


Islamic Repo & Collateralization Possibilities and the Role of Sukuk

Euroclear Treasury & Collateral Management Conference
 Thursday, 11th February 2010
 Emirates Palace, Abu Dhabi

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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

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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
- Shariah harmonization in documentation, products and processes

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IIFM Standardization Initiatives



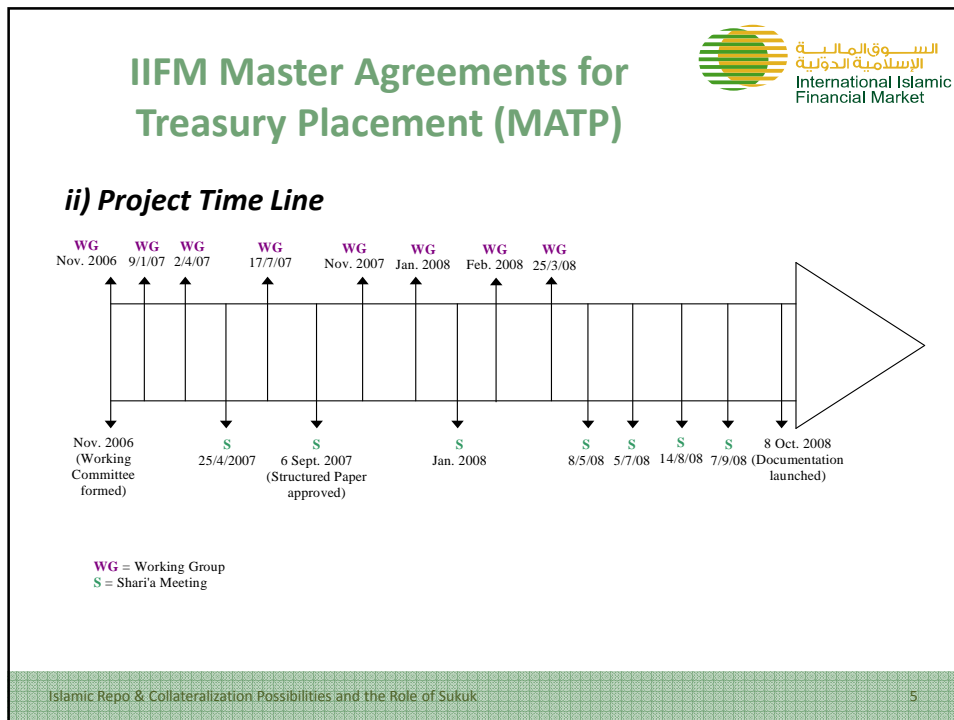
- IIFM Master Agreements for Treasury Placement (MATP) – *completed*
- IIFM/ISDA Tahawwut (Hedging) Master Agreement – *soon to be launched*
- Repurchase and Collateralization prospects – *exploring possibilities*
- Other initiatives – *standardization of products and documentation*

IIFM Master Agreements for Treasury Placement (MATP)



i) Commodity Murabaha – Why Standardize

- 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
- Reduces burden on Shariah scholars – *frees up their time to concentrate on other more flexible and innovative liquidity management products thereby making Commodity Murabaha a supplemental product*



Islamic Repurchase Master Agreement - Possibilities



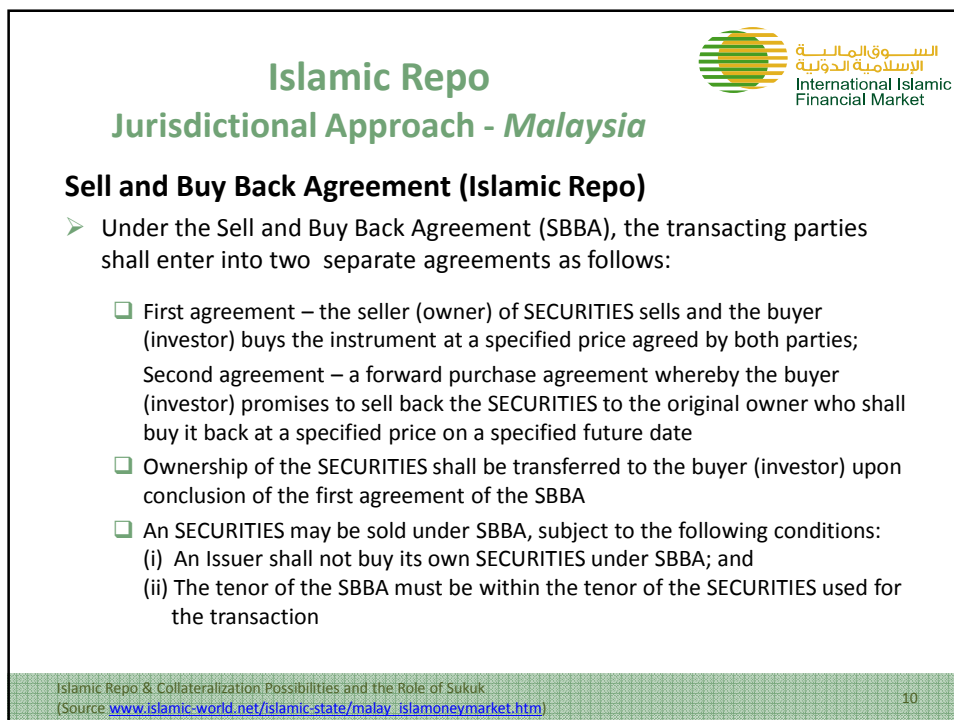
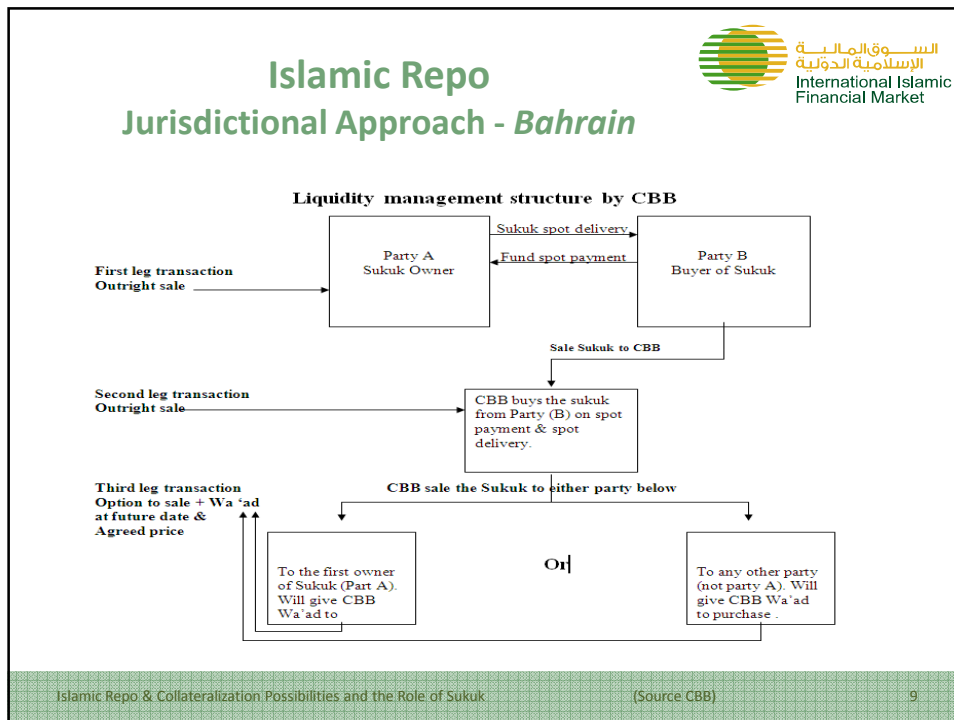
- Why Repo is an important tool
 - Cash and liquidity management
 - Creating liquidity in the underlying instrument
 - Financing and leveraging the investment
 - Credit enhancement and greater volume
 - Role in other structured products (derivatives, swaps etc)
 - Repo oils the wheel of the bond market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


Islamic Repurchase Master Agreement - Possibilities



b) IIFM/ICMA 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





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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)

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IIFM /ICMA I'aadat Al Shira'a (IS) Project

Shariah Considerations – Way Forward

a) **Bilateral Repo Structuring**

- Securities – equivalent securities but different serial numbers
 - ❑ Shariah View – not possible for two parties to transact using equivalent securities as results in Bai Al I'nah
- Undertakings "Wa'ad"
 - ❑ Pricing – 1st sale as pure sale
2nd 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
 - ❑ Shariah View – I'nah on second sale hence not allowed
- Fixed price raises Riba issue

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Shariah Considerations – Way Forward (cont...)



➤ Bilateral Repo Possibility

- Unilateral Wa'ad – based on good faith, non-binding
- At Market Price

➤ Issue

- Difficult to bridge the gap between market requirement and Shariah
- However, certain possibilities may still exist such as exchange of Wa'ad by both parties but having different terms

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Shariah 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/non-binding
- Unilateral or simple Wa'ad
- Whether C has right to exercise Wa'ad
- Contingent or non-contingent contract

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Shariah 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

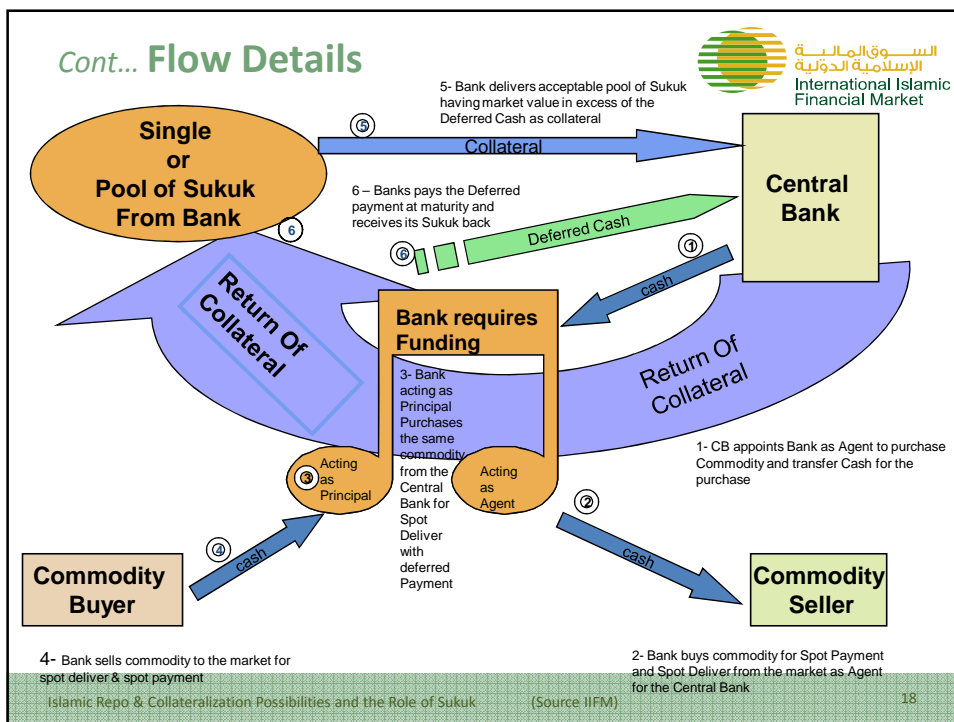
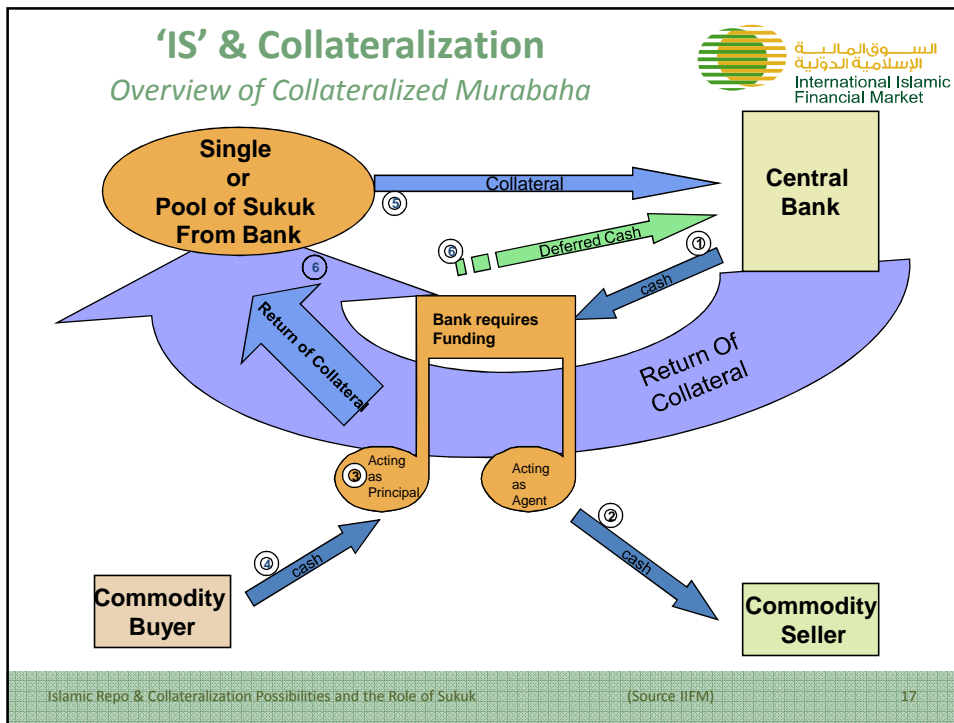
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Shariah Considerations – Way Forward (cont...)

- 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 agree 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

'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

'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



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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

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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

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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

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Documentation, Legal & Regulatory Challenges
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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

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Role of Sukuk in Collateralization



Sukuk Emergence

International Corporate Sukuk Structures

- 2001 – 2005
 - ❑ Ijarah (Dominant structure)
- 2005 – H2 2009
 - ❑ Musharaka, Mudaraba, Exchangeable, Convertible
- H2 2009
 - ❑ Ijarah & Investment

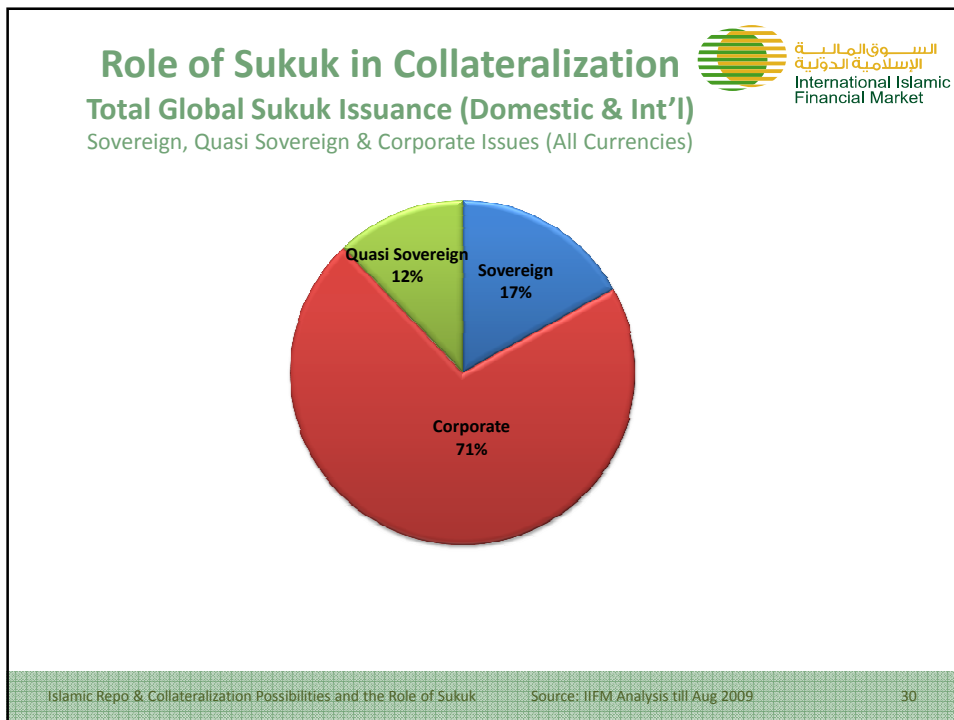
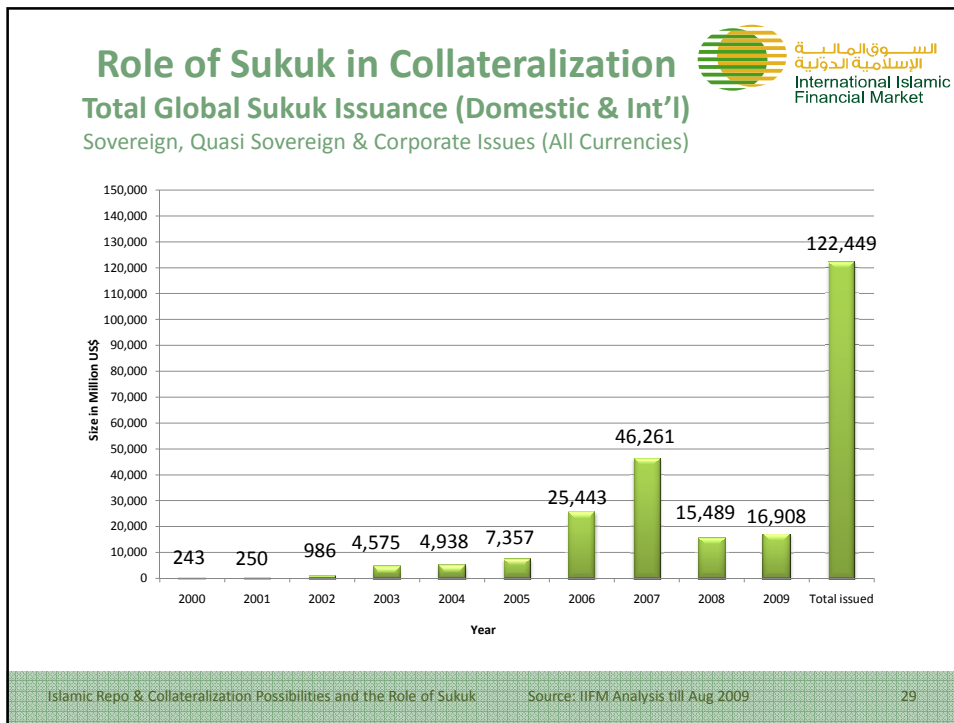
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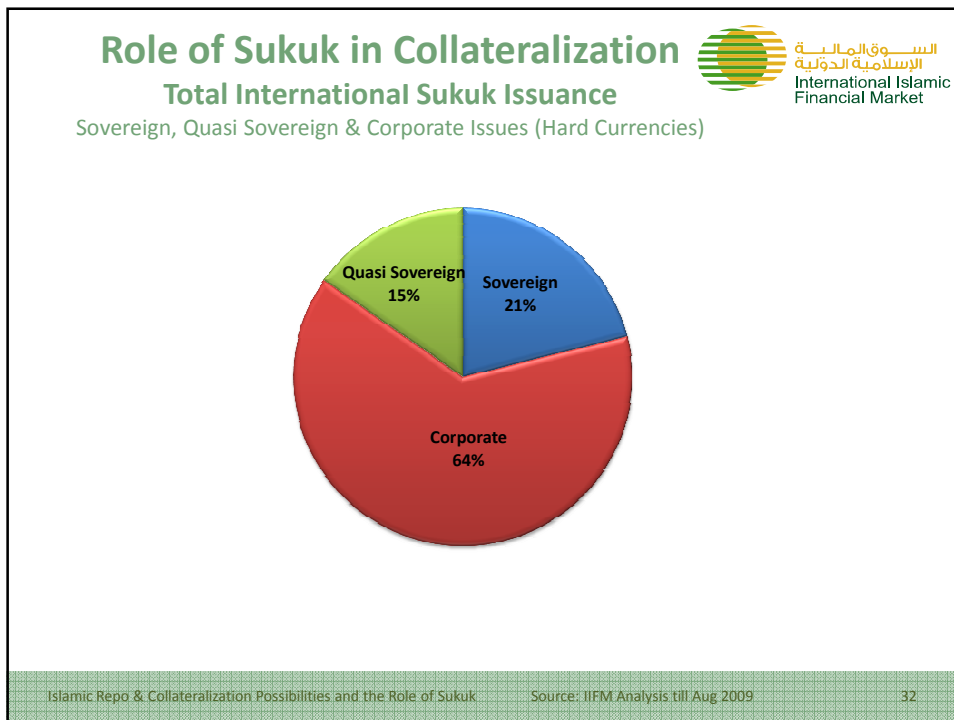
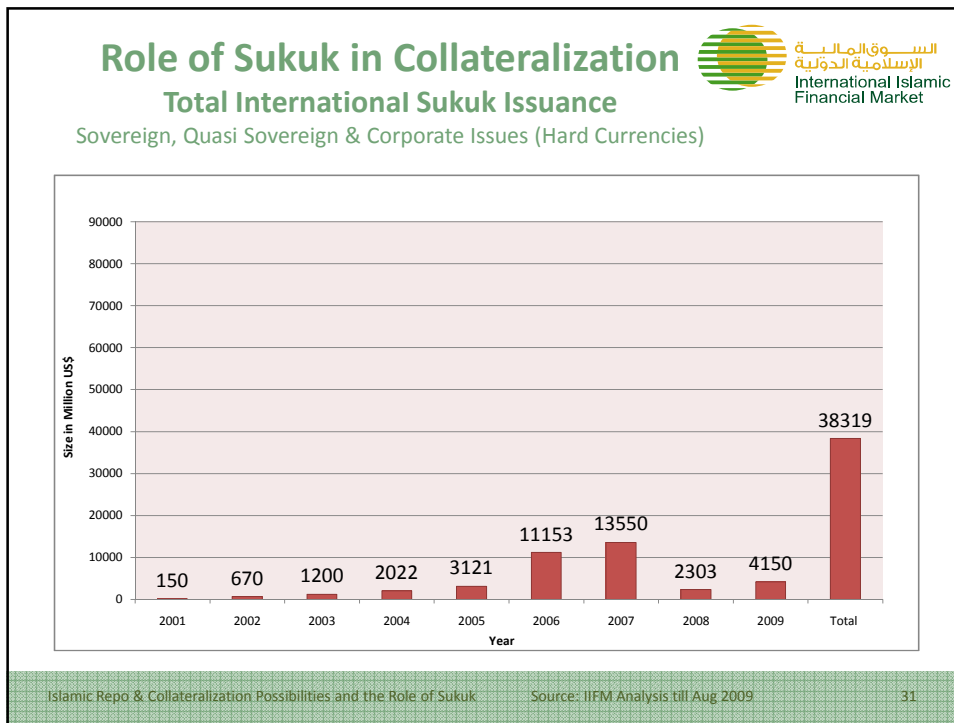


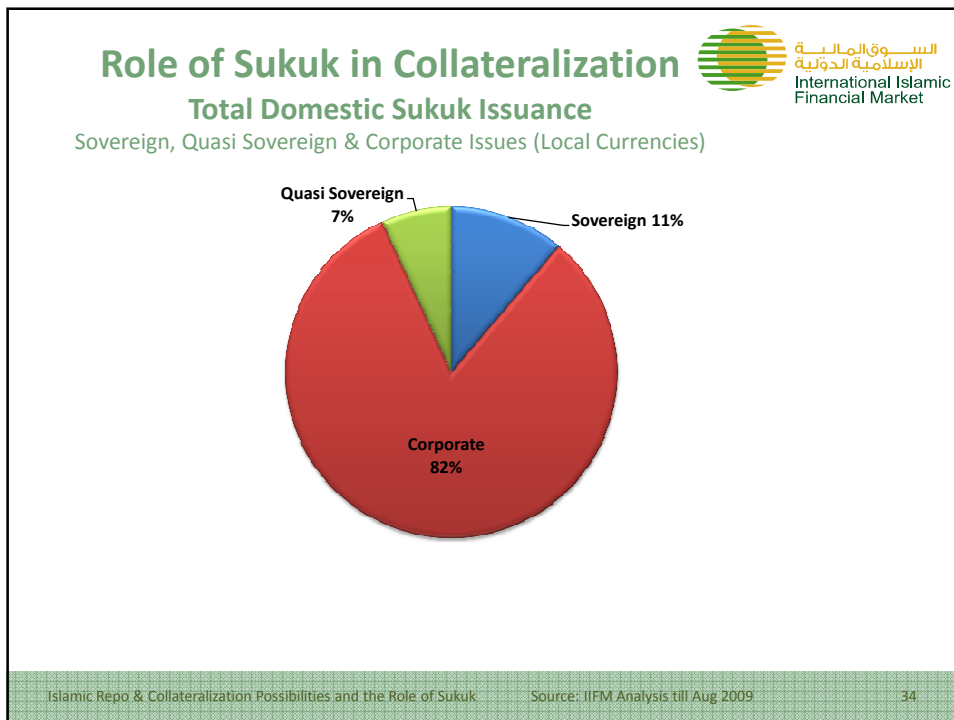
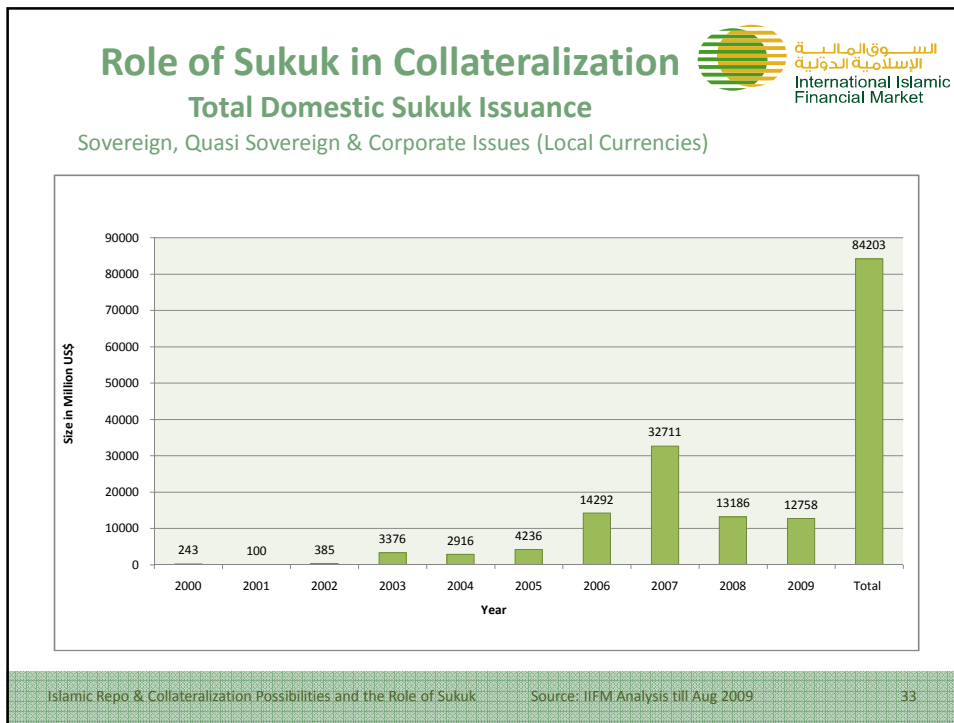
Sukuk Emergence

Structural break-up of international issues			
	No. of issues	Value in USD millions	% of total Value
Ijara	30	13,975	40%
Musharakah	18	7,726	22%
Mudharabah	7	7,255	21%
Islamic Exchangeable Bond	6	3,660	10%
Manfaa	1	650	2%
Hybrid	3	487	1%
Murabahah	3	438	1%
Intifar	1	390	1%
Wakala	1	325	1%
Total	70	34,906	100%

Wherever exchangeability as a feature has been combined with some other Islamic mode of financing or investment such as Ijarah, Musharaka or Mudaraba, we have categorized the Sukuk issue according to the latter and not as an exchangeable bond







Role of Sukuk in Collateralization

Lessons from Corporate Issuance



Asset Based & Asset Backed

- Are Sukuk holders investment pari pasu with other secured or unsecured creditors?
- Do Sukuk holders have title transfer?
- In case of Real Estate, is property freehold?
- Do we have enough quality Sukuk?



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