreements.

The Wa'ad, which are in the form of two parallel purchase undertakings, can be structured in such a way to allow for "two sales" where both purchase undertakings are exercised or a "single sale" where only one purchase undertaking is exercised.

The basic structure of each transaction is as follows:

4.4.1 Two Sales

(a) On the Trade Date, two purchase undertakings (Wa'ad) are granted: one by Party A to Party B and one by Party B to Party A.

In that granted by Party A, Party A (as promisor) undertakes in favour of Party B (as promisee) to enter into a Murabaha agreement on each of a series of specified future exercise dates (each an "**Exercise Date**" and each of which is an anniversary of the Trade Date) to buy a quantity of a Shari'ah compliant asset from Party B for a purchase price of cost price + 2% (the fixed leg), if the promisee exercises such undertaking.

In the Wa'ad granted by Party B, Party B (as promisor) undertakes in favour of Party A (as promisee) to enter into a Murabaha agreement on each of the same series of Exercise Dates to buy a quantity of a different Shariah compliant asset for a purchase price which in each case will be calculated by reference to LIBOR on the relevant Exercise

Date ie. cost price + LIBOR + 1% (the floating leg), if the promisee exercises such undertaking.

Each purchase undertaking will be exercisable by the promisee on each of the Exercise Dates.

4.4.2 On an Exercise Date:

(a) each promisee will exercise the purchase undertaking given to it for which that is the specified Exercise Date; (the exercise of the purchase undertaking in this two sale structure is not subject to any conditions - in other words the promisee simply has to decide to exercise the promisor's undertaking);

(b) the promisee may exercise the purchase undertaking by sending a notice to the promisor (the "**Exercise Notice**") which will crystallise the obligation of the promisor to purchase the specified asset at the specified price on the specified anniversary of the Effective Date (the "**Settlement Date**") i.e. it will crystallise the promisor's obligation to enter into a Murabaha; and

(c) two Murabaha agreements will be entered into and the assets deliverable under each Murabaha will be delivered and the purchase prices will be payable on the Settlement Date; and

(d) the purchase price under each Murabaha will be Cost plus Profit.

4.4.3 On the Settlement Date, under each Murabaha agreement, the promisor shall pay to the promisee the Purchase Price for the relevant asset and the promisee shall deliver the assets.

The purchase undertakings are DFT Terms Agreements for the purposes of the Master Agreement, that is, each is an agreement which sets out the terms of a future transaction (a Designated Future transaction) to be entered into by the parties or which will be required to be entered into if the relevant purchase undertaking is exercised.

A purchase undertaking is not a Transaction for the purposes of the Master Agreement. The Murabaha that will be entered into upon exercise of a purchase undertaking will be a Transaction for the purposes of the Master Agreement.

Use of this structure results in there being a cash flow and an asset flow under each of the two Murabaha agreements. Each party's cost of acquiring the asset it delivers is covered by the Cost element of the Purchase Price payment which it secures from the other party. Each party purchasing an asset is in practice expected to cover the Cost element in the price it has paid by immediately on-selling the asset it received and thereby realising the amount of the Cost. The overall net result should therefore be that the fixed rate paying party receives (through the Profit element paid to it), the floating rate amount, and the floating rate paying party receives (through the Profit element paid to it), the fixed rate.

4.5 Single Sale

As an alternative, in order to reduce the administration and cost associated with two cash flows and two asset flows between the parties, they may wish to modify and simplify the above structure as follows:

4.5.1 On day one, two purchase undertakings (Wa'ad) are granted: one by each of Party A and Party B and under each of which Party A or, as the case may be, Party B undertakes to purchase a Shariah compliant asset from the other if certain conditions (set out in paragraph 4.5.2(c) below) are satisfied and the other party exercises the purchase undertaking. It is the inclusion of these conditions which distinguishes the "single sale" structure from the "two sales" structure (in the two sales structure there are no such conditions which must be satisfied in order for the undertaking to be exercisable).

4.5.2

(a) As with the two sale structure, each purchase undertaking will be exercisable on a series of Exercise Dates by way of an exercise notice specifying the Purchase Price and the Settlement Date. The Exercise Dates under Party A's purchase undertaking will match those under Party B's purchase undertaking;

(b) on an Exercise Date, the parties will determine whether the fixed profit amount for the relevant calculation period is greater than or less than the floating profit amount for that calculation period;

(c) the condition of exercise of the fixed profit amount payer's purchase undertaking on an Exercise Date will provide that such purchase undertaking will only be exercisable if the fixed profit amount is greater than the floating profit amount. The condition of exercise of the floating profit amount payer's purchase undertaking on an Exercise Date will provide that such purchase undertaking will only be exercisable if the floating profit amount is greater than the fixed profit amount. As a result, on any Exercise Date, only one purchase undertaking will be exercisable;

(d) the purchase price payable in respect of the Murabaha arising upon exercise of the relevant purchase undertaking will be Cost plus Profit, where Profit equals the amount by which the fixed rate amount (of the fixed leg) for the calculation period exceeds the floating rate amount (of the floating rate leg) for the same period or, as the case may be, the floating rate amount exceeds the fixed rate amount; and

(e) only one Murabaha agreement will be entered into and the assets deliverable and the purchase price payable under it will be deliverable/payable on the Settlement Date.

The single sale structure therefore achieves an outcome where there is only one asset flow and one cash flow, and the Profit element comprised in the cash flow is the net amount which is the difference between the fixed rate amount and the floating rate amount payable on the relevant settlement date.

5. ISLAMIC CROSS CURRENCY OR FX SWAPS

5.1 Definition

Islamic Cross Currency or FX Swap is a contract that is designed as a hedging mechanism to minimize market participants' exposure to market currency exchange rate which is volatile and fluctuating. Its structure must not contravene with the principles of Shari'ah. In other words, the main objective of this product is to protect the investor from currency rate fluctuation risks.

5.2 Objective

The objective of engaging in an Islamic Cross Currency or FX Swap is to enable a counterparty to obtain funds in one currency for a certain period of time (e.g. funds in a currency less readily available to it by other means) against funds in another currency that is readily available. Profit rate, tenor and amount are all agreed-upon between the two parties before commencement of the transaction.

5.3 Islamic Cross Currency & FX Swap - Structure 1

The Islamic Cross Currency and FX Swap structure involves two simultaneous Murabaha transactions linked with a unilateral Wa'ad committed separately by each counterparty. The parties to the swap agree to sell Shariah-compliant assets to each other for immediate delivery but on deferred-payment terms in different currencies. The working of the Islamic Cross Currency or FX Swap is briefly described below:

Step 1

- 2 days prior to the transaction day, Party A and Party B, enter into a Murabaha under which Party A agrees to purchase commodities on a spot delivery basis with the purchase price (in currency 1) being payable on a deferred basis. The terms of the Murabaha including the tenor, the profit rate, etc. are agreed.
- Party B delivers the commodity on the transaction date.
- Party A sells the commodities and retains the sale cash amount in currency 1.
- Party A pays Party B, the deferred purchase price equal to cost price plus profit, in currency 1, on the deferred payment date.

Step 2 – Simultaneous to Step 1

- 2 days prior to the transaction day, Party A and Party B enter into a Murabaha under which Party B agrees to purchase commodities on a spot delivery basis with the purchase price (in currency 2) being payable on a deferred basis. The terms of the Murabaha including the tenor, the profit rate, etc. are agreed.
- Party A delivers the commodities on the transaction date.

- Party B then sells these commodities and retains the sale cash amount in currency 2.
- Party B pays Party A the deferred purchase price equal to the cost price plus profit, in currency 2, on the deferred payment date.

The above two are linked with a Wa'ad that obligates each counterparty to enter into a series of pre-defined (in terms of amount, tenor and profit rate) Murabaha transactions. With reference to the example below, each counterparty promises to invest for another period (e.g. 3 or 6 months) until the final maturity of the intended Murabaha transactions (i.e. 2 years in this case). The most important justification for having a series of transactions rather than one deal for the whole period is to prevent counterparties from being exposed to profit rate risk and changing market conditions. In addition to the foreign exchange risk that any single counterparty can be exposed to. (e.g. having to wait 6 months before conducting a new transaction where the foreign exchange rate may have adversely changed.

The profit rate can be fixed (a fixed rate for the tenor of the Murabaha) or a floating rate (a rate fixed 2 days prior to the deal based on LIBOR) for either leg of the transaction.

Example:

Assuming Party B needs Euro to fulfill an investment requirement for a certain period of time and does not want to actually buy the euro due to foreign exchange fluctuations. It can enter into a cross currency swap with Party A to fulfill its needs in exchange of another currency, say US dollars, equivalent to the required Euro amount at the spot exchange rate.

In order to enter into a cross currency swap, there will be 2 simultaneous Murabaha's between Party B and Party A, which will be adjoined by the Wa'ad.

Assumptions:

Currency Required by Party B:	EUR
Currency in exchange:	USD
Tenor:	2 years
Reinvestment in the Murabaha:	Every 6 months
Profit to be paid:	Every 6 months
Amount:	Amount will be equivalent in both currencies at the exchange rate at the beginning of the overall Murabaha.
EUR/USD Spot Rate:	1.35

Scenario 1: Both rates are fixed

Party B's Murabaha:

Currency:	USD
Fixed rate:	4%
Nominal:	USD 10,000,000

Party A's Murabaha:

Currency:	EUR
Fixed rate:	4.5%
Nominal:	EUR 7,407,407

	S1	S2	S3	S4
USD fixing (fixed)	4.0%	4.0%	4.0%	4.0%
Party B Profit paid	$ 200,000	$ 200,000	$ 200,000	$ 200,000
EUR fixing (fixed)	4.5%	4.5%	4.5%	4.5%
Party A Profit paid	€ 166,667	€ 166,667	€ 166,667	€ 166,667

On the Start Date:

- Party B will invest $10,000,000 with Party A
- Party A will invest € 7,407,407 with Party B

In the Interim (at maturity periods - every 6 months):

- Party B will pay € 166,667 as profit to Party A (payment in Euro)
- Party A will pay $200,000 as profit to Party B (payment in USD)
- The profit rate remains the same for the coming period.
- Principal is re-invested for another period without being exchanged (i.e. only profit for the previous period is exchanged in the respective currencies).
- Period is defined as a "Murabaha Transaction". (i.e. S1, S2, S3 & S4) are all stand-alone Murabaha transactions being re-invested for another period.

On End Date:

- Party B will receive $ 10,000,000 (principal) + $ 200,000 (profit on the final Murabaha) from Party A
- Party A will receive € 7,407,407 (principal) + € 166,667 (profit on the final Murabaha) from Party B.

Scenario 2: One rate is fixed while the other is floating

Party B's Murabaha:

Currency:	USD
Floating rate:	LIBOR 6M (as follows)
Nominal:	USD 10,000,000

Party A's Murabaha:

Currency:	EUR
Fixed rate:	4.5%
Nominal:	EUR 7,407,407

	S1	**S2**	**S3**	**S4**
Libor 6M fixing	4.75%	4.90%	5.10%	5%
Party B Profit paid	$ 237,500	$ 245,000	$ 255,000	$ 250,000
EUR fixing (fixed)	4.5%	4.5%	4.5%	4.5%
Party A Profit paid	€ 166,667	€ 166,667	€ 166,667	€ 166,667

On the Start Date:

- Party B will invest $10,000,000 with Party A
- Party A will invest € 7,407,407 with Party B

In the Interim (at maturity periods - every 6 months):

- Party B will pay € 166,667 as profit to Party A (payment in Euro)
- Party A will pay the LIBOR 6M (spot rate at the reinvestment time) equivalent in USD as profit to Party B (payment in USD)
- The profit rate (for the floating leg) is then fixed for the coming period.
- The profit rate (for the fixed leg) remains the same for the coming period.
- Principal is re-invested for another period without being exchanged (i.e. only profit for the previous period is exchanged in the respective currencies).
- Period is defined as a "Murabaha Transaction". (i.e. S1, S2, S3 & S4) are all stand-alone Murabaha transactions being re-invested for another period.

On End Date:

- Party B will receive $ 10,000,000 (principal) + $ 250,000 (profit on the final Murabaha) from Party A

- Party A will receive € 7,407,407 (principal) + € 166,667 (profit on the final Murabaha) from Party B

Islamic Cross Currency & FX Swap - Structure 2

An alternative structure is also based on *Wa`ad* but involves exchange of currencies (*bay` al-sarf*) at the beginning, and promise or undertaking (*wa'ad*) to carry out another *bay` al-sarf* at the future date based on the rate determined today. At the expiry date, the second *bay` al-sarf* will be implemented to get back the original currency.

Example

An investor has USD14.5 million. He wants to invest in the currency Euro (€) but does not want to be exposed to fluctuation in the currency market. He can sell this USD to the bank on spot basis to obtain €. This complies to bay` *al-sarf* principles which requires transaction to be on spot. Thereafter the investor will enter into *wa'ad* or undertakes to enter into a contract of currency exchange based on the principle of *bay` al-sarf* at a future time. The future exchange of currencies will be based on an exchange rate that is referred to today's rate. So at the future time, the investor will get back the USD without being exposed to the risks of currency fluctuation. The following diagram gives an illustration of the mechanism:

Islamic FX Swap based on *wa`ad*