KEY FEATURES AND SCOPE OF THE IIFM *SHARI 'AH* BOARD REVIEW AND GUIDELINES OF THE IIFM COLLATERALIZED *MURABAHAH* AGREEMENT (THE "MCM AGREEMENT")

BACKGROUND

Liquidity management instruments are a very important tool that can be used to facilitate and manage the liquidity of financial institutions, allowing it to operate at its optimal level and keeping the overall banking system running smoothly. It is specifically used to absorb surplus or add liquidity in the market and Islamic bank's can also manage their liquidity mismatch positions more efficiently.

IIFM in its continued efforts to find alternative liquidity management solution for financial institutions has aimed through this Master Collateralized *Murabahah* Agreement (MCMA) to address issues and diversity in practices around Collateralized *Murabahah* transactions, as especially, there is a near consensus among the *Shari 'ah* scholars that the conventional repo as a liquidity management and credit-risk mitigation instruments cannot be replicated in Islamic Finance because of its non *Shari 'ah* compliance features such as buying and selling with the same counterparty in future date, reuse of the collateral by the creditor etc., hence, finding a Shari 'ah compliant alternative has become absolutely essential and imperative in order to meet the urgent needs and requirements of the IFSI.

As a result, IIFM through its research and industry consultation process, has managed to develop this Master Collateralized *Murabahah* Agreement that have been designed to meet the urgent requirements of the IFSI.

OBJECTIVE OF THE MCM AGREEMENT

The MCM Agreement is a master agreement or framework agreement which sets out terms upon which the parties to the MCM Agreement (Parties) can subsequently enter liquidity management arrangements. Its main objective and each subsequent Collateralized *Murabahah* Transaction is to allow a Buyer an opportunity to raise liquidity by creating security over its *Shar 'ah* compliant assets.

BENEFIT OF THE MCM AGREEMENT

Collateralized *Murabahah* is a contract designed to be used between financial institutions for managing their liquidity management through *Shari'ah* complaint inter-bank treasury transactions and the benefit of the MCM agreement manifested clearly in this regard as follows:

1. The Islamic Financial Institutions as well as corporates and other institutions will be able to better utilize their Sukuk Portfolios and other approved Islamic instruments such as equities which are currently not used.
2. The clean financing market is not as readily available as it used to be before the global financial crisis and Islamic Institutions needs to develop a contingency plan in case they cannot obtain liquidity from the inter-bank market, hence this collateralized product will help to meet and fulfill this objective.
3. The Islamic banks can better manage their liquidity mis-match postions more efficiently

4. Having the comfort of the collateral will allow institutions to finance for a longer duration and probably larger quantum as the credit risk is reduced.

5. The collateralized product will help the development of *Sukuk* market as investors will be able to maintain less cash and allocate more income generating *Sukuk* , hence giving rise to greater take-up of *Sukuk* Market.

SCOPE OF IIFM *SHARI 'AH* BOARD REVIEW AND GUIDELINES

The IIFM *Shari 'ah* Board has been requested to consider only the MCM Agreement itself, not any Collateralized *Murabahah* Transaction, *Murabahah* Contract nor any amendments or additions to the MCM Agreement. Hence, the terms of the IIFM MCM Agreement are approved by the IIFM *Shari 'ah* Board. Any potential users who intend to use this agreement may rely on the IIFM *Shari'ah* Board Pronouncement or obtain independent view of their respective *Shari'ah* Supervisory Board as they consider necessary. Until amended by notice, the IIFM *Shari'ah* Board Pronouncement would be considered as the primary reference for the IIFM Agreement.

In order to assist market participants, the IIFM *Shari'ah* Board has indicated the following guidelines regarding *Shari'ah* compliance:

(a) Collateralized *Murabahah* Transactions should be entered into only for the purpose of liquidity management.

(b) Collateralized *Murabahah* Transactions should not be entered into for purposes of speculation, i.e. actual settlements of assets and payments must take place. Cash settlement should relate to actual transactions involving a deliverable asset.

(c) The underlying assets which are the subject of a *Murabahah* Contract or to be used as collateral must be *Shari 'ah* compliant.

(d) No interest (whether called interest or an alternative name but which represents interest) is to be chargeable under a Collateralized *Murabahah* Transaction.

KEY FEATURES OF THE MCM AGREEMENT

Following factors need to be considered in the context of any Collateralized *Murabahah* Contract arrangement:

(a) Collateral/*rahn* in the context of Islamic finance refers to a contract of security. And conceptually, it means requiring a particular asset to be made subject to security for a financing or loan so that in the event of default by the debtor, the debt may be satisfied out of the value of the security or the financed asset.

(b) From *the Shari 'ah* perspectives it is permissible to use *Shari 'ah* compliant tradable instruments such as equities and *Sukuk* be it International or Domestic, as collateral. Whereas it is not permitted to under any circumstances in *Shari 'ah* to mortgage several things of which include, interest based bonds, preference shares, non *Shari 'ah* compliant investment certificates, shares of a company where its activities are non *Shari 'ah* compliant such as dealing and trading in *Riba*, alcohols, swine etc.

(c) The Posted Collateral shall be held in a segregated and identifiable account and there shall be no use of the Posted Collateral by the Seller/Secured Party.

Key features

- **Creation of Security Interest**

Security Interest is the term used to describe the interest granted, by way of security, by the Buyer/Chargor in the Collateral delivered to the Seller/Secured Party as a condition to the effectiveness of a *Murabahah* Contract.

The taking of a Security Interest over the Posted Collateral differs from the title transfer structure used in conventional repo where the lender takes ownership of the collateral and agrees to return the collateral (or equivalent collateral) on maturity. On event of default, the lender's obligation to return the collateral is extinguished and the value of the collateral is set off against the value of the financing due from the borrower. Under a security interest, ownership of the collateral remains with the borrower and on an event of default, in order to realise the value of the collateral, the lender has to enforce under the security and use its remedies to sell or appropriate.

- **Collateral Substitution/Replacement Possibility**

The MCM Agreement has tackled the issue of posted collateral substitution with other with the same specifications as the first one placed, whereby the Buyer/Chargor may elect to substitute, in certain conditions, such Posted Collateral and the conditions attached to such substitution shall be agreed by the Parties prior to such substitution.

- **Margin Maintenance Mechanism (Mark to Market of the Collateral Pool)**

The MCM Agreement clearly put in place margin maintenance mechanism whereby the Posted Collateral which has been delivered under each *Murabahah* Contract is held together to collateralise the Buyer's obligations under each Collateralized *Murabahah* Transaction.

- **Collateral Management and Custody Services**

The MCM Agreement is designed and drafted in order to cater to the two possibilities for Collateral management i.e. Monitoring the Collateral conditions, mark to market of the collateral, substitution, reporting etc. **the first possibility is bi-lateral collateral management services by the secured party which is generally its related party.**

And the second possibility is the **Tri- Party Custodian** where the parties to the MCM Agreement could use the services of an independent third party for collateral management under a separate Service Agreement to be executed with the Tri-Party service provider. There are many Tri-Party services providers among them, for example, but not limited to, Euroclear, Clearstream, Bony, Standard Chart etc.

It’s important to note that the Tri-Party arrangement does not impact the Murabahah transaction flow. Once the Murabahah transaction is executed then the Tri-Party Operational facility comes in order to move the Collateral into a separate segregated account.

- **Other Clauses**

Also among the important features of MCM Agreement is the way it addressed and tackled the clauses such as: **Prepayment, Late payment Amount, Events of Default, Rights of Enforcement, Early Termination and Set-Off.** It does it in a clear and comprehensive manner with objective of achieving more transparency in the application as well as facilitating understanding of these clauses in the Agreement.

- **Footnotes**

The MCM Agreement features for the first time in the history of Islamic finance Master Agreements the inclusion of *Shari ‘ah* standards footnotes for the purpose of clarification, authentication and acceptance of all the related transactions.

- **Schedules**

The MCM Agreement also included schedules hardly to be found in any other Master agreement, such as: **Form of valuation notice from valuation agent, form of collateral call notice, form of notice of acceleration, form of substitution notice and consent/acknowledgement of substitution notice.**

OPERAIONAL GUIDANCE MEMORANDUM

One of the key IIFM contributions to the industry with regard to this Master Collateralized *Murabahah* Agreement is the publication of the detailed Operational Guidance Memorandum on issues and mechanics of this agreement as well as how it should be applied by the transacting parties.