ISDA/IIFM TAHAWWUT MASTER AGREEMENT

MUBADALATUL ARBAAH (Profit rate swap) DOCUMENTATION

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(A presentation to the IIFM scholars)

1. Introduction

As the Islamic financial institutions market develops and many *Shari'ah* compliant products are innovated, basic hedging and risk management tools need to evolve within the boundaries of *Shari'ah* so as to maintain not only *Shari'ah* compliance credibility, but also to expand trade at global level.

Mubadaltul Arbaah (profit rate swap) agreement is a mechanism structured to allow bilateral exchange of profit streams using two parallel and back-to-back Islamic marked-up sale transactions (*Murabaha*) or a series of single Islamic marked-up sale transactions (*Murabaha*). In this transaction, a series of *Murabaha* sale and purchases are conducted, allowing parties to swap or exchange profit rates from fixed to floating rate or vice versa. *Mubadaltul Arbaah* transaction was introduced to assist in the management of profit rate risks, thus enhancing cash flows.

This paper of the discussion is aim to focus on three (3) types of the *Mubadaltul Arbaah* (profit rate swap) structures as practice in the Market as follows:

(a) Two sale Structure

(b) Single Sale Structure

(c) Pure *Murabaha* Structure

2. Definition of *Mubadaltul Arbaah* (profit rate swap)

Mubadaltul Arbaah (profit rate swap) can be defined as an agreement to exchange profit rates between a *Mu 'addal Ribh Thabit* **(**fixed rate) party and a *Mu 'addal Ribh Mutaghayyer* (floating rate) party, or vice versa, implemented through the execution of a series of underlying *Shari'ah* compliant contracts.

2.1. Utilization of *Wa'ad*

Wa'ad in this transaction is a binding unilateral promise and is binding one way only. It is being used or utilized in this transaction in order to ensure that the *Mubadalah* (swap) reaches its maturity. A *Wa'ad* is given by each party in respect of each relevant *Murabaha* commodity transaction stage until the *Mubadalah* (swap) expires.[1]

3. Types of the *Mubadaltul Arbaah* (profit rate swap) structures as market practice

3.1 Type (1): Two sale Structure of *Mubadaltul Arbaah Wa'ad* based transaction

Mubadaltul Arbaah (profit rate swap) agreement comprises of the following:

(a) *Mu 'addal Ribh Thabit* (Fixed Profit Rate)
(b) *Mu 'addal Ribh Mutaghayyer* (Floating Profit Rate)

The basic two sales structure of *Mu 'addal Ribh Thabit* (Fixed Profit Rate) and *Mu 'addal Ribh Mutaghayyer* (Floating Profit Rate) *Wa'ad based* transaction as follows:

3.2 The Transaction scenario

3.2.1 *Mu 'addal Ribh Thabit* (Fixed Profit Rate) scenarios as follows:

(a) Bank A has a fixed rate investment profile from its purchase of a *Shari'ah* compliant assets maturing in three years and paying semi annually (eg 3 year Sukuk).

(b) Bank A wishes to swap the above mentioned fixed rate payment profile with a floating payment profile. Bank A (in this case) may decide to enter into a *Mubadaltul Arbaah* agreement (Islamic profit rate swap) with a counterparty Bank B.

(c) Bank A receives a cash flow from its investment (the investment referred to in paragraph (a) above - eg the 3 year Sukuk) every six months on a fixed rate profit margin.

(d) On day one Bank A gives a ***Wa'ad*** under which it promises to enter into commodity *Murabaha* purchase agreements with Bank B if Bank B exercises the *Wa'ad*.

(e) Bank B sells a *Shari'ah* compliant asset to Bank A on a *Murabaha*[2] basis at a selling price that comprises both principal and profit margin to be paid upon

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[1] In this paper we envisage that on day one a party will grant one *Wa'ad* and there will be multiple exercises under that one *Wa'ad* during the life of the profit rate swap

[2] One question for the scholars is whether it makes a difference whether the *Murabaha* is entered into at the beginning of the calculation period or at a later date during the calculation period. For example, in the above example, Bank A is hedging its 6 month paying fixed rate investment. It grants a *Wa'ad* on Day 1. Does it matter whether the *Murabaha* that is entered into (upon exercise by Bank B of Bank A's *Wa'ad*) is entered into at the beginning of the 6 month calculation period or at a later date during the six month

subsequent transaction (floating rate portion). Thus the first leg of the transaction is concluded. This is repeated every 6 months until maturity.

3.1.3 *Mu 'addal Ribh Mutaghayyer* (Floating Profit Rate) scenario as follows:

(a) On day one Bank B gives a ***Wa'ad*** to Bank A under which B promises to purchase a *Shari'ah* compliant commodity from Bank A. Bank A will sell a *Shari'ah* complaint asset to Bank B at a selling price of notional principal, plus a mark-up based on the prevailing profit rate (agreed spread plus current benchmark). Thus the reverse commodity *Murabaha* is executed by the two parties (reverse commodity *Murabaha* as seen from Bank B's point of view)[2].

(b) Payment of selling price by both Bank A and Bank B is netted-off. (The principle of Muqasah (set-off) has been utilized in this respect.

(c) The net difference is profit, and is paid to the swap counterparty as initially agreed between both counterparties in the ISDA/IIFM *Tahawwut* Master Agreement.

(d) Floating profit rate is repeated every six months until maturity.

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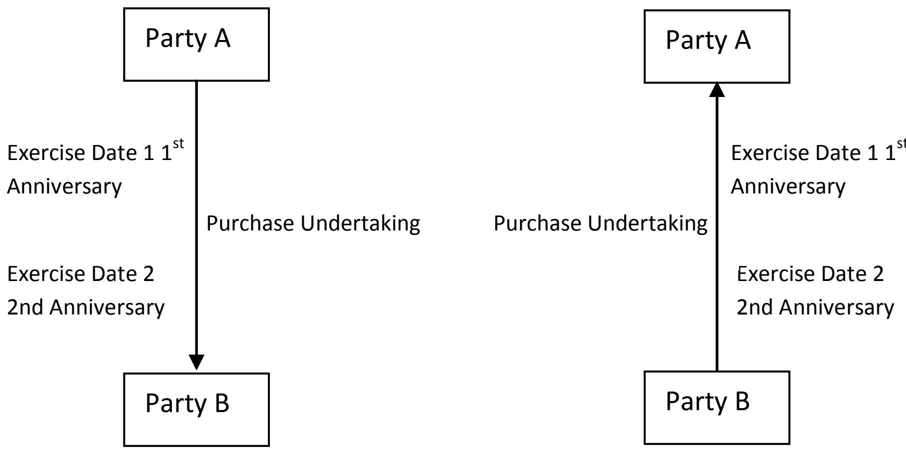
calculation period (in both cases, delivery of the purchased assets will be made at the time the *Murabaha* is entered into). For example does Bank B need to exercise the *Wa'ad* at the beginning of the 6 months, immediately enter into the *Murabaha* and deliver the commodity, leaving the purchase price payable by Bank A deferred for 6 months to the end of the calculation period? Or could Bank B exercise the *Wa'ad* say one week before the end of the 6 month period, enter into the *Murabaha* upon exercise of the *Wa'ad,* and deliver the commodity immediately leaving the purchase price deferred for one week to the end of the 6 month calculation period (the purchase price would be the same whether the *Murabaha* is entered into at the beginning of the 6 month calculation period or one week prior to the ending of the 6 month calculation period). The advantage of entering into the *Murabaha* on the later date is that the period for which the purchase price is deferred is a shorter period.

3.1.4 ILLUSTRATION (TWO SALES)

In this example:

Party A and Party B enter into a 3-year *Mu ‘addal Ribh Thabit/ Mu ‘addal Ribh Mutaghayyer* **(**fixed/floating profit rate swap) where Party A pays a *Mu ‘addal Ribh Thabit* (fixed rate) and Party B pays a *Mu ‘addal Ribh Mutaghayyer* (floating rate).

Day One - Purchase Undertakings



Explanation:

On day one[3], Party A grants a purchase undertaking exercisable on three Exercise Dates. The first Exercise Date falls immediately, the second on the first anniversary, and the third on the second anniversary.

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[3] **Fixed Rate Leg.** First Murabaha entered into on Day 1, with spot asset delivery and purchase price payment of cost plus profit on first anniversary. Second Murabaha entered into on first anniversary with spot asset delivery and purchase price payment of cost plus profit on second anniversary. Third Murabaha entered into on second anniversary with spot asset delivery and purchase price payment of cost plus profit on third anniversary.

Floating Rate Leg. First Murabaha entered into on Day 1, with spot asset delivery and purchase price payment of cost plus profit on first anniversary. Second Murabaha entered into on first anniversary with spot asset delivery and purchase price payment of cost plus profit on second anniversary. Third Murabaha entered into on second anniversary with spot asset delivery and purchase price payment of cost plus profit on third anniversary

NEW

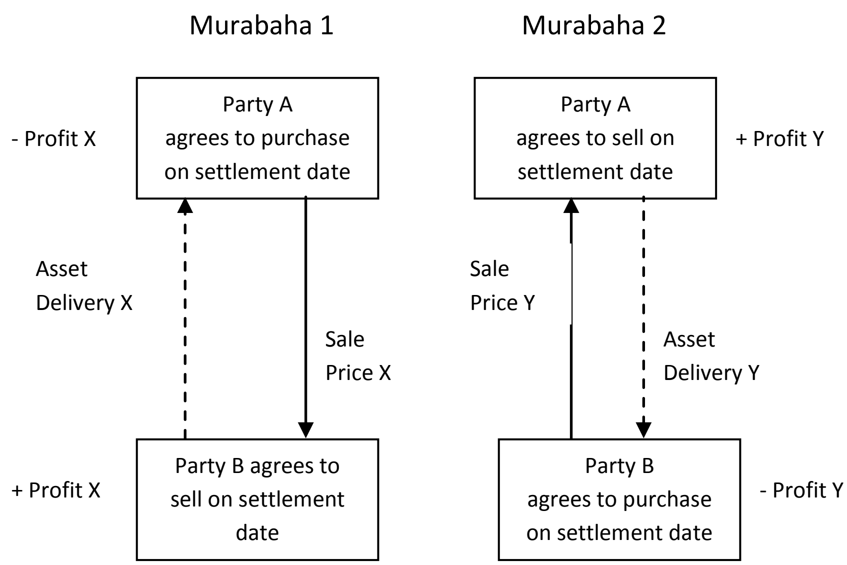
Party B also grants a purchase undertaking exercisable on the same three dates as Party A's purchase undertaking.

The First Anniversary will be defined as an Exercise Date

On the date specified in the confirmation as the rate fixing date of the floating rate amount for the first calculation period (i.e. the period from day one to the first anniversary) the floating rate will be determined by reference to LIBOR on that rate fixing date.[4]

Immediately after the undertakings have been granted, each purchase undertaking is exercisable and each is exercised, as a result of which two *Murabaha* agreements will be entered into as follows:

Two Murabaha agreements (Illustration):



Explanation:

***Murabaha* 1:**

On the settlement date, Party A purchases the asset (Asset X) for Sale Price X

Sale Price X = Cost of asset plus Profit, where Profit equals the fixed rate amount

Settlement date is upon entry into the *Murabaha* deferred payment date is the first anniversary.

[4] The rate fixing date will always be on or before the date of entry into the relevant *Murabaha*

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The first exercise of Party A's purchase undertaking therefore results in Party A's payment of the fixed rate leg for the first calculation period i.e. the period from entry into the purchase undertaking to the first anniversary.

***Murabaha* 2:**

On the settlement date, Party B purchases the asset (Asset Y) for Sale Price Y

Sale Price Y = Cost of asset plus Profit, where Profit equals the floating rate amount for the first calculation period

On the rate fixing date on or immediately prior to the start of the first calculation period, the floating rate amount for the first calculation period, i.e. the period from the start date to the first anniversary, can be determined by determining LIBOR on that rate fixing date.

The first exercise of Party B's purchase undertaking therefore results in Party B's payment of the floating rate leg for the first calculation period.

Second and Third Anniversaries

On the second and third anniversaries the same procedure as for the first anniversary will be repeated.

3.2 Type (2): Single Sale Structure

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 two sale structure as follows:

- If first year fixed rate exceeds first year floating rate, one Murabaha entered into on Day 1 under which fixed rate payer purchases asset with spot asset delivery and purchase price payable on first anniversary (purchase price of cost plus profit equal to amount by which fixed rate exceeds floating rate)

OR

- If first year floating rate exceeds first year fixed rate, one Murabaha entered into on Day 1 under which floating rate payer purchases asset with spot asset delivery and purchase price payable on first anniversary (purchase price of cost plus profit equal to amount by which floating rate exceeds fixed rate)

- If second year fixed rate exceeds second year floating rate, one Murabaha entered into on first anniversary under which fixed rate payer purchases asset with spot asset delivery and purchase price payable on second anniversary (purchase price of cost plus profit equal to amount by which fixed rate exceeds floating rate)

OR

- If second year floating rate exceeds second year fixed rate, one Murabaha entered into on first anniversary under which floating rate payer purchases asset with spot asset delivery and purchase price payable on second anniversary (purchase price of cost plus profit equal to amount by which floating rate exceeds fixed rate)

- If third year fixed rate exceeds third year floating rate, one Murabaha entered into on second anniversary under which fixed rate payer purchases asset with spot asset delivery and purchase price payable on third anniversary (purchase price of cost plus profit equal to amount by which fixed rate exceeds floating rate)

OR

- If third year floating rate exceeds third year fixed rate, one Murabaha entered into on second anniversary under which floating rate payer purchases asset with spot asset delivery and purchase price payable on third anniversary (purchase price of cost plus profit equal to amount by which floating rate exceeds fixed rate).

More explanation:

(i) 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 (ii)(3) 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).

(ii) (1) 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 Sale Price and the Settlement Date. The Exercise Dates under Party A's purchase undertaking will match those under Party B's purchase undertaking;

(2) on an Exercise Date, it will be determined whether the fixed rate amount for the relevant calculation period is greater than or less than the floating rate amount for that calculation period;

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

(4) the Sale 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

(5) only one *Murabaha* agreement will be entered into and the assets deliverable and the Sale 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.

3.2.1 Single Sale Structure Transaction Scenario

Party A and Party B enter into a 3 year fixed/floating profit rate swap where Party A pays the fixed rate and Party B pays the floating rate.

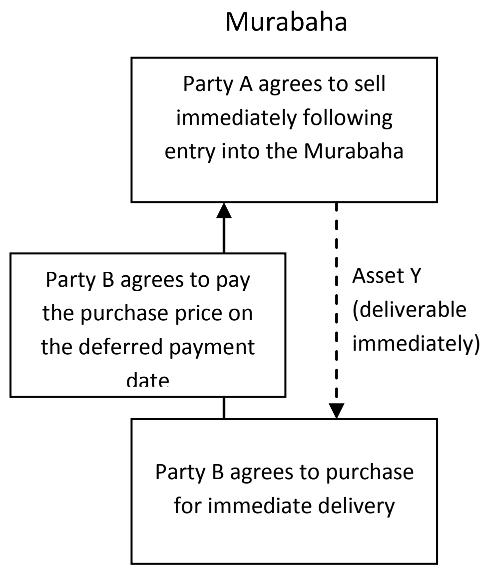
On day one, Party A grants a *Wa'ad* (purchase undertaking) to Party B with three Exercise Dates. The first Exercise Date is immediately following grant of the *Wa'ad*, the second on the second anniversary and the third on the third anniversary.

Party B also grants a purchase undertaking to Party A, with the same exercise dates as those of Party A.

Party A's purchase undertaking is only exercisable if in respect of the relevant calculation period the fixed rate exceeds the floating rate. Party B's purchase undertaking is only exercisable if in respect of the relevant calculation period the floating rate exceeds the fixed rate.

3.2.2 Illustration

The exercise of Party B's purchase undertaking will result in the following *Murabaha* being entered into:



Sale Price Y = Cost plus Profit, where Profit equals the amount by which the floating rate exceeds the fixed rate

Party A's undertaking is not exercisable as floating rate exceeded the fixed rate.

Assume in relation to the first calculation period that the floating rate exceeds the fixed rate. This will result in Party A exercising Party B's purchase undertaking on the first Exercise Date (Party A's purchase undertaking will not be exercisable on that date, as the conditions for exercise have not been satisfied).

3.2.3 First and Second Anniversaries

On the first and second anniversaries the same procedure as for the first anniversary will be repeated.

NEW

3.3 Type (3): Pure *Murabaha* Structure

As an alternative to entry into *Wa'ad*, the parties could seek to achieve the same profit rate swap by either agreeing to enter into dual *Murabaha* or into a single *Murabaha* in relation to each calculation period. This structure (***Murabaha* at the end of the period**) can be explained as follows:

Fixed Leg

- First Murabaha entered into two days prior to first anniversary with spot asset delivery and spot purchase price payment on first anniversary (purchase price of cost plus profit)

- Second Murabaha entered into two days prior to second anniversary with spot asset delivery and spot purchase price payment on second anniversary (purchase price of cost plus profit)

- Third Murabaha entered into two days prior to third anniversary with spot asset delivery and spot purchase price payment on third anniversary (purchase price of cost plus profit)

Floating Leg

- First Murabaha entered into two days prior to first anniversary with spot asset delivery and spot purchase price payment on first anniversary (purchase price of cost plus profit)

- Second Murabaha entered into two days prior to second anniversary with spot asset delivery and spot purchase price payment on second anniversary (purchase price of cost plus profit)

- Third Murabaha entered into two days prior to third anniversary with spot asset delivery and spot purchase price payment on third anniversary (purchase price of cost plus profit)

More explanation:

The structures are the same as the two *Wa'ad* structures except that on day 1 instead of A and B granting *Wa'ad* to each other, they simply agree either:

- to enter into dual *Murabaha* for each calculation period, in each case the dual *Murabaha* only being entered into once the floating rate is known: so the transaction would be:

    - Party A purchases under a *Murabaha* to pay fixed rate

    - Party B purchases under a *Murabaha* to pay floating rate; or

- to enter into a single *Murabaha* for each calculation period so that
    - if fixed exceeds floating, Party A purchases from Party B the price being cost plus the amount by which fixed exceeds floating rate; or
    - if floating rate exceeds fixed rate, Party B purchases from Party A, the price being cost plus the amount by which floating exceeds fixed rate.

Dual *Murabaha* at the beginning of the period (without Wa 'ad) structure.

To be discussed during the meeting (insha Allah)

4. Agency appointment during the *Murabaha* commodity trades

During the *Murabaha* commodity trades Bank B can also act as an agent for Bank A in the commodity trades between the brokers and facilitate the individual legs involved in the process.

4.1 Agency appointment during the *Murabaha* commodity trades as market practice

In a scenario whereby a customer appoints the principal bank to be its agent to do on its behalf any of the following acts with respect to Transactions:

(a) to buy and/or sell Assets as required by the Agreement and each Transaction;

(b) enter into Purchase Agreements, Sale Agreements and/or other agreements as fully as the Customer could do itself;

(c) negotiate with suppliers, manufacturers, dealers, traders, brokers and/or clients on behalf of the Customer in relation to the Sale and Purchase of Assets;

(d) utilise the services of any agents where the Agent itself may deem this necessary;

(e) sign all Purchase Agreements, Sale Agreements and other documents as required in the name of and on behalf of the Customer; and

(f) to take any other action in the reasonable opinion of the Agent which is necessary or desirable in order to accomplish the forgoing.

NB.
The Agent will enter into each Purchase and Sale in the name of the Customer at its discretion on either a disclosed or an undisclosed basis.