



## IIFM Activities and Recent Trends in IFSI Focus: Repo

OIC Member States' Stock Exchanges Forum  
3<sup>rd</sup> Meeting  
24-25 October 2009, Istanbul

Mr. Ijlal Ahmed Alvi, Chief Executive Officer, IIFM

## Contents



1. **About IIFM**
2. **IIFM Standardization Initiatives**
  - Master Agreements for Treasury Placement (MATP)
  - IIFM-ISDA Tahawwut (Hedging) Master Agreement
3. **Repurchase Master Agreement**
  - Repo in conventional markets & its significance
  - IIFM Repo project - objectives
4. **Islamic Repo – Jurisdictional Approach**
  - Bahrain
  - Malaysia
5. **IIFM I'aadat Al Shira'a (IS) Project – Shari'a Considerations & Way Forward**
  - Bilateral Repo & issues
  - Tri-Partied Repo & issues
6. **'IS' and Collateralization**
  - Documentation, Legal and Regulatory challenges to reach Classical Repo outcome
  - IIFM Project Team's View

## About IIFM



IIFM is a non-profit international development institution supported by the central banks and government agencies of Bahrain, Brunei, Dubai, Indonesia, Malaysia, Saudi Arabia, Sudan, Pakistan as well as number of regional and international financial institutions

The objective of IIFM is to take part in the establishment, development and promotion of the Islamic Capital and Money Market (ICMM)

IIFM's primary focus lies in the advancement and standardization of Islamic Financial Services Industry (IFSI) documentation, structures and instruments; processes and infrastructure; and recommendations for the enhancement of ICMM

## About IIFM



- Standard setting body with regulatory heritage
- Addressing the standardization needs of the industry
- Providing universal platform to market participants through 'Global Working Groups' for the development of ICMM
- Shari'a harmonization in documentation, products and processes

## IIFM Standardization Initiatives



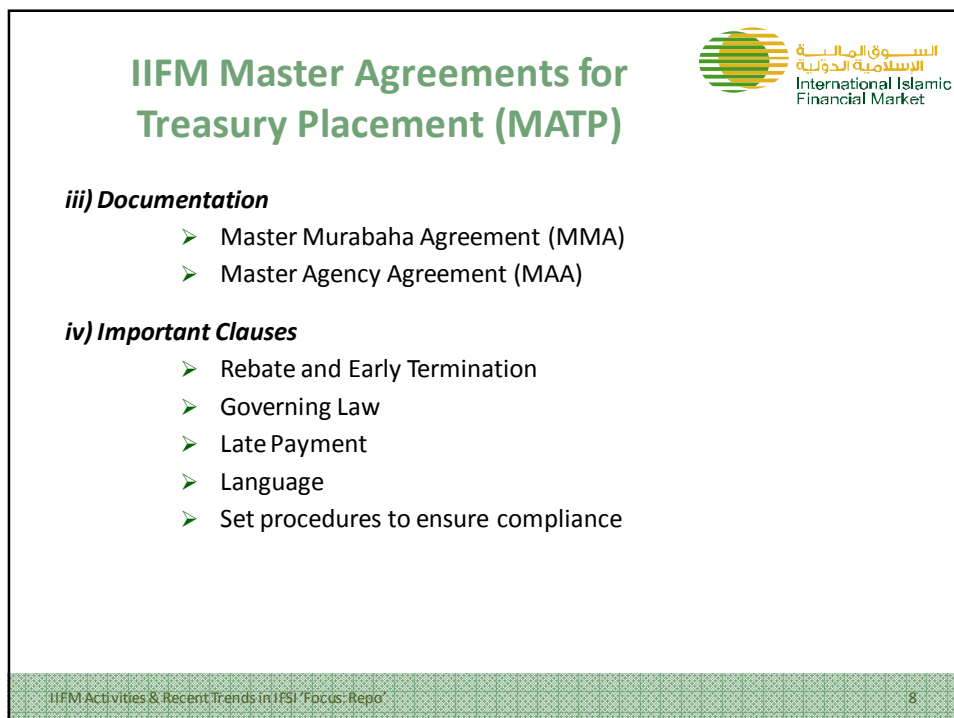
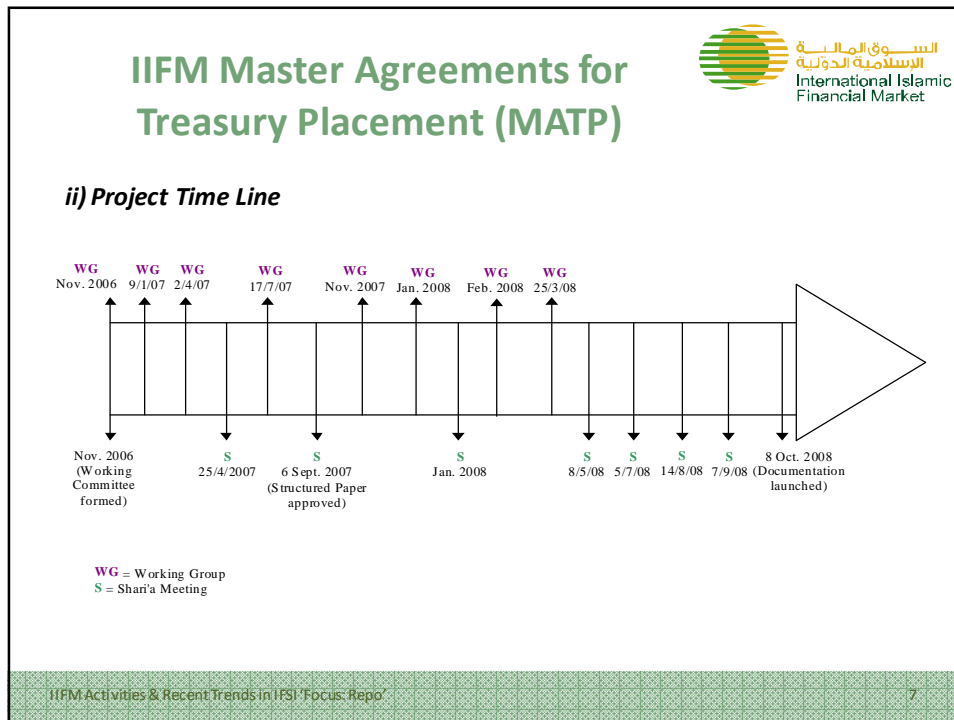
- IIFM Master Agreements for Treasury Placement (MATP) – completed
- IIFM Tahawwut (Hedging) Master Agreement – advanced stage
- Repurchase and Collateralization prospects – under consideration
- Other initiatives

## IIFM Master Agreements for Treasury Placement (MATP)



### *i) Commodity Murabaha – Why Standardize*

- Commodity Murabaha plays a dominant role in some jurisdictions
  - ❑ industry requires an alternative to make it supplemental product
- Frequent legal, Shariah, operational and other costs
- Lengthy negotiation time and constant Shariah involvement
- Variations in documentation processes and procedures leads to divergence of Shariah and practices
- Moving away from costly bilateral documentation to efficient standardization approach..... **IIFM MATP**



## IIFM Master Agreements for Treasury Placement (MATP)



### v) Benefits & Utilization

- In line with rulings of other standard setting bodies
- Best market practices
- High quality and comprehensive documentation
- Reducing transaction arrangement cost (critical factor in present environment)
- Improving documentation standard and bringing smaller institutions on same level as large International banks
- Improving transparency
- MMA and MAA, with addition/changes in clauses can be utilized for other products involving Murabaha contracts and Agency arrangements
- Reduces burden on Shariah scholars – will free up time to concentrate on other more flexible and innovative liquidity management products thereby making Commodity Murabaha **supplemental product (IIFM aim)**

## IIFM / ISDA Tahawwut (Hedging) Master Agreement



### i) Background

- Islamic Financial Institution's require hedging to mitigate risks
- Framework Master Agreement's functions and risk management role
- Net Risk Management
- Early Termination
  - ❑ Concluded transactions
  - ❑ Future transactions

## IIFM / ISDA Tahawwut (Hedging) Master Agreement



### *ii) Framework Document*

- The Framework Document sets out general terms on the basis of which the parties can then enter into individual hedging transactions for risk mitigation
- The current project is addressing only the Framework Document; not individual products

## IIFM / ISDA Tahawwut (Hedging) Master Agreement



### *iii) Transactions under the Framework Document*

- Only for the purpose of hedging an actual risk of the relevant party
- No speculation
- Real transactions, involving the actual transfer of ownership of real assets, actual risk and real settlement
- The asset must be Halal
- Interest must not be chargeable under the transaction

## IIFM / ISDA Tahawwut (Hedging) Master Agreement



### iv) Benefits of Framework Document

- Clear and agreed terms and conditions governing hedging transactions
- The ability to early terminate and net out on early termination allows each party to limit its risk legally, in the event of default or insolvency of the counterparty, to the net exposure, and therefore to treat its credit risk exposure during the life of the agreement as a **net risk management position** in respect of its transaction with the counterparty, thereby enabling it to calculate its credit risk exposure on this net basis for credit risk and accounting purposes throughout the life of the transaction
- The ability to early terminate and net out on early termination also allows each party to calculate its **regulatory capital requirement on the net risk management position**, thereby reducing its regulatory capital requirement

## Repurchase Master Agreement



### a) What is Repo in conventional market & its significance

- Conventional terms – Simultaneous purchase & sale of security at a pre-agreed time & price
  - Agreement between 2 parties, whereby one party sells to other party a security at market price (Shari'a wise ok)
  - Commitment to buy the same security back at a later date for a pre-agreed price (major Shari'a issue)
- Structures
  - Classic Repo – transfer of title takes place but ownership is maintained. The economic benefit not transferred which means interest or dividend paid to original owner. Mark to market and margin mechanism is allowed
  - Buy & Sell – complete transfer of all rights and benefits

## Repurchase Master Agreement



- Why Repo is an important tool
  - Cash and liquidity management
  - Creating liquidity in the underlying instrument
  - Financing and leveraging the investment
  - Credit enhancement and greater volume
  - Role in other structured products (derivatives, swaps etc)
  - Repo oils the wheel of the bond market
- Repo Documentation
  - Global Master Repo Agreement – key features
    - Hair cut
    - Mark to market
    - Netting
    - Margin Calls – acceptable instruments

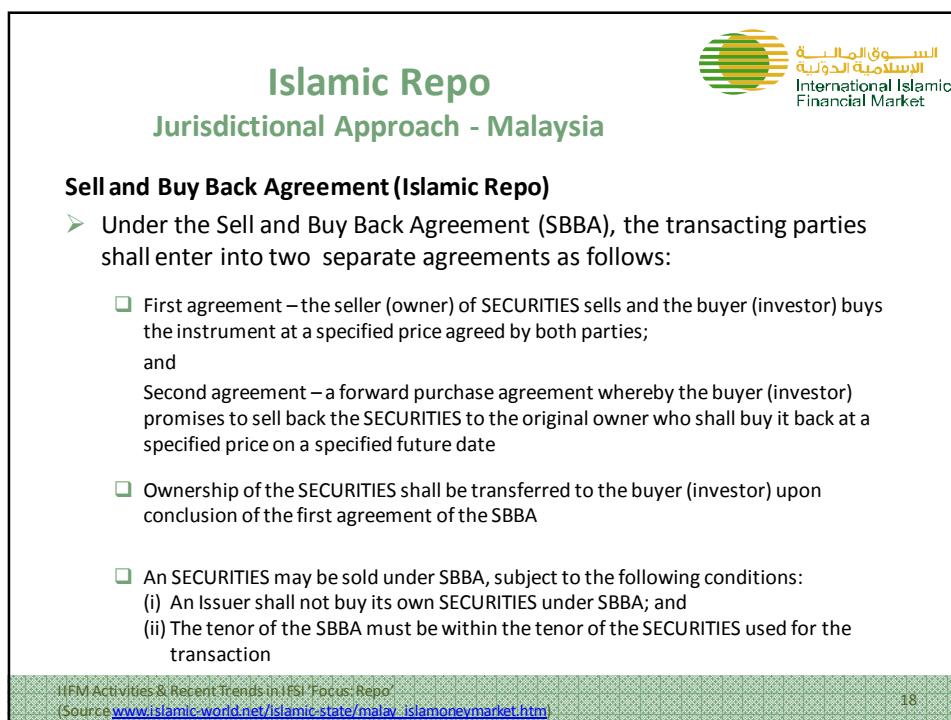
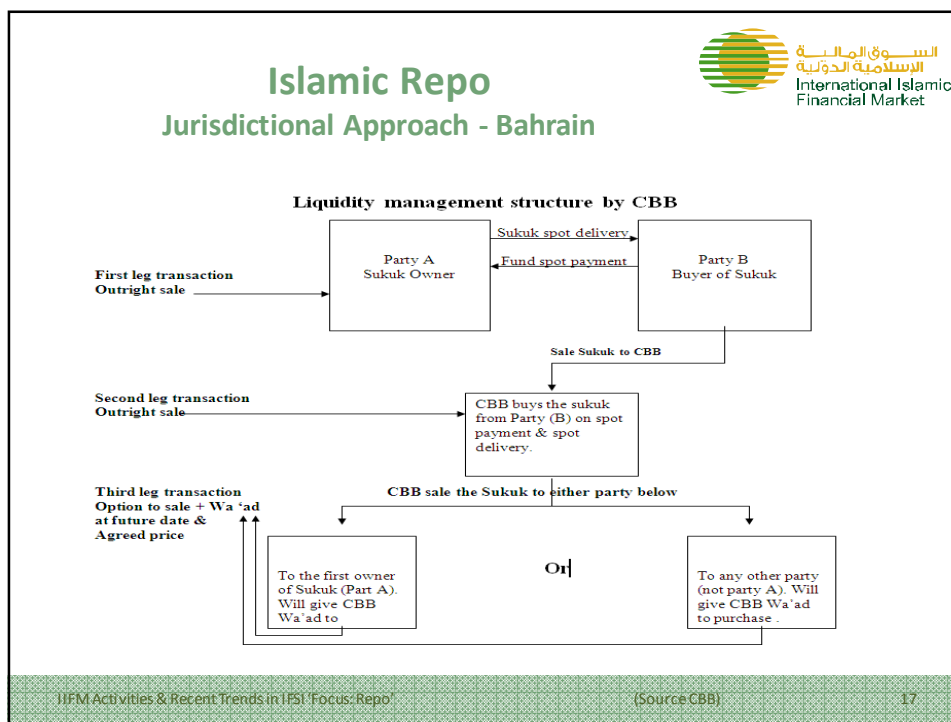
## Repurchase Master Agreement



### ***b) IIFM I'aadat Al Shira'a (Repurchase) Project - objectives***

- Funding of sukuk and other instruments positions
- Liquidity management & cash management
- Sukuk credit & yield pickup
- Larger lines to IFI's for Repo to Collateralization element
- Master document to address all or some of the way features under GMRA
- Better asset & liquidity management
- Increases secondary market liquidity in Sukuk
- Central Bank can use the tool to control money supply
- Better fulfillment of reserve requirements







 السوق المالية  
 الإسلامية الدولية  
 International Islamic  
 Financial Market

## Islamic Repo

### Jurisdictional Approach – Malaysia cont...

- The SECURITIES used for the SBBA is not required to be delivered, unless otherwise agreed by the two transacting parties
- Where the SBBA transaction involves an SECURITIES that does not pay interim dividends or coupon profits (as in the case of NIDC), the amount of proceeds receivable by the seller under the first agreement of the SBBA shall not exceed the nominal value of the SECURITIES
- A licensed financial institution may provide on a regular basis a two-way quotation either by quoting rates or profit-sharing ratio to indicate its willingness to enter into SBBA
- Upon its release, the Guidelines on Sell and Buy Back Agreement shall govern SBBA transactions involving SECURITIES

IIFM Activities & Recent Trends in IFSI Focus: Repo  
(Source: [www.islamic-world.net/islamic-state/malay-islamoneymarket.htm](http://www.islamic-world.net/islamic-state/malay-islamoneymarket.htm))
19


 السوق المالية  
 الإسلامية الدولية  
 International Islamic  
 Financial Market

## IIFM I'aadat Al Shira'a (IS) Project

### Shari'a Considerations – Way Forward

**a) Bilateral Repo Structuring**

- Securities – equivalent securities but different serial numbers
  - ❑ Shari'a View – not possible for two parties to transact using equivalent securities as results in Bai Al Inah
- Undertakings "Wa'ad"
  - ❑ Pricing – 1<sup>st</sup> sale as pure sale  
2<sup>nd</sup> leg as per formula
    - i) Term Repo – fixed term and on Day 1 prices are determined
    - ii) Open Repo – undertaking can be exercised anytime in a given period
    - iii) Buyer undertakes to sell
  - ❑ Shari'a View – I'nah on second sale hence not allowed  
- Fixed price raises Riba issue

IIFM Activities & Recent Trends in IFSI Focus: Repo
(Source: IIFM)
20

## IIFM I'aadat Al Shira'a (IS) Project Shari'a Considerations – Way Forward (cont...)



- Bilateral Repo Possibility
  - Unilateral Wa'ad
  - At Market Price
- Issue
  - Difficult to bridge the gap between market requirement and Shari'a

## IIFM I'aadat Al Shira'a (IS) Project Shari'a Considerations – Way Forward (cont...)



### b) **Tri-Partied Repo**

- Undertaking "Wa'ad"
  - Party A (Bank 1) sells to Party B (Broker)
  - Party B sells to Party C (Bank 2)

*Ideally IFSI should have Central Counter Party (CCP)*

- Possible Structure and Considerations
  - Form of Undertaking b/w A & C
  - Unilateral or simple Wa'ad
  - Whether C has right to exercise Wa'ad
  - Contingent or non-contingent contract

## IIFM I'aadat Al Shira'a (IS) Project Shari'a Considerations – Way Forward (cont...)

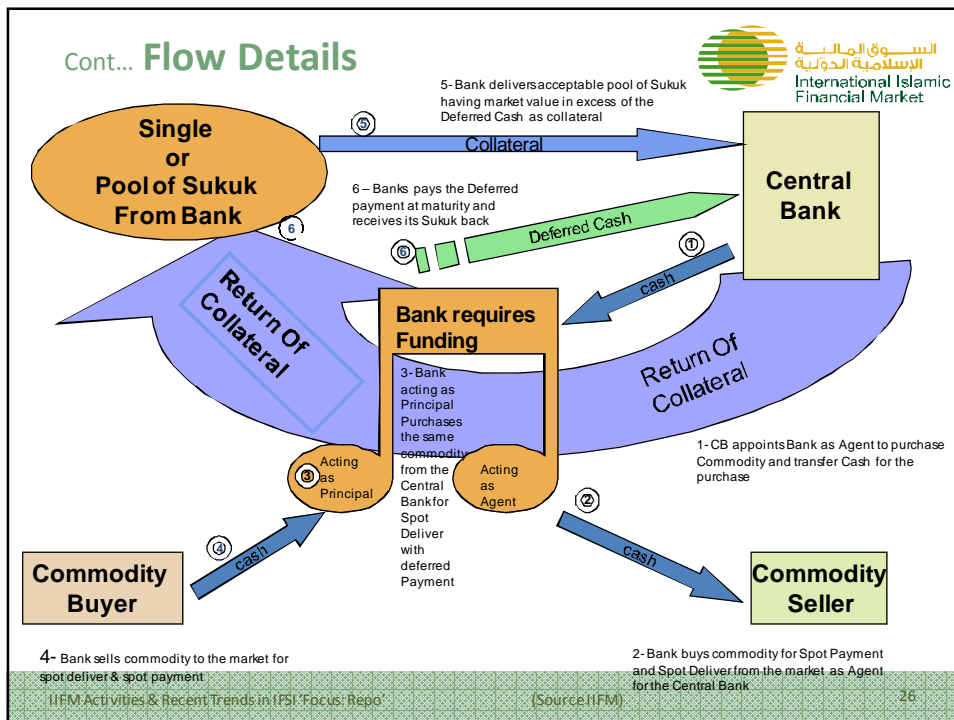
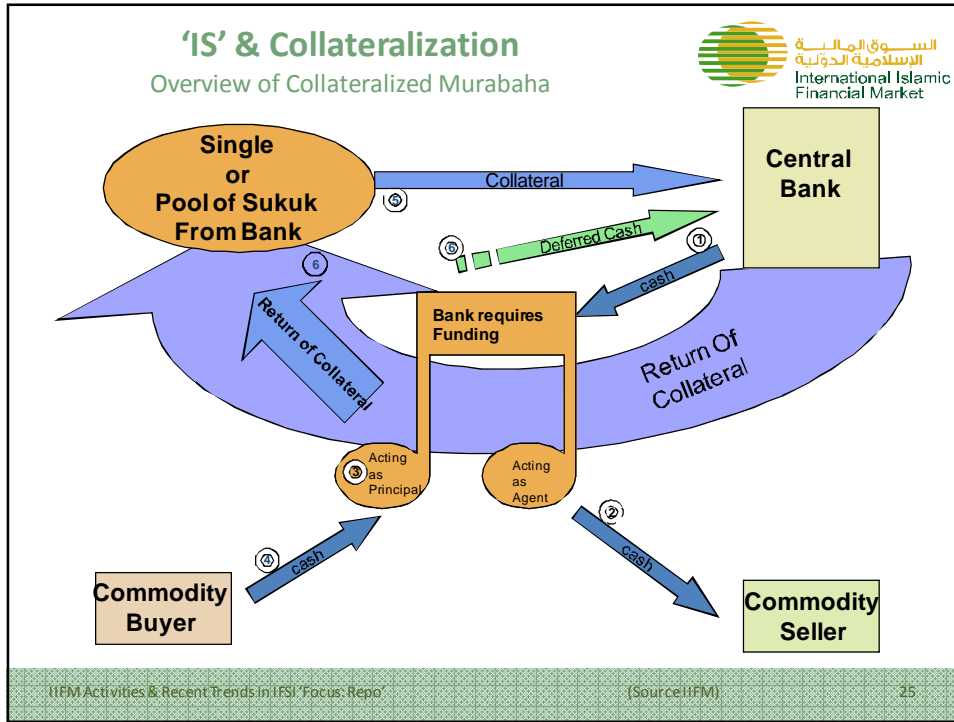


- Overview of Tri-Partied Structure
  - ❑ Party A sells the securities to a Broker against immediate payment
  - ❑ Broker sells the securities to Party B for immediate payment
  - ❑ Party A undertakes to buy back equivalent securities from Party B @ future date and @ cost + profit
- Issues for Consideration
  - 1) Underlying Securities
  - 2) Margin Call
  - 3) Accounting Treatment
  - 4) Broker Credit Risk
  - 5) Income / Dividend Treatment
  - 6) Master Terms
  - 7) Netting Issues

## IIFM I'aadat Al Shira'a (IS) Project Shari'a Considerations – Way Forward (cont...)



- Tri-Partied global 'IS' Master Agreement is possible if the above identified considerations are developed
- Concerted efforts from all stakeholders required



## 'IS' & Collateralization



### **Transactional Steps**


- **Step One** – Both parties agrees on Term of the transaction, the mark up, type of Sukuk, and Margin call parameters (Haircut, Threshold & Base Currency)
- **Step Two** – Central Banks invest \$100 myn Cash for say 1 Month via a Murabaha transaction with a local bank
- **Step Three** – Central Banks receives acceptable Sukuk as agreed by both parties to a value of \$ 110myn to collateralise the exposure and allow 5% variance on both side. Reason to provide 10myn extra coverage is to allow for price fluctuation and to reduce the movement of Collateral back and forth
- **Step Four** – Assuming Collateral fluctuation remains within the band then on the deferred maturity date the Central Bank receives its \$ 100myn + the profit and the Central Bank returns all of the Sukuk Collateral to the Islamic bank

## 'IS' & Collateralization



### **Assuming the Collateral Value Decreases Below the Treshold Variance**

- Bank to provide more same or other acceptable Sukuk
- Provide other acceptable Collateral as previously agreed
- Or Provide acceptable Letter of Credit
- Or Provide Reverse Murabaha
- To bring the collateral level back to 110%
- If non of the above agreed instrument is delivered then the Bank will be in Default




السوق المالية  
الاسلامية الدولية  
International Islamic  
Financial Market

## ‘IS’ & Collateralization

***Assuming the Collateral Value Increase Above the Treshold Variance***

- The Central Bank will Return part of the Sukuk in order to bring it down to 110% of the Murabaha Amount
- Or the Bank may consider not to request this extra amount from the Central Bank if it wishes to leave extra buffer and save of operational cost

IIFM Activities & Recent Trends in IFSI Focus: Repo
(Source: IIFM)
29




السوق المالية  
الاسلامية الدولية  
International Islamic  
Financial Market

## ‘IS’ & Collateralization

***Commitment of Both Parties***

- At All times during the 1 Month Murabaha a 100% to 110 % collateral cover will be maintained against its Deferred payment exposure
- Any Increase above the 115%, the Bank has the right to call collateral back
- Any Decrease below 105%, the Central Bank has the right to ask for Top up

IIFM Activities & Recent Trends in IFSI Focus: Repo
(Source: IIFM)
30



السوق المالية  
الاسلامية الدولية  
International Islamic  
Financial Market

## ‘IS’ & Collateralization

**Notes & Considerations**

- The transaction could be between a Bank and Central Bank or Bank and any Financial Institution
- Sukuk could be clearing house based as well as domestic Sukuk
- Rating benefit is taken as implied
- Other securities which could be used as collateral are not considered at this time
- Use of collateral i.e. Sukuk by CB and FI – probably FI is likely to use Sukuk as compare to CB
- Governing Law – seems English law needs to be used
- Clearing system based Sukuk and its treatment ?
- Accounting treatment for collateral assuming leaving pledge or security interest

IIFM Activities & Recent Trends in IFSI Focus Repo
(Source IIFM)
31



السوق المالية  
الاسلامية الدولية  
International Islamic  
Financial Market

## ‘IS’ & Collateralization

### Documentation, Legal & Regulatory Challenges to Reach Classical Repo Outcome

**Documentation**


- Agency Agreement (IIFM MATP) OR Wakala Agreement
- Transfer Instructions
- Purchase Contracts
- Collateral Documentation

**Collateral Structure**

- Security Interest
  - ❑ Customarily a Security Interest does not transfer title to the assets to the Security Interest beneficiary. Instead the beneficiary would obtain security which it could enforce in the event of default by the Security Interest provider to meet the Secured Obligations or an earlier bankruptcy or other event of default in relation to the Security Provider

IIFM Activities & Recent Trends in IFSI Focus Repo
(Source IIFM)
32




 السوق المالية  
 الإسلامية الدولية  
 International Islamic  
 Financial Market

## ‘IS’ & Collateralization

Documentation, Legal & Regulatory Challenges  
to Reach Classical Repo Outcome

**Collateral Structure (Cont...)**

- Conditions for Security Interest
  - ❑ The Security Interest provider must have the necessary capacity to provide the relevant security interest, and it needs to be practical for this to be checked quickly and easily
  - ❑ Which law governs the formalities for taking security over the secured asset needs to be readily determinable
  - ❑ Readily available documentation so that a Security Interest can be put in place quickly and easily
  - ❑ The Security Interest needs to be robust in the insolvency of Bank

**End result Classic Repo type instrument**

IIFM Activities & Recent Trends in IFSI Focus: Repo
(Source: IIFM)
33


 السوق المالية  
 الإسلامية الدولية  
 International Islamic  
 Financial Market

## ‘IS’ & Collateralization

Documentation, Legal & Regulatory Challenges  
to Reach Classical Repo Outcome

**IIFM Project Team’s View**

- Collateralized Murabaha comes close to achieving Repo like benefits. However, the project team now invites the market and individual institutions to build from this initial ground work as they feel fit for their own businesses

IIFM Activities & Recent Trends in IFSI Focus: Repo
34



**Disclaimer: The document is prepared for information and discussion only. Information may have been condensed or incomplete in case of Repo. This document does not constitute offer by IIFM nor it contains any Shari'a ruling on Repo**

***THANK YOU***

***[www.iifm.net](http://www.iifm.net)***