Islamic Repo & Collateralization Possibilities

IIFM Seminar on Hedging & Liquidity Management in Islamic Finance
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IIFM Reference Paper on *I'aadat Al Shira'a* (Repo Alternative) and Collateralization Possibilities

- **Published on 28th July 2010**
- **Purpose**
  - The Reference Paper aims to provide general information on the concept, operational mechanism and uses of conventional repurchase agreements (known as Repo or Sale and Repurchase agreements) and explore the possibilities for *I'aadat Al Shira'a* (repurchase) as an alternative to Repo
  - The aim is to provide for the Islamic financial institutions, another tool to effectively manage its liquidity as well as to help it finance its inventory of Asset, *Sukuk* and equities

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- **Recommendation**
  - **Concept 3 – Three Party Structure *I'aadat Al Shira'a***

    The three party structure should be explored further by involving an active Repo Stock Exchange such as the clearing company of Istanbul Stock Exchange or bringing other financial institution such as a clearing house or custodian bank who will be willing to assume the risks of acting as a third party and not the agent role as is the case with conventional tri-party repo

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- **Recommendation**
  - **Concept 4 – Collateralized *I'aadat Al Shira'a***

    Institutions may initiate this concept which will give similar results as those achieved by a repo. Moreover, this concept will allow Islamic financial institutions to raise cash to fund the inventory while providing the cash investor a return which is further comforted in form of collateral

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- **Concept 3 – Three Party *I'aadat Al Shira'a* 'IS'**

(i) Overview of Structure

The major difference between a conventional Tri-Party repo and the Three Party 'IS' under consideration is that, in the case of a conventional repo, the role of the third party is that of an Agent while for the Three Party 'IS' the third party will act as a principal even though It is acting in an intermediary capacity between the other two parties. Therefore, the working team has named this structure Three Party 'IS', as the seller, the buyer and the third party are all required to assume risk.

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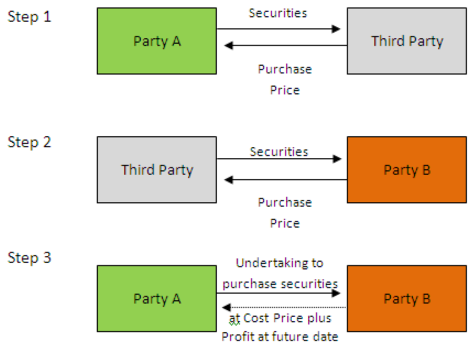
- **Concept 3 – Three Party *I'aadat Al Shira'a* 'IS'**



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Step 1: Party A sells securities to a third party (who may be a broker, a clearing agent, a custodian or another third party) against the payment of cash (ideally the aim should be to find an independent third party such as the clearing house of a Stock Exchange or a custodian bank)

Step 2: The third party immediately sells the securities to Party B against the payment of cash

Step 3: Party A undertakes to Party B to buy equivalent securities at maturity at a specified agreed price.

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(ii) Issues for Consideration

1. **Underlying securities:**

(a) The securities involved need to be *Shari'ah* compliant. *Sukuk* would in principle be satisfactory, as would other *Shari'ah* compliant securities such as *Shari'ah* compliant equities

(b) The parties will need a basis for agreeing what securities are acceptable to them both for these purposes

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(ii) Issues for Consideration

2. Margin

Consideration needs to be given to the following:

A. How to replicate margin maintenance? A *Shari'ah* compliant basis for valuing the collateral and delivering more collateral or returning some collateral needs to be determined in cash or *Sukuk* form
B. Re-pricing of transactions in terms of pricing Data, Hair Cut, Margin Variances and the actual mechanic of booking and transferring the cash or the securities
C. How to deal with margin which is cash? Under conventional repo documentation cash margin represents an interest bearing debt obligation – this could be replicated with *Murabaha* and Reverse *Murabaha*. An alternative may be either to generate cash through a *Murabaha* transaction or to use an instrument like an L/C as an alternative to cash

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(ii) Issues for Consideration

D. How to effect collateralization? In conventional repo documentation, the collateralization technique used is usually netting i.e. the ability to close out and set off in an insolvency where the value of the collateral securities can be determined and applied in set off against the repurchase price. The lack of recognition of set off in many GCC countries means that the applicability and efficacy of this technique would be limited for the present

E. Complicating steps of going through 3 parties every time there is a margin call

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(ii) Issues for Consideration

3. **Accounting Treatment** – Confirmation of the accounting treatment that would be applied to a repo structured in this way.

4. **Third Party Credit Risk** – The parties will be taking settlement credit risk on the third party in respect of its obligations. Any third party involved would also be taking risk on the parties and would need to be comfortable with this.

5. **Income Treatment** – Consideration as to whether there should be a mechanism for passing to Party A the income on coupon or dividend securities received prior to Party A's Undertaking being exercised or whether the income should simply be reflected in the "Repurchase Price"

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(ii) Issues for Consideration

6. **Master Terms** – *Shari'ah* acceptance of the Master terms and conditions have certain obligations which may be regarded by *Shari'ah* as adversely affecting the unilateral nature of the *Wa'ad*.

7. **Party B Undertaking** – Consideration needs to be given to whether an Undertaking from Party B is required to ensure on-sale by Party B of the equivalent securities should their value exceed the "Repurchase Price". From a *Shari'ah* perspective, it may not be permissible to make such an Undertaking binding on Party B.

8. **Netting Issues** – As indicated above, the applicability and efficacy of netting is a practical issue with this structure. There is a need to develop law provisions allowing effective netting.

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(iii) *Shari'ah* issues to be tackled

I'aadat Al Shira'a 'IS' if affected on a three party basis is possible and the recommended approach by some scholars, although resolution is still required on the following:

1. Type of arrangement between A & B and what form of undertaking
2. Whether the undertaking may be a unilateral undertaking or simple undertaking
3. Whether B has the right to exercise: If yes then, this may raise *Shari'ah* issues
4. Contingent contracts and entering the contract now for future (has to be non-contingent contracts)
5. Undertaking by B to A; has to be developed based on different scenarios
6. Linking of undertaking and transactions, keeping in view the *Shari'ah* rulings

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(iv) Conclusion

The working team is of the view that this concept should be further developed based on the above findings and the third party who is willing to step in as principal. Moreover, as mentioned in the background, the 'third party' will be required to assume risk similar to the CBB structure. It is also recommended that Islamic Development Bank (multilateral institution) or clearing company of a major OIC Stock Exchange (could be Istanbul Stock Exchange) or clearing/custodian institution may assume the role of principal in Three Party Concept.

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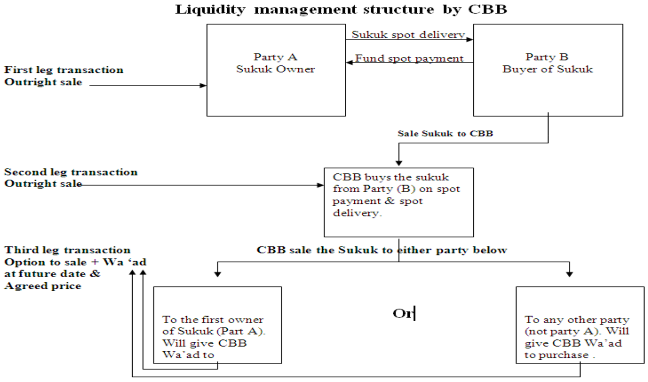
- **Concept 3 – Three Party *I'aadat Al Shira'a 'IS'* Jurisdictional Approach by Bahrain**



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Clearing company as third party - consideration

- Risk Taking – Clearing company do take risk in transaction as against no risk by custodian/agent
- Operational mechanism may need to be developed considering Shari'ah apprehension in three party structures
- CBB liquidity management tool process or innovative process
  - Order Book maintenance by clearing company for forward trades

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In order to make use of parties *Sukuk* portfolios and to initiate the process while further research and deliberation on finding an ideal 'IS' structure may continue, the working team is of the view that a collateralized structure is one of the options which perhaps can be initiated now given the industry's urgent requirement for a workable liquidity management tool.

The proposal is to make use of *Sukuk*, which are currently not utilized in a bank's portfolio, through either a *Murabaha* or *Wakala* arrangement. Since *Murabaha* is more developed and widely used, the working team is of the view that the following proposed structure may be initiated in various jurisdictions so that not only do funds remain within the Islamic system but the required legal procedures can be managed at the jurisdiction level (the suggestion is to seek required legal changes in OIC countries to facilitate the process).

Sukuk collateralization through a *Wakala* arrangement is another option which, if required, can be further developed by the IIFM working team if requested by the industry. Continued...

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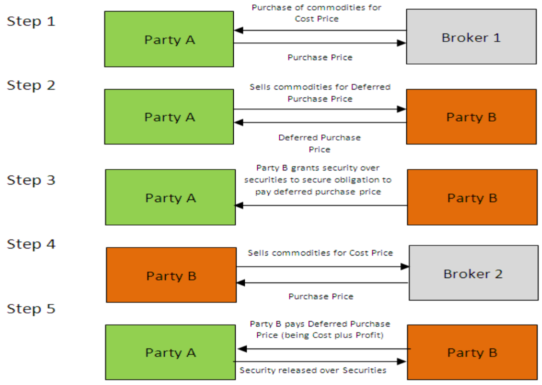
To show how the structure will work the following commodity *Murabaha* based structure is proposed for illustrative purposes only:

(i) Overview of Structure



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Step 1: Party A buys commodities ("Commodities") from a broker 1 against payment of the cash purchase price.

Step 2: Party A sells the Commodities to Party B against payment of a deferred purchase price (being cost plus profit) (the "Deferred Purchase Price").

Step 3: As security for payment of the Deferred Purchase Price, Party B grants security over securities held by it in favor of Party A.

Step 4: Party B sells the Commodities to a broker against payment of the cash purchase price.

Step 5: At "maturity", Party B pays the Deferred Purchase Price to Party A and the security granted in favor of Party A is released.

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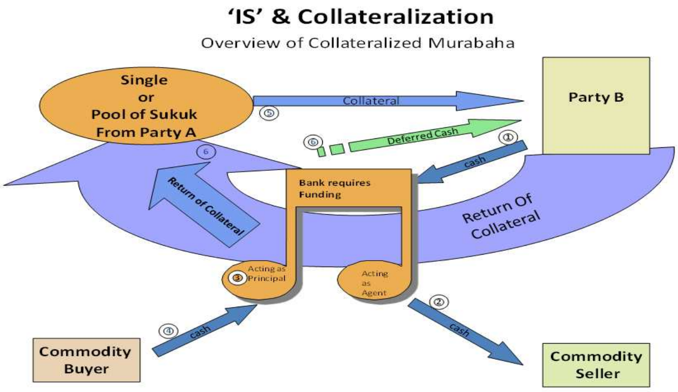
(ii) Working of Collateralization



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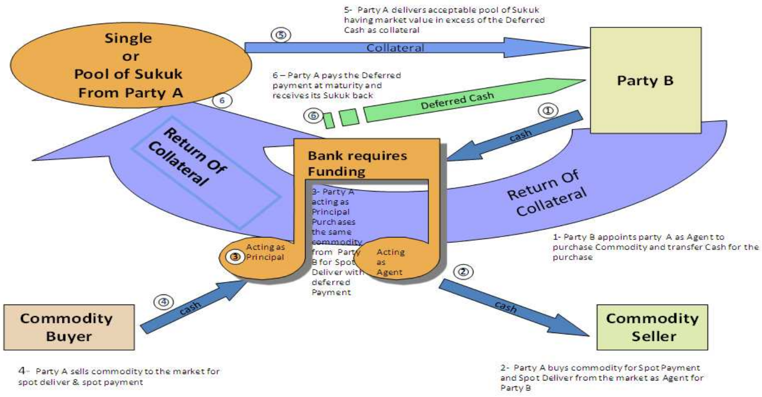

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a) Transactional Steps

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 – Party B invest $100 million Cash for say1 Month via a *Murabaha* transaction with a local bank

Step Three – Party B receives acceptable *Sukuk* as agreed by both parties to a value of $ 110 million to collateralize the exposure and allow 5% variance on both side. Reason to provide 10 million 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 Party B receives its $ 100 million + the profit and the Party B returns all of the *Sukuk* Collateral to the Islamic bank

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b) *Assuming the Collateral Value Decreases Below the Threshold 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 none of the above agreed instrument is delivered then the Party A will be in Default
- The Party B will Return part of the *Sukuk* in order to bring it down to 110% of the *Murabaha* Amount
- Or the Party A may consider not to request this extra amount from the Party B if it wishes to leave extra buffer and save of operational cost

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c) 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%, Party A has the right to call collateral back
- Any Decrease below 105%, Party B has the right to ask for Top up

d) Notes & Considerations

- The counter parties could be Bank and Central Bank, or Banks 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 compared 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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(iii) Issues for Consideration

1. **Taking Security**: For this structure to be practical, it would need to be possible to take security over the securities quickly, effectively and robustly. In addition it needs to be possible for Party A to re-hypothecate the securities over which Party B has granted security.

2. **Securities used as security for the obligation to pay Deferred Purchase Price**: It is presumed that the securities used as security will be limited to *Shari'ah* compliant securities.

3. **Margin Maintenance**: The margin maintenance methodology also needs to be resolved and again needs to be quick, effective and robust. Easiest form would be to add or return *Sukuk* depending on collateral level agreement

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(iii) Issues for Consideration

4. **Broker Credit Risk**: The parties will be taking a credit risk on the commodity broker in respect of its obligations. However, this is similar to standard commodity *Murabaha* documentation.

5. **Re-hypothecation**: In conventional repo, the buyer has an ability to make use of the repo'd securities in its own business, which adds to the economic value of the repo to the buyer. How to replicate this in *Shari'ah* complaint way needs to be determined. Potentially Title Transfer Agreement may achieve the desired result.

6. **Accounting Treatment**: The applicable accounting treatment would need to be clarified.

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- **Proposed Structures Documentation (once the structure is approved)**

Concept 3: Three Party Structure 'IS' – Proposed documentation

1) Party A – Third Party Sale Agreement
2) Party B – Third Party Sale Agreement
3) Undertaking from Party A in favour of Party B ("Party A Undertaking")
4) Undertaking from Party B in favour of Party A ("Party B Undertaking")
5) Master terms and conditions between Party A and Party B

Concept 4: Collateralized 'IS' – Proposed Documentation

1) Party A – Broker Commodity Sale Agreement
2) Party B – Broker Commodity Sale Agreement
3) Party A – Party B Commodity Sale Agreement (to include any other terms between the parties such as events of default etc.)
4) Collateral Document
5) [Potential Title Transfer Agreement]

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