INTERNATIONAL ISLAMIC FINANCIAL MARKET ("IIFM")

&

BANKERS ASSOCIATION FOR FINANCE AND TRADE ("BAFT")

MASTER UNFUNDED & FUNDED PARTICIPATION AGREEMENTS
FOR TRADE FINANCE TRANSACTIONS

OPERATIONAL GUIDANCE MEMORANDUM

مذكرة إرشادية تشغيلية

Disclaimer

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All perfect praises are due to Allah Almighty, the Lord of all that exist. We praise and thank Him for His help and guidance. May peace and blessings of Allah Almighty be upon the Prophet Muhammad the son of ‘Abdullah, his family and his companions.
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1. PURPOSE AND STRUCTURE OF THESE GUIDELINES

The purpose of these guidelines (the "Guidelines") is to highlight and document the key operational aspects of the proposed form of Shari'ah compliant standardised master unfunded & funded participation agreements for trade finance transaction (the “IIFM-BAFT Participation Agreements”) jointly developed by IIFM and BAFT for use by financial institutions for participating in Islamic financial services industry. These Guidelines are not intended to be exhaustive and attempt to provide clarification on key operational and Shari'ah aspects of the IIFM-BAFT Participation Agreements. In many cases, the analysis will help to identify the key issues that may need further consideration by parties to an IIFM-BAFT Participation Agreement.

The defined terms used and the references made in these Guidelines are to be read in conjunction with the definitions and the detailed clauses contained in the IIFM-BAFT Participation Agreements.

Further analysis and interpretation will be needed in order for a user of an IIFM-BAFT Participation Agreement to consider the potential impact of these Guidelines in light of such user's own circumstances, the legal and regulatory environment under which the user is operating and the particular facts of individual transactions. The information contained in these Guidelines is based on initial observations developed by the IIFM in coordination with IIFM BAFT joint global working group. These observations may change in the future but IIFM has no obligations to update any such observation as be changed.

2. DEFINITION AND TYPES OF PARTICIPATION AGREEMENTS

2.1 What is a risk participation?

Risk participation, in the context of finance transactions, refers to when a financial institution sub-contracts all or part of its risk, deriving from its entry into certain transaction documentation with one or more obligors, to another financial institution. The parties generally execute a participation agreement pursuant to which the financial institution offering the risk participation in its capacity as grantor sells certain of its exposure under the transaction documentation to another financial institution which is accepting such risk participation in its capacity as participant.

2.2 What are the types of participation agreements?

Participation in general terms are agreements for trade finance transactions and could be one of the following forms: (i) Unfunded participation, and (ii) Funded participation.

(a) **Unfunded participation:** In the case an unfunded participation, the participant does not provide funds to the grantor. However, the parties agree that the participant will reimburse the grantor amounts corresponding to the participant's pro rata share in the participated transaction if the obligor(s) default under the transaction documentation or in case of the obligor’s insolvency and failure to fulfil payment obligations at maturity. In return of the participant's participation, the grantor pays a fee to the participant.

   In normal course of business, the risk sharing will be limited to transactions such as LC confirmation, letter of guarantee etc.

(b) **Funded participation.** In a funded participation arrangement, the parties agree that the participant will fund the grantor so it can fulfil its obligations under a drawdown request. In return, the grantor pays a fee to the participant and passes the participant's share of the capital and profit when these are received by the grantor from the
obligor(s). The participant through its participation takes credit risk of the obligor(s). The participant's return is subject to the obligor(s) complying with its payment obligations under the transaction documentation and on the grantor complying with its payment obligations under the participation agreement.

2.3 Nature of the IIFM-BAFT Participation Agreements

(a) The IIFM–BAFT Participation Agreements are Shari’ah compliant agreements designed to use in trade finance transactions by both Islamic and conventional banks.

(b) The IIFM–BAFT Participation Agreements are master agreements in nature and provide mechanism to include general and specific terms and conditions to be entered into between Grantor and Participant.

(c) The IIFM–BAFT Participation Agreements are not transaction or product specific documents. However, transaction specific terms and conditions in a funded or unfunded transaction will be set out in offer and acceptance which are required to be exchanged between Grantor and Participant to make a participation transaction Shari’ah compliant.

2.4 What is the relationship between the IIFM–BAFT Participation Agreements and transaction documentation entered into between Grantor and Obligor?

Transaction documentation is not part of the IIFM–BAFT Participation Agreements, however Grantor may require to send transaction documentation agreed with Obligor to Participant if Participant so requests.

2.5 Features of the IIFM-BAFT Participation Agreements

The IIFM-BAFT Participation Agreements aim to provide the following to financial institutions in a Shari’ah compliant manner:

(a) Solution to the problem of lack of credit line;

(b) Improvement of risk coverage capacity and optimization of asset portfolio; and

(c) Assistance in expanding business within local and international network of banks and financial institutions.
2.6 Process flow

(a) Unfunded Participation Structural Diagram

Note: In case of Obligor default:

Payment is due to Beneficiary on due date pursuant to unfunded participated transaction

(2) Grantor agrees to provide unfunded trade finance transaction (LC or LG or alike) to Obligor in support of Obligor's obligation to Beneficiary.

(5) Grantor and Obligor enter into transaction documentation to set out the terms of the unfunded trade finance transaction.

(1) Grantor and Participant enter into a Master Unfunded Participation Agreement.

(3) Grantor offers Participant to participate in an unfunded participated transaction on agency (Wakalah) basis in respect of Obligor's trade finance transaction.

(4) Participant accepts Grantor's offer and appoints Grantor as Participant's non-paid or paid agent in relation to its participation in unfunded participated transaction.

(6) Grantor pays fees and commission to Participant upon receipt by Grantor of the same from Obligor.
3.1 **General Shari’ah ruling on trade finance for unfunded & funded transactions**

(a) In principle, risk participation agreements must not create any *Shari’ah* repugnant obligation on any party, such as entitlement of penalty interest in case of default. While it is permissible to subscribe to an Islamic insurance coverage as security for debt obligations, it is contrary to the principles and rules of *Shari’ah* that debts are insured on a conventional insurance basis.

(b) Unfunded transaction. As per the *Shari’ah* principles it is allowed for two or more parties to jointly guarantee any *Shari’ah* compliant obligation through a *Shari’ah* compliant mechanism. Therefore, it is permissible for an Islamic bank to share part of its risk exposure under an LC or LG etc., with Islamic or conventional banks, taking into consideration the following:

The above structure diagrams provide an illustrative flow of both master unfunded & funded participation for trade finance transactions as envisaged in the IIFM-BAFT Participation Agreements. These should not be considered complete and conclusive on its own and should be read and interpreted in conjunction with the IIFM-BAFT Participation Agreements.
(i) Risk participation agreement must not create any Shari’ah repugnant obligation on any party, such as entitlement of penalty interest in case of delay by the client in funding any claim under LG or LC; and

(ii) Since an LC or LG is to be issued only in the name of the Grantor, the Grantor shall sign an agency agreement with other participating banks whereby the other banks will appoint the Grantor as their collective agent to issue the LC or LG in its name under the facility. In this case, an LC or LG shall be issued by the Grantor on its own behalf for its own share in the relevant LC or LG and on behalf of the other participating banks as an agent for their respective share in such LC or LG.

(c) Funded transaction. Funded trade finance transaction is generally financed through a Murabahah structure whereby an Islamic bank, based on a facility request and promise to purchase from a customer, purchases the relevant goods from a supplier and subsequently sells the same to the customer with a sale price which comprises of procurement cost plus pre-agreed profit.

So, the standard Shari’ah practice for financing the goods through Murabahah is that the bank first purchases the goods directly from a supplier; which fact is evidenced by the commercial invoice issued by the supplier in the name of the bank and then sells the same to the customer by way of Murabahah.

As per the Shari’ah principles it is allowed for two or more parties to participate in any Shari’ah compliant obligation through a Shari’ah compliant mechanism. Therefore, it is permissible for an Islamic bank to share part of its risk exposure under a funded risk participation arrangement with one or more Islamic or conventional banks taking into consideration the following:

(i) It is not allowed for an Islamic bank to sell its obligation under this arrangement to any bank, Islamic or conventional, after such obligation has been established. This means that risk participation agreement must be signed between a Grantor and the participating banks prior to the entry into the transaction documentation between the Grantor and the customer;

(ii) It is not allowed for an Islamic bank to purchase or sell goods which are prohibited in Shari’ah, such as alcohol etc.; and

(iii) It is not allowed for an Islamic bank to sell to any party the goods which apparently will be used in producing goods which are prohibited in Shari’ah or in facilitating Shari’ah repugnant activity in whatsoever form. However, it is allowed for an Islamic bank to sell Shari’ah compliant goods to a party who, directly or indirectly, is involved in Shari’ah repugnant business, as long as the goods being sold to such party have no connection to that Shari’ah repugnant activity.
3.2 **Kafalah general rulings**

As per the AAOIFI *Shari’ah* Standard No. 5 (*Guarantees*):

(a) It is not permissible to combine agency and personal guarantees in one contract at the same time (i.e. the same party acting in the capacity of an agent on one hand and acting as a guarantor on the other hand), because such a combination conflicts with the nature of these contracts. In addition, a guarantee given by a party acting as an agent in respect of an investment turns the transaction into an interest-based loan, since the capital of the investment is guaranteed in addition to the proceeds of the investment, (i.e. as though the investment agent had taken a loan and repaid it with an additional sum which is tantamount to *riba*). But if a guarantee is not stipulated in the agency contract and the agent voluntarily provides a guarantee to his clients independently of the agency contract, the agent becomes a guarantor in a different capacity from that of agent. In this case, such an agent will remain liable as guarantor even if he is discharged from acting as agent.

(b) Personal guarantees are divided into two types. One type is a guarantee where the guarantor has a right of recourse to the debtor, and this guarantee is offered at the request or with the consent of the debtor. The other type is a non-recourse guarantee, which is offered voluntarily by a third party without the debtor’s request or consent (voluntary guarantee).

(c) An institution is not entitled to guarantee financial commitments without a right of recourse to the debtor, i.e. to be a non-recourse guarantor, unless the institution is already authorized by its shareholders and investors to make donations or to perform acts of benevolence.

(d) It is permissible to fix the duration of a personal guarantee. It is also permissible to set a ceiling on the amount to be guaranteed and it is permissible that such a guarantee be made contingent upon a future event, for example, by fixing a future date at which liability will commence and, in this case, the guarantor may validly withdraw the guarantee, by notifying the creditor, before the prospective obligation to be guaranteed arises.

(e) The creditor is entitled to claim the amount of his debt from either the debtor or the guarantor and he has the choice of claiming his right from either of them. However, the guarantor is entitled to arrange the order of liability, for example, by stipulating (at the conclusion of the contract of guarantee) that the creditor shall first claim payment from the principal debtor and that the creditor is entitled to recourse to the guarantor for payment only if the principal debtor refuses to fulfil his obligation.

(f) A valid guarantee may be given for debts, the exact amount of which is unknown. Similarly, a valid guarantee may be given for a debt that will arise in the future. However, it is permissible for the guarantor to withdraw such a guarantee before a future debt is actually created, after notifying the person having interest in the guarantee.

(g) It is permissible for a personal guarantee contract to be designated in a separate contract. It can also be concluded together with, or before, or after, the conclusion of the contract of a credit transaction.

(h) It is not permissible to take any remuneration whatsoever for providing a personal guarantee per se, or to pay commission for obtaining such a guarantee. The guarantor is, however, entitled to claim any expenses actually incurred during the period of a
personal guarantee, and the institution is not obliged to inquire as to how the guarantee produced has been obtained by the customer.

(i) There is no objection in Shari’ah to include a number of guarantees in one contract, such as incorporating a personal guarantee together with a pledge of security in the same contract.

3.3 Playing role of kafil (guarantor)

The participant can play the role of a third-party guarantor (kafil) to the debtor (Obligor). As per the AAOIFI Shari’ah Standard No. 5 (Guarantees):

Personal guarantees are divided into two types. One type is a guarantee where the guarantor has a right of recourse to the debtor, and this guarantee is offered at the request or with the consent of the debtor. The other type is a non-recourse guarantee, which is offered voluntarily by a third party without the debtor’s request or consent (voluntary guarantee).

To avoid turning a transaction into an interest-based loan, it is not permissible to combine agency and personal guarantees in one contract at the same time (i.e. the same party acting in the capacity of an agent on one hand and acting as a guarantor on the other hand).

It is not permissible to combine agency and personal guarantees in one contract at the same time (i.e. the same party acting in the capacity of an agent on one hand and acting as a guarantor on the other hand), because such a combination conflicts with the nature of these contracts. In addition, a guarantee given by a party acting as an agent in respect of an investment turns the transaction into an interest-based loan, since the capital of the investment is guaranteed in addition to the proceeds of the investment, (i.e. as though the investment agent had taken a loan and repaid it with an additional sum which is tantamount to riba).

But if a guarantee is not stipulated in the agency contract and the agent voluntarily provides a guarantee to his clients independently of the agency contract, the agent becomes a guarantor in a different capacity from that of agent. In this case, such an agent will remain liable as guarantor even if he is discharged from acting as agent.

3.4 Agency arrangement

In relation to an unfunded and funded participation, a Participant will appoint the Grantor as its Wakil (agent) and the Grantor will accept such appointment to act as a Wakil (agent) of the Participant in accordance with the terms of the relevant participation agreement.

In case of an unfunded participation, the agency agreement must be signed before issuance of any LC or LG to allow risk participation in a Shari’ah compliant manner. This will also facilitate sharing the administrative fee, if any, the customer shall pay to the Grantor in a Shari’ah compliant manner with the Participant.

In case of a funded participation, the agency agreement must be signed between the Grantor and the Participant before the Grantor enters into the transaction with Obligor in order to allow risk participation in a Shari’ah compliant manner. This will also facilitate sharing the administrative fee, if any, the Obligor shall pay to the Grantor in a Shari’ah compliant manner with the Participant.

A form of agency agreement is appended to each of the IIFM-BAFT Participation Agreements (for Shari’ah reasoning, the form of agency agreement is not part of the IIFM-BAFT Participation Agreements but only for the information/reference purpose). Before entering into an agency agreement, the parties should consider whether the underlying
principal-agent relationship between the Grantor (as agent) and the Participant (as principal) would raise any local law issues.

3.5 **Unfunded transactions:**

(a) **Issuance of documentary credit**

As per the AAOIFI *Shari’ah* Standard No. 14 (*Documentary Credit*):

Documentary credit is defined as follows: A Documentary credit is a written undertaking by a bank (known as the issuer) given to the seller (the beneficiary) as per the buyer’s (applicant’s or orderer’s) instruction or is issued by the bank for its own use, undertaking to pay up to a specified amount (in cash or through acceptance or discounting of a bill of exchange), within a certain period of time, on condition that the seller present documents for the goods conforming to the instructions (it is an undertaking by a bank to pay subject to conformity of the documents to the contractual instructions).

(b) **Use of cheques or promissory notes:**

There is no *Shari’ah* objection to obtaining cheques or promissory notes from the debtor (unless not allowed by law) as a means to force the debtor to make timely payment of instalments in cash, whereby if the debtor pays on time such cheques or promissory notes shall be returned to him, and in the event of default on payment they may be produced for recovery. The party providing these cheques or promissory notes as security is entitled to obtain an undertaking from the institution that they will be used only for timely recovery of its due debts without any addition.

(c) **Insurance coverage:**

It is permissible to subscribe to an Islamic insurance coverage as security for debt obligations and it is not permissible that debts are insured on a conventional insurance basis.

(d) **Shari’ah ruling on documentary credit:**

Dealing in documentary credit includes agency for providing procedural services, the most important of which is the examination of documents, and the provision of institutional guarantee to the importer. As both agency and guarantee contracts are permissible, documentary credit becomes permissible subject to the conditions stipulated in the AAOIFI *Shari’ah* Standard No. 14 (*Documentary Credit*).

(e) **Opening of all types of documentary credit:**

Its issuance and confirmation, on the basis of the client’s order or for the institution itself, are permitted to an institution.

(f) **Should not involve *riba* bearing profits:**

The issuance of a credit facility should not involve *riba* bearing profits or become a means for such profits. All transactions and procedures must be in accordance with the provisions and principles of *Shari’ah*.

(g) **Guarantees in documentary credits:**

(i) It is permissible for the institution to secure the obligations arising out of documentary credit, or to provide documentary credit as security for payment
in favour of institutions and banks dealing with it. The institution may act as an intermediary for facilitating documentary credit using other permissible and acceptable forms of guarantee. It is, therefore permissible to use a number of means as a cover for documentary credit including cash, freezing of permissible accounts and negotiable instruments valid according to the Shari’ah, certificates of shares in real estate and withholding the documents of the credit that stand for the goods.

(ii) The cover of a documentary credit may be also one of the following: a transferable letter of credit; a back-to-back letter of credit; a letter of guarantee issued by the bank of the beneficiary against the advance payment in case of advanced payment credits; a letter of guarantee issued by a bank participating in the issuance or confirmation of the credit; relinquishment receivables and commercial papers, such as bill of exchange and promissory notes.

(iii) It is not permissible for an Islamic financial institution to accept the following types of guarantees: interest-based bonds, shares of companies that deal in prohibited activities, and interest-based receivables. It is also not permissible for a Shari’ah compliant institution to provide any of these guarantees as security for its obligation to other institutions or banks or to act as an intermediary to facilitate such guarantees.

(iv) It is permissible for an Islamic financial institution and the applicant for documentary credit to agree on investing the cash cover of the credit in accordance with Mudaraba partnership.

(h) Remuneration for issuing a letter of guarantee:

(i) Letters of guarantee: As per the AAOIFI Shari’ah Standard No. 5 (Guarantees), it is not permissible to take remuneration for issuing a letter of guarantee, whether with cover or without cover, if the remuneration is intended as consideration for the guarantee per se, since the amount guaranteed and the duration of the guarantee are usually taken into consideration in computing remuneration.

(ii) Bearing administrative expenses by an applicant: Asking an applicant for a letter of guarantee to bear administrative expenses incurred in issuing a letter of guarantee of either type (i.e. preliminary or final) is permissible in Shari’ah, provided the remuneration for such expenses does not exceed the commission that others would charge for such services. Where full or partial cover is provided, it is permissible, in estimating the expenses for issuing a letter of guarantee, to take into account anything that will reflect the actual service to be rendered in providing a cover for the transaction.

(iii) It is not permitted for the institution to issue a letter of guarantee in favour of an applicant who will use it to acquire an interest-based loan or to conclude a prohibited transaction.

(i) Default under the Unfunded Participated Transaction

As per the clause 5 (Default under the Participated Transaction) of the IIFM-BAFT Participation Agreements.

In case of default by the Obligor in relation to an unfunded transaction, the following should be applicable:
(A) If a Grantor (a bank) issues a guarantee to a beneficiary at the request of a Obligor (customer), either in the form of a letter of guarantee or a letter of credit, and if such guarantee is called by the beneficiary in accordance with the terms set out therein, then it shall be mandatory on the Grantor to pay the guarantee amount covered by the respective guarantee to the beneficiary.

(B) Generally, guarantees issued by the Grantor at the request of the Obligor (customer) provide the Obligor with the ability to have a right of recourse against Obligor in the event of such guarantee being called by the beneficiary. Such a right of recourse creates a debt relationship between the Grantor and the Obligor, whereby the Obligor is considered to be under a debt obligation for the guarantee amount to the Grantor. From a Shari’ah perspective it is not allowed for a Grantor to charge an Obligor any extra amount for allowing additional time to pay the guarantee amount. Such prohibition is because the extra amount is in the nature of interest, which is strictly prohibited in Shari’ah.

(C) As per the Shari’ah, a Grantor (a bank) cannot convert an unfunded facility such as a guarantee into a funded facility, since the same is tantamount to extending an interest-bearing loan, it is however possible to structure a Shari’ah compliant solution between the Grantor who is acting on behalf of the Participants, and the Obligor whereby the Grantor can provide the Obligor (customer) with a separate Shari’ah compliant contingent financing facility such as Murabahah, Salam etc, with which the Obligor will be able to generate cash proceeds and will be able to settle its liability under guarantee. The liability created on the Obligor under such a facility shall be standalone and shall be paid by the Obligor as per an agreed payment plan.

3.6 Funded transactions:

In a funded transaction, the Grantor may from time to time desire to offer and the Participant may desire to accept and adopt funded participations in relation to any trade finance transactions which are to be entered into between the Grantor and the Obligor in compliance with the principles of Shari’ah including on the basis of any one or more of the following modes of Islamic finance:

(a) **Murabahah**: Sale contract with a disclosure of the asset cost price and profit margin to the buyer (cost plus profit sale).

(b) **Musharakah**: Profit and loss sharing contract. It is an investment partnership in which all partners are entitled to a share in the profits of a project in a mutually agreed ratio. Losses are shared in proportion to the amount invested.

(c) **Salam**: Advance purchase. Sale contract based on order of certain asset with certain specifications. Full payment is made in cash at the time of conclusion of the contract, whereas the delivery of the asset is deferred to a specified time.

(d) **Musawamah**: Bargain on price. Sale contract without the disclosure of the asset cost price and profit margin to the buyer.
(e) **Ijarah**: Lease or service contract that involves benefit/usufruct of certain asset or work for an agreed payment within an agreed period. *Ijarah muntahia bi al-Tamlik*: Lease contract which ends with acquisition of ownership of the asset by the lessee.

(f) **Mudarabah**: A partnership in profit whereby one party provides capital (*rab al-maal*) and the other party provides labour (*mudarib*).

(g) **Istisna’a**: Advance purchase of goods or buildings. It is a sale contract by way of order for a certain product with certain specifications and certain mode of delivery and payment (either in cash or deferred).

(h) **Wakalah (agency)**: A contract of agency in which one party appoints another party to perform a certain task on its behalf. *Wakalah bi al-istithmar* is agency contract for investment.

(i) Any other type of *Shari’ah* compliant trade financing obligation acceptable in *Shari’ah*.

All transactions shall be executed after the signing of an offer and an acceptance between the Grantor and the Participant.

### 3.7 Murabahah and Musharakah transactions in trade for import and export

(a) **Murabahah transactions in trade finance**

Purchasing of imported goods through *Murabahah* financing shall be done pursuant to the following conditions:

(i) Opening of the documentary credit facility should not precede the conclusion of the sale contract between the Grantor (the orderer) and the Beneficiary (the seller) irrespective of the orderer (the Grantor) having taken possession of the goods that are the subject-matter of the contract; and

(ii) The finance provider (the Grantor) should be the party who purchases from the supplier, and then sells to the Obligor (the customer) through *Murabahah* as per the *Murabahah Shari’ah* rulings.

In other words, the standard *Shari’ah* practice for financing the goods through *Murabahah* is that the bank first purchases the goods directly from a supplier; which fact is evidenced by the commercial invoice issued by the supplier in the name of the bank, and then sells the same to the customer by way of *Murabahah*.

(b) **Musharakah contract to finance goods**

Signing a *Musharakah* (partnership contract) between the Grantor and the Obligor to finance goods and to purchase goods prior to the opening of credit and before the Obligor concludes a sale contract with the supplier, can be done by taking the following into consideration:

(i) Possibility of opening the credit in the name of either *Musharakah* partner.

(ii) Possibility for the Grantor, after receipt of the goods, to sell its share to a third party or to its partner (the Obligor) through a spot or deferred payment *Murabahah* on the condition that the sale to the partner is not based on an earlier exchange of binding promised or stipulated in the *Musharakah* contract.
(iii) Possibility for the Grantor to sign a *Musharakah* contract with the Obligor (the customer) in respect of goods purchased by the Obligor on the condition that the institution does not sell its share to the Obligor on a deferred payment basis.

3.8 **Fees and Commission (Profit, Rental Payment Fees and Recoveries)**

Clause 6.1 (*Payment of Commission and Fees*) of the IIFM-BAFT master unfunded participation agreement & Clause 6.1 (*Payment of Profit or Rental or Fees*) of the IIFM-BAFT master funded participation agreement:

(a) The fees payable to the Participant shall be solely for the direct services provided by the Participant including, but not limited to, an assessment of the Transaction, assessment of the Obligors and verification of documentation, or for indirect services. All fees will be commensurate to real operative market rates with any fees not deemed *Shari’ah* compliant (as determined by the *Shari’ah* board of the Participant) not being payable to the Participant.

All references to "rental payment" in the IIFM-BAFT master funded participation agreement are relevant to the extent the underlying trade finance transaction is a funded Ijarah transaction.

(b) All commissions and fees payable by the Grantor to the Participant will be generated from the Participated Transaction.

As per the AAOIFI *Shari’ah* Standard No. 14 (*Documentary Credit*): Commissions and expenses in documentary credit:

(a) It is permissible for the institution to charge actual expenses incurred in issuing documentary credit. It is also permissible for the institution to charge a fee for providing the required services, whether such a fee is in the form of a lump sum or a certain percentage of the credit amount, provided that the duration of the credit is not considered in determining the commission. This rule applies to services rendered for both import and export credit, except where the amendment involves a rescheduling for the institution to charge only the actual expenses incurred, in which case it will be a definite sum and not a percentage.

(b) The aspect of guarantee per se must not be taken into account when estimating fees for documentary credit. Accordingly, it is not permissible for an institution to charge an amount in addition to the actual expenses incurred if it endorses a credit facility issued by another bank, because endorsing a credit facility is an addition over guarantee. The rule for endorsement applies to participation in the issuance and endorsement of credit as well as issuance of standby credit (guarantee credit), as long as services or obligations are not required.

(c) The issuance of a credit facility should not involve *riba* (interest) bearing profits or become a means for such profits.

(d) It is not permissible to use a combination of contracts in documentary credit as an excuse for involvement in the prohibited transactions, such as taking a commission for providing a guarantee or extending a loan.

(e) The ruling of commission for providing letters of guarantee that was stated in the AAOIFI *Shari’ah* standard No. (5) on Guarantees must be applied when determining commissions for the letters of guarantee that accompany documentary credits, such as letters of guarantee provided in the case of advance payment of a portion of the amount or the shipping guarantee that is issued for releasing the goods before the
arrival of documents. The Parties to agree on a case-by-case basis as to which rules should govern commission payments.

3.9 Termination of the Agreements under clause 19 (Termination) of the IIFM-BAFT master unfunded and funded participation agreements.

(a) Each party may terminate an unfunded or funded participation agreement by giving a written notice for an agreed period to the other Party. Notwithstanding any such termination: (i) an unfunded or funded participation agreement shall continue to govern before termination and (b) such termination will be without prejudice to any rights or obligations accrued prior to the date such termination takes effect.

(b) The parties may negotiate, upon termination of an unfunded or funded participation agreement, whether any rebate of profit or rental payment relating to the relevant participation agreement shall be applicable in relation to the payment of profit or rental payment to the Participant under such participation agreement, provided always that any rebate shall be at the sole discretion of the Participant subject to any applicable regulations.

As per the AAOIFI Shari‘ah Standard No. 23 (Agency and the Act of an Uncommissioned Agent (Fuduli)), paragraph 4/3 "Binding agency" states that "Agency is, basically, not binding, because each of the two parties has the right to revoke the contract without denying its effects that may continue after revocation. However, agency becomes binding under paragraph 4/3/2 when agency is a paid agency." Therefore, in the case of a paid agency arrangement between the Participant (as principal (Muwakkil)) and the Grantor (as agent (Wakil)), the parties may not terminate a participation agreement entered into hereunder without mutual consent or agreement of both Parties.

3.10 The relationship between the Grantor and the Participant under an unfunded or funded participation agreement

The relationship between the Grantor and the Participant is that of a principal (Muwakkil) and an agent (Wakil) with the right of the Participant (as principal (Muwakkil) to receive amounts from the Grantor (as agent (Wakil)) restricted to the relevant participation percentage of any amount received and applied by the Grantor from any Obligor and the Participants' rights against the Grantor under the relevant participation agreement.

3.11 Miscellaneous and other related matters

(a) Sharing part of risk under LCs and LGs under the unfunded transactions

Can an Islamic financial institution share part of its risk under LCs and LGs with other Islamic financial institution as well as conventional banks?

It is allowed in Shari‘ah for two or more parties to jointly guarantee any Shari‘ah compliant obligation through a Shari‘ah compliant mechanism.

Therefore, it is permissible for an Islamic bank to share part of its risk exposure under LC or LG with conventional or Islamic financial institution, taking into consideration the following:

(i) If the LC or LG is to be issued only in the name of Islamic financial institution, the Islamic financial institution shall sign a Wakalah (agency) agreement with other participating banks whereby the other banks will appoint the Islamic financial institution as their collective Wakil (agent) to issue the LC or LG in its name under the facility. In this case, the LC or LG shall be issued by the
Islamic financial institution on its own behalf for its own share in the LC or LG and on behalf of the other participating banks as a *Wakil* (agent) for their respective share in the LC or LG.

(ii) The aforementioned *Wakalah* (agency) agreement must be signed before issuance of any LC or LG to allow risk participation in a *Shari’ah* compliant manner. This will also facilitate sharing the administrative fee the client shall pay to the Islamic financial institution in a *Shari’ah* compliant manner.

(iii) Risk participation agreement must not create any *Shari’ah* repugnant obligation on any party, such as entitlement of penalty interest in case of delay by the client in funding any claim under LG or LC.

(iv) The above guidance only applies to the risk participation of an Islamic transaction where conventional banks can have risk participation. It is not allowed for an Islamic financial institution to share the risk under LC or LG to be issued by a conventional bank since these may not comply with *Shari’ah* terms and conditions.

(b) **Converting Non-funded facility into a funded facility**

**Scenario**

Conventional banks are able to meet the requirement of clients to convert their non-funded facility into a funded facility by entering into the relevant arrangements at the relevant point of time. For example:

(i) A client has obtained LG or LC from a conventional bank favoring a subject beneficiary.

(ii) If the relevant guarantee has been called by the subject beneficiary and if the client does not have the necessary funds to provide the same to the conventional bank to meet the call under the guarantee, the client can request the conventional bank to convert the subject guarantee amount, being an unfunded facility, into an interest-bearing funded loan facility.

(iii) As a result, the conventional bank pays to the subject beneficiary from its own fund and books the interest-bearing loan under the client’s account.

(c) Can the Islamic institutions provide the above to their clients in a *Shari’ah* compliant manner?

If an Islamic financial institution issues a guarantee to a beneficiary at the request of a client, either in the form of LG (i.e. letter of guarantee) or LC (i.e. letter of credit), and if such guarantee is called by the beneficiary in accordance with the terms set out therein, then it shall be mandatory on the Islamic financial institution to pay the guarantee amount covered by the respective guarantee to the beneficiary.

In general, guarantees issued by an Islamic financial institution at the request of the client provide the Islamic financial institution with the ability to have a right of recourse against such client in the event of such guarantee being called by the beneficiary. Such a right of recourse creates a debt relationship between the Islamic financial institution and its client, whereby the client is considered to be under a debt obligation for the guarantee amount to the Islamic financial institution.
From a Shari’ah perspective it is not allowed for an Islamic financial institution to charge its client any extra amount for allowing additional time to pay the guarantee amount. Such prohibition is because the extra amount is in the nature of interest, which is strictly prohibited in Shari’ah.

Therefore, Islamic financial institutions must take all Shari’ah compliant measures to ensure that the client shall be able to meet its obligation under the guarantee on time and the Islamic financial institution is not exposed to any situation of default on account of the client.

In this situation, an Islamic financial institution, as a condition for extending the unfunded facility, like a guarantee, may impose an obligation on the client to maintain in its account with the Islamic financial institution funds equal to the guarantee amount in its account as collateral.

Or, the Islamic financial institution may also agree with the client that in the event that the guarantee is called then the client shall be obliged to arrange for the funds equal to the guarantee amount and credit its account immediately, and in case of any delay then the client shall be liable to pay a delay penalty, which amount upon realization shall be donated to charity under the supervision of the Shari’ah Board of the Islamic financial institution.

Although an Islamic financial institution cannot convert a non-funded facility such as a guarantee into a funded facility, since the same is tantamount to extending an interest-bearing loan, it is however possible to structure a Shari’ah compliant solution whereby the Islamic financial institution can provide the client with a separate Shari’ah compliant contingent financing facility, with which the customer will be able to generate cash proceeds and will be able to settle its liability under guarantee. The liability created on the client under such a facility shall be standalone and shall be paid by the client as per an agreed payment plan. For example, an Islamic financial institution may purchase certain commodities from the customer by way of Salam, whereby the delivery of the described commodity will be deferred and the purchase price of Salam sale will be paid by the Islamic financial institution to the client up front, which the client will be able to utilize to settle its liability under guarantee. Also a sale of commodity through Murabahah can be a solution as well in this situation.

(d) LC with a usance period of 90 days

Scenario

An Islamic bank issued a letter of credit (LC) with a usance period of 90 days, with financing through a Murabahah facility for another 90 days.

Upon receiving the shipping documents, the bank signed the Murabahah agreement with the customer and delivered the goods to the customer by endorsing the shipping documents in favour of the customer.

The customer being a trader, after getting title and possession of the subject goods, sold the same to other buyers. Now, as the payment date to the supplier is close by, the customer has requested the bank to terminate the Murabahah facility and to make payment to the supplier from funds that will be provided by the customer.
Shari’ah standpoint in this regard as follows:

In terms of procedure, it is very easy for conventional banks to terminate the loan relationship if the bank has not paid the loan amount to the supplier, for the simple reason that the conventional bank has no role in the sale or purchase of the goods.

However, in case of trade finance operated by an Islamic bank, a Murabahah contract, being a sale contract, may be terminated with the mutual consent of both parties (i.e. the buyer and the seller) provided that the goods which are the subject matter of the Murabahah sale are intact and have not been consumed.

Since the goods in the above case have been sold to other parties, it is not possible to terminate the sale contract. Therefore, a Shari’ah solution must be sought without termination of the sale contract.

In the aforementioned situation, there exist two obligations: one is the obligation of the Islamic bank to pay the purchase price to the supplier upon maturity date of the usance LC. On the other hand, there is an obligation of the customer to pay the Murabahah sale price to the Islamic bank under the Murabahah agreement and as per the agreed schedule of payment. Therefore, the Islamic bank will agree with the client on an early settlement of the Murabahah sale price, whereby the bank will waive a part of the Murabahah sale price based upon its own discretion. Such waiver may be equal to the profit element which is one component of the Murabahah sale price.

The Islamic bank will receive from the client a reduced Murabahah sale price, and on the other hand it shall make payment to the supplier to fulfil its obligation of the purchase price payment, which is due and payable by the bank to the supplier.

3.12 Purpose

What is the purpose of entering into the IIFM-BAFT Participation Agreements?

The IIFM-BAFT Participation Agreements aim to provide the following to financial institutions in a Shari’ah compliant manner:

(a) Solution to the problem of lack of credit line;
(b) Reduction of risk assets, improvement of risk coverage capacity and optimization of asset portfolio; and
(c) Assistance in expanding business within local and international network of banks and financial institutions.

3.13 Key elements

What are the important elements that must be taken into account in the IIFM-BAFT Participation Agreements?

The basic elements of participation agreements include the form, the subject matter of participation and the parties to the contract (i.e. Grantor and Participant). The form of participation comprises any act that is a customary practice traditionally considered as an invitation by a Grantor to a Participant to participate in trade finance transactions. Such participation comprises of an offer and acceptance.
The subject matter of trade finance is the underlying transaction for which a trade finance participation agreement is entered into.

The key elements reflected in the IIFM - BAFT Participation Agreements includes:

- Rights and obligations of both parties
- Nature of the underlying transactions which can be subject to a participation agreement
- Mechanism for the exchange of offer and acceptance
- Clauses dealing participation and funding and default
- Sharing of commission, fees and recoveries
- Charging and dealing with late payment amount
- Tax and payments related issues
- Fraud Risk
- Information
- Mechanism of a binding amendment and financing restructuring / reorganizing;
- Parties’ confidentiality undertaking;
- Mechanism of any assignment and transfer by the parties;
- Representations and warranties from the parties;
- How the parties will communicate with each other;
- Termination clause;
- indemnities by each party;
- Relationship between the Grantor and the Participant;
- How the parties will deal with the issue of set-off and counterclaim;
- Parties' confirmation of no waiver of rights;
- Shari’ah compliant and not to violate any principles of Shari’ah; and
- Parties’ irrevocable and unconditional waiver and rejection of any entitlement to recover interest from each other.

3.14 Need for the standard documentation

Why IIFM, based on the market consultation, decided jointly with BAFT to develop standard documentation on unfunded & funded participation agreements for trade finance transactions?

IIFM focuses on addressing the documentation standardization and harmonization of practices needs of the industry in the areas of Capital & Money Market, Corporate Finance &
Trade Finance. Its primary focus lies in the standardization and harmonization of practices of Islamic financial products, documentation and related processes at the global level.

Through these IIFM-BAFT Participation Agreements, IIFM has aimed to address the issues and diversity in practices around participation for trade finance transactions and has through its research and consultation process has developed a suggested approach for documenting the arrangement incorporating features that have been designed to meet the requirements of the Islamic financial services industry.

3.15 **Use of this IIFM-BAFT Participation Agreements by conventional counterparties**

Can conventional financial institutions use this IIFM Agreement and be a grantor?

Use of the IIFM–BAFT Participation Agreements is not necessarily restricted to Islamic financial institutions. Conventional financial institutions may also use the IIFM-BAFT Participation Agreements for entering into *Shari’ah* compliant trade finance transactions. If they do so, such conventional financial institutions would be expected to undertake their own assessment of demonstrating *Shari’ah* compliance, contracting risk involved and the potential commercial benefits of the transactions as determined in accordance with their own internal risk framework.

It is expected that the conventional financial institutions, acting as Grantor shall address the following as minimum requirements:

(a) The underlying transaction must be conducted in a *Shari’ah* compliant manner the details of which must be documented in the participation Offer; and

(b) The conventional financial institutions must have a *Shari’ah* board / *Shari’ah* governing body supervising the whole process (including the deployment of the transaction funds) on an ongoing basis;

In such cases, an Islamic financial institution participating in a transaction where the grantor is a conventional bank may also need to assess its own compliance with *Shari’ah* principles when dealing with conventional financial institutions in the capacity of a participant.

3.16 **Sale of Debt (i.e. Bay’-al-dayn) and Discounting of the Commercial Papers**

(a) **Sale of Debt:**

Sale of Debt is defined as “the thing due” (which can be either in the form of money or commodity) owed by a certain debtor.

It is a sale of payable right or receivable debt either to the debtor himself, or to any third party and it could be paid immediately or for deferred payment.

(i) **Is it permissible to sell a confirmed debt at discounted price?**

According to scholars any sale of debt (Bay’-al-dayn) or transfer of debt (i.e. *Hawalat-al-dayn*) must be at face value. This means when the bank buys the instrument of debt (i.e. *Shahada-al-dayn*) from the original buyer, it is not entitled to any discount or premium. Any difference between what it pays (purchase price of the instrument) and what it receives on maturity (its maturity value) is not allowed to avoid *riba*. 

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(ii) Resolution of the Islamic Fiqh Academy of Jeddah

The Islamic Fiqh Academy of Jeddah in its 16th convention at Makkah on 5-10th January 2002 has re-discussed the issue and stated that sale of debt is prohibited including the following:

(A) Sale of debts to debtors with a deferred payment plan exceeding debt amount as this can be considered as Riba al-Fadl and Riba an-Nasiah. (Jadwalah ad-Dayn)

(B) Sale of debts to a third party with a deferred payment plan whether the debt is paid with the same type of kind or not as this can be considered as sale of debt with debt (bai’ al-kali bi al-Kali which is clearly prohibited by Prophet Muhammad).

According to the Academy, commercial papers such as cheques, promissory notes and bill of exchange cannot be sold at a discount as there is element of riba.

It is not allowed to deal, issue, distribute or trade with riba based bonds because the element of riba is present.

It is not allowed to deal with debt notes in the secondary market as it involves discounts and sale of debts to third parties which has riba elements.

(b) Discounting of the Commercial Papers (Bill discounting)

AAOIFI Shari’ah Standard No. 16: Discounting of the Commercial Papers:

(i) Importance of the bill discounting tools

Bill discounting is certainly one of the most important tools of trade financing.

With the growing economic industry, the importance of bill discounting is not something hidden any more. It is a tool that in the practice of all conventional financial institutions. But this practice as per the Shari’ah rulings is considered as non Shari’ah compliance because this transaction consists of debt sale and interest.

(ii) Bill discounting how it works

According to the known practice the exporter sells his goods at an agreed price to someone living in other country in exchange of a bill for payables. As soon as the trader loads his goods on the ship, the importer signs a bill to transfer it to the exporter from his bank, the bill actually is a promissory note on behalf of the importer that he will pay the amount on mutually agreed date to the exporter. This bill is known as a letter of credit or bill of exchange and the date at which amount will be paid is the maturity. After that, most of the time, the exporter is in a hurry to get the amount as soon as possible so that he can make further investments, therefore, the bill is taken to a bank for discounting. This process is called endorsement and the person who signs is known as endorser. Bank accepts this receipt against the receivable amount and reimburses some amount which is much lesser than the amount receivable (depending upon the outstanding number of days left from the maturity date) to exporter at that time. This procedure is identified as bill
discounting. Banks most often take its profit according to the corresponding number of days left from the maturity date.

(iii) AAOIFI Shari’ah Standard No. 16: Discounting of the Commercial Papers

AAOIFI Shari’ah Standard No. 16 on Discounting of the Commercial Papers provide the following rulings:

(A) It is not permitted to discount commercial papers, but it is permitted to pay an amount that is less than the value of the paper to the first beneficiary prior to the date of maturity.

(B) It is not permitted to sell commercial paper that has not become due for an amount similar to its value (Riba al-Nasi’ah) nor for an amount that is more than its value (Riba al-Nasi’ah plus Riba al-Fadl).

(C) It is permissible to the beneficiary to treat commercial paper that is not yet due as price for ascertained goods or usufruct, but not those that are sold by description as a liability with the condition of actual or legal delivery of goods or usufructuary asset (commodity – based discounting of debts).

(D) The holder of commercial paper is permitted to purchase goods to be delivered later (on the date of maturity of the paper), and after the debt is established as a liability. The holder of the paper transfers the claim of his creditor to his debtor through this paper. In such a case, the transaction amounts to Hawalah. (See AAOIFI Shari’ah Standard No. 16: Commercial Papers, p 446).

In sum, it can be gathered from those rulings, that as a general principle, the sale of debt at its equivalent value and on spot payment is permissible.

This opinion is later endorsed by the Islamic Fiqh Academy of Jeddah in 2002 which held that sale of debt for immediate payment is allowed. In other words, the debt must be sold at an equivalent value; not more and not less or else any additional sum accruing from the sale of debt is riba. The foregoing ruling regarding the sale of debt includes a sub-participation arrangement with a third party.

3.17 Pre-Shipment Financing versus Post Shipment Financing

(a) Pre-Shipment Financing:

Pre-shipment financing is issued when the seller wants the payment of the goods before shipment.

With pre-shipment financing the working-capital finance requirements are provided for by a financial institution to the customer / exporter provided there is a confirmed export order from an end buyer/off-taker or against a letter of credit. IIFM–BAFT Participation Agreements are based on pre-shipment financing.

(b) Post Shipment Financing:

Post shipment financing is on the other hand provided to an exporter or seller against a shipment that has already been made. It is provided against evidence of shipment of goods or supplies made to the importer or seller or any other designated agency.
With this facility, exporters don’t wait for the importer to deposit the funds. This facility is usually provided against avalised bills by the importer’s bank or under accepted bills under the LC.

4. **RISK MANAGEMENT**

Do the IIFM–BAFT Participation Agreements require minimum risk assessment procedures and due diligence to be carried out by the contracting parties and what are the contracting parties responsibilities?

The IIFM–BAFT Participation Agreements do not stipulate any specific risk assessment procedures or due diligence requirements to be met. However, the key factors that may need to be considered and understood in the context of a risk participation arrangement are, amongst others, (a) satisfying with each party's internal requirements, (c) compliance with operational and administrative mechanism and (c) compliance with local law issues and regulatory requirements.

5. **OTHER MATTERS**

5.1 **IIFM Shari’ah pronouncement**

The terms of the IIFM–BAFT Participation Agreements are approved by the IIFM Shari’ah Board. Any party who intends to use the IIFM–BAFT Participation Agreements may rely on the IIFM Shari’ah pronouncement or obtain independent view of their respective Shari’ah board as they consider necessary. Until amended by notice, the IIFM Shari’ah pronouncement would be considered as the primary reference for the IIFM–BAFT Participation Agreements.

5.2 **Amendment to the IIFM–BAFT Participation Agreements due to change in Shari’ah views**

Can a subsequent amendment in Shari’ah view lead to a modification or amendment in terms of the trade finance transactions?

The terms of the IIFM–BAFT Participation Agreements assume that parties using the IIFM–BAFT Participation Agreements has satisfied themselves, through their Shari’ah boards or advisors, in relation to their assessment of Shari’ah compliance of the terms of the IIFM–BAFT Participation Agreements prior to executing the agreements. Accordingly, a subsequent revised ruling by the Shari’ah board or advisors of either parties on matters of Shari’ah compliance should not impact the legal basis of the IIFM–BAFT Participation Agreements or change the nature of obligations of either parties. The necessary provisions of the IIFM–BAFT Participation Agreements are steady and do not change, but sometimes there are some jurisprudence variation in some related issues. This should be addressed by users on a case-by-case basis.