Tahawwut Master Agreement: Pertinent Issues and Legal Practices in Malaysia

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- TMA (Tahawwut Master Agreement)
- Shari’ah Resolutions and Standards: International and Malaysian Perspective
- Close-out Mechanism: Malaysian Approach
What is TMA??

- Tahawwut Master Agreement (TMA) is a standard master agreement that governs the Islamic Profit Rate Swap operations and the TMA is issued by the IIFM and International Swaps and Derivatives Association, Inc. (ISDA).

- The Tahawwut Master Agreement was developed under the guidance and approval of the IIFM Shari’ah Advisory Panel, and was designed for use in all jurisdictions where Islamic finance is practiced.

- Tahawwut Master Agreement provides a standard global framework that sets out many of the basic terms pursuant to which parties may enter into Shari’ah-compliant hedging transactions.

Tahawwut Standard Documentation

Standards related to Islamic hedging have been published as follows:

- Tahawwut (Hedging) Master Agreement (TMA)
- Islamic Profit Rate Swap (IPRS) - Single Sale
- Islamic Profit Rate Swap (IPRS) - Two Sale
- Islamic Cross-Currency Swap (ICRCS)
- Islamic Foreign Exchange Forward (IFX Forward) – Single Binding Wa’ad based
- Islamic Foreign Exchange Forward (IFX Forward) – Two Unilateral and Independent Wa’ad based
- Islamic Credit Support Deed for Cash Collateral (VM)
● **Tahawwut Master Agreement**

**Documentation Architecture**

- Islamic Credit Support Documents to reduce credit risk*
- Tahawwut Master Agreement (Completed)
- Annexes*
- Confirmations*
  - Long form confirmations
- Definitions for use in documenting Hedging Transactions*
  - Cross Currency Swap
  - Profit Rate Swaps
  - Others to Hedge risk
- Confirmations*
  - Short form confirmations
  - Master confirmation agreements

● **Two Sales Structure**

**Documentation Architecture**

- Tahawwut Master Agreement (Master Terms)
- Schedules
- Islamic Profit Rate Swap (Two Sales Structure):
  - DFT Terms confirmation (Wa'd) – Fixed Profit Rate/FRP Leg
  - Exercise Notice
  - Murabahah Sale
  - DFT Terms confirmation (Wa'd) – Floating Profit Rate/FRP Leg
  - Exercise Notice
  - Murabahah Sale
**Single Sale Structure**

**Documentation Architecture**

- Tahawwut Master Agreement (including Schedules)
- Islamic Profit Rate Swap (Single Sale Structure)
- DFT Terms confirmation (Wa'ad) – Fixed Profit Rate/FPR Leg
- DFT Terms confirmation (Wa'ad) – Floating Profit Rate/FLPR Leg
- Exercise Notice in relation to undertaking where Exercise Condition is met
- Murabahah Sale

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**Tahawwut Master Agreement**

**Risk Management Perspective – Need for a Framework Agreement**

- **Third Level**: Framework – Counterparty Relationships
  - *Shari’ah Implications V
- **Second Level**: Usage and Structure of Hedges
  - *Shari’ah Implications X
- **First Level**: Risk arising from Assets and Liabilities
  - *Shari’ah Implications X

*Tahawwut Master Agreement* covers primarily the third level of risk management, covering relationship framework, events of early termination, early termination netting mechanisms, representations.
**Shari’ah Resolutions and Standards: International Perspective**

1. AAOIFI in its Shari’ah Standard Number 1 declares that it is permissible for institutions to hedge against the future devaluation of the currency. To do so, parties could hedge via:
   - Back-to-back interest free loans (qard) by using different currencies
   - A promise (wa’ad) is another instrument allowed to be used as to hedge against the currency devaluation risk
   - In AAOIFI’s Shari’ah Standards Number 20, Article no. 5/2/3, Shari’ah-compliant option in the form of urbūn is allowed.

2. Similar stance is taken by the Dallah Al-Barakah. This institution in its Sixth Symposium for Islamic Economy on 2-6 March 1990 resolves that hedging is lawful as it is an agreement to enter into another contract in future with the subject of the contract being lawful.

3. In 2010, the Shari’ah board of the International Islamic Financial Market (IIFM) has approved profit rate swap through the use of wa’ad and contract of murābahah (cost plus profit sale where profit margin is disclosed to the buyer) and musāwamah (general sale contract where profit margin is not disclosed to the buyer).

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**Shari’ah Resolutions and Standards: Malaysian Perspective**

SAC-SCM and SAC-CBM have issued a number of Shari’ah resolutions permitting the development of Islamic hedging. Examples of their Shari’ah resolutions are as follows:

- Islamic banking institution is allowed to enter into forward foreign currency transaction, based on unilateral binding promise (binding only on the promisor – wa’ad mulzim) and that if the promisor breaches the promise, he is bound to remit compensation for breaching such promise.
- Besides approving the forward foreign currency transaction, the SAC-CBM also approves foreign currency option
- With regards to swaps, the SC-CBM (2007) resolved in their 44th meeting dated 24 June 2004 that the arrangement of Islamic profit rate swap through the contract of bay inah conducted amongst the financial institutions or between the Islamic financial institutions and other Islamic profit rate swap counterparties is permissible
- SAC-SCM resolved that the crude palm oil futures contract (a commodity futures contract where parties sell and purchase crude palm oil at an agreed price and at future date of delivery) is permissible as it is free from any element of gharrar (uncertainty) and maysir (gambling)
- Resolved that the composite (stock) index futures contracts (a type of financial futures contract) does not contradict Shari’ah principles.
**Description of Close-Out Netting**

- When counterparties have a number of obligations to each other, they can agree to offset and net those obligations. This is known as close-out netting. In the event of some kind of termination event, such as one counterparty defaulting on obligations, any outstanding contracts are terminated at the point in time of default. The remaining obligations are then marked to market and settled with a net payment.

- Close-out netting, which applies to transactions between a defaulting firm and a non-defaulting firm. Close-out netting refers to a process involving termination of obligations under a contract with a defaulting party and subsequent combining of positive and negative replacement values into a single net payable or receivable.

- The close-out netting process involves three steps: termination, valuation, and determination of net balance. Termination means that the non-defaulting party puts an end to the obligations under the Agreement. The second step, valuation, is the process of determining the replacement cost of each transaction under the contract. Finally, determination of net balance means that positive values—those owed to the non-defaulting party—and negative values—those owed by the non-defaulting party—are netted against each other under the single agreement in order to determine a final close-out amount.

**Murabahah and Musawwamah in IPRS**

- IIFM has approved profit rate swap through the use of wa‘ad and contract of murābahah (cost plus profit sale where profit margin is disclosed to the buyer) and musāwamah (general sale contract where profit margin is not disclosed to the buyer).

- This hedging arrangement is used to hedge against adverse profit-rate movements usually by swapping or exchanging floating payment obligations with fixed payment obligations or vice versa.

- In the event that one of the contracting parties defaulted in exercising its wa‘ad to purchase the Shari’ah compliant assets, contract of musāwamah will be used.
Process: The Close-Out Netting under Tahawwut Master Agreement

- Calculate Market Quotation (or Loss)
  - The Relevant Index Amount for a terminated DFT Terms Agreements or terminated Non-Fully Delivered Transactions is determined through the Market Quotation method, and in the event a Market Quotation cannot be determined or would not lead to a commercially reasonable

- Result may be positive or negative
  - If Relevant Index is positive (Determining Party is in the money), Determining Party can exercise the section wa’ad of counterparty requiring counterparty to enter into musawama and purchase asset from Determining Party at the Positive Indexed Value
  - If Relevant Index is negative (Determining Party is out of the money) other party can exercise the section wa’ad of the Determining Party requiring the Determining Party to purchase asset from the other party at the Negative Indexed Value

- Becomes value of Relevant Index
- Index Amount means, with respect to each DFT Terms Agreement or each group of DFT Terms Agreements, the amount of the losses or costs that would be incurred or gains that would be realised in replacing, the material terms of that DFT Terms Agreement or group of DFT Terms Agreements

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TMA: Enforceability of Close-Out Netting Under Malaysian Law

1. Enforceability of Automatic Early Termination (AET) Provision: Elected and Not Elected
   - The non defaulting party terminates by notice all outstanding transaction where AET is not elected
   - If AET is elected, all outstanding transactions and DFT terms agreements are automatically terminated.

2. Enforceability of Netting of Termination Values
   - The provision of TMA providing for Netting of termination values in determining single lump sum termination amount upon the insolvency of a counterparty is enforceable under Malaysian law i.e., bankruptcy act 1967 section 41, 291, 293

3. Enforceability of Termination Currency Which is a Foreign Currency
   - The provision under TMA obliging a party to pay the termination currency in a foreign currency would be enforceable and recognized under Malaysian law so long as the agreement by the parties to enter into the TMA was made bona fade and was not a result of fraud, mistake or made with intention to evade any provision of Malaysian law.

4. Malaysian Banks Entering into TMA on Multibranch Basis
   - All enforceability would apply where Malaysian banks operating multi branches basis entering into TMA.

5. Insolvency Proceedings for Foreign Banks Located in Malaysia
   - All foreign banks located in Malaysia are required to be incorporated as a public company in Malaysia
Pertinent Issues

☐ Can a non-Islamic indices, such as LIBOR, S&P Global Index be used as a mirror/benchmarking for netting valuation purpose?

☐ Whether the compensation/damages paid by the party that breach the wa’ad, in the form of close-out amount, is based on actual loss?

☐ As the close-out amount that is mark-to-market allows one of the contractual parties to gain when the market rate moves in its favour, would the Shari’ah allows the gaining party, who happened to breach the wa’ad to gain on the basis that the market moves in its favour?

Some Remedies: International and Malaysian Approach

☐ The Islamic Fiqh Academy of OIC resolved that if the promisor breaches his promise, the promisee can seek legal remedy in a court of law for specific performance or damages. This resolution in line with AAOFI Standard No 8, article 2/5/4, Dallah al-Barakah as it is stated in article no 6/18 and Shariah Board of Qatar Islamic Bank (Fatwa No. 53)

☐ In Malaysia, the Central Bank of Malaysia (2016) has, on 11th April 2016 issued a Concept Paper on wa’ad. This Concept Paper stipulates that the promisor is deemed to breach the wa’ad if he does not fulfill the conditions specified therein:

- the actual loss shall be measured based on the difference between the sale price of the commodity and the promised purchase price of the commodity
- the Islamic financial institution may acquire the whole amount of hāmish jiddiyah to recover the actual losses if the calculated amount based on the above methodology is equal or more than the value of hamish jiddiyah.

☐ SC-SAC during 54th meeting dated 27 October 2005 that the methodology in determining the close-out amount under the conventional interest rate swap could also be applied onto the Islamic profit rate swap.

☐ In the event that one of the contracting parties defaulted in exercising its wa’ad to purchase the Shari’ah compliant assets, contract of musāwamah will be used.

☐ The close-out amount is determined based on the market quote methodology, which refers to the standard formula adopted by market participants to determine the payable compensation amount.

☐ Calculation methodology is deemed to be acceptable and applicable to Islamic profit rate swap.
THE END