CONFIDENTIAL

INTERNATIONAL ISLAMIC FINANCIAL MARKET (IIFM)

INTER – BANK UNRESTRICTED ON-BALANCE SHEET MASTER *WAKALAH* AGREEMENT

CONCEPT PAPER

1. Background

Given the strict prohibition of *riba* (interest) under the *Shari'ah* (Islamic law), the scope for *Shari'ah* compliant liquidity management is severely limited since it is essential for the Islamic Financial Institutions (IFIs) to manage its excess liquidity in a way that produces a return for them. For many years, IFIs have relied mainly on Commodity *Murabahah* for their liquidity management purposes in spite of issues and concerns related to Commodity *Murabahah* transactions, such as cost of commodity brokerage, amount of *Shari'ah* compliant commodity to cover the transaction volumes etc.

In order to diversify the liquidity management range in the industry, Islamic banks in the last few years have actively used *Wakalah* arrangement/transaction (restricted or unrestricted) as an alternative liquidity management tool which in turn would reduce the over reliance on Commodity *Murabaha*. Although Unrestricted (On-Balance Sheet) *Wakalah* Agreement has potential to emerge as one of the main Islamic inter-bank money market tool, however there are number of issues which need more comprehensive deliberations and extensive discussions, among such issues, the issue of credit, the issue of off-balance sheet and on-balance sheet treatment, operational handling of asset pool & indicative rate of return, impact on shareholders if the risk is transferred back from the *Muwakkil* (investor) to *Wakil* (agent), regulatory environment & applicability of arrangement, accounting issues and legal interpretation. Addressing these issues through standardized approach is likely to provide the Islamic Industry clear direction on whether Inter-Bank Unrestricted On-Balance Sheet *Wakalah* can be developed with features similar to interbank deposit account arrangement (same as Commodity Murabaha accounting treatment) or as it has to be an asset management product.

2. Aims and Objectives

The primary goal and objective of this concept paper is to identify issues related to Inter-Bank Wakalah transactions, carry out constructive deliberation on these issues at the consultative meeting and achieve consensus then to find solutions to these issues and develop a standardized Inter-Bank On-Balance Sheet Wakalah documentation with comprehensive operational process and other matters such as legal, accounting etc. The emphasis is on finding unified solutions of issues related to the usage of *Wakalah* Agreement based on On-Balance Sheet treatment.

More specifically the paper aims to:

(a) Assess the current market practices with respect to Islamic inter-bank *Wakalah* market, issues in unrestricted (on-balance sheet) *Wakalah* arrangement and possible standardized solution to address the issues like the operational process, legal and other items which need to be incorporated in the documentation.

(b) Initiate market consultation, obtain *Shari'ah* guidance and market feedback on Master *Wakalah* Agreement with related template so that the issue of whether the *Wakalah* is just an asset management product or it can be treated similar to inter-bank deposit can be addressed.

(c) Broaden *Wakalah* Agreement usage so that the heavyweight commercial financial institutions may also be able to use this product in the inter-bank market as against present practice of its use by IFIs only.

3. IIFM Standardization Procedure

In order to prepare the groundwork for standardization of Unrestricted (On-Balance Sheet) *Wakalah* Agreement, the normal IIFM standardization procedure has been also adopted in this process as follows:

(a) Formation of the IIFM working group team

IIFM *Wakalah* working group team was formed. The team included experts from European Islamic Investment Bank, Standard Chartered Saadiq, HSBC Amanah, Bank Islam Malaysia Berhad and Kuwait Finance House-Bahrain. IIFM also established contact with Association of Islamic Banking Institutions Malaysia (AIBIM) to collaborate in the standardization efforts of Unrestricted (On-Balance Sheet) *Wakalah* Agreement.

(b) The task of the IIFM working group team

The task of the IIFM working group team is to provide guidance based on the market requirement. In this project the IIFM *Wakalah* working group team and other institutions like Abu Dhabi Islamic Bank and AIBIM have provided valuable guidance and basis to develop the first draft of the Master *Wakalah* Agreement, Operational Process Document and regulatory environment in selected jurisdictions. Keeping in view the industry's requirements, the IIFM

Wakalah working group team has strongly recommended that Unrestricted (On-Balance Sheet) *Wakalah* Master Agreement and supporting templates to be developed.

(c) IIFM's approach of market requirement and consultation

Since the IIFM approach is market requirement and consultation based, therefore, consultative meeting between scholars on IIFM *Shari'ah* Panel and market practitioners is always considered to be the best way to move forward and also to provide a very comprehensive and acceptable document to all parties. Consistent with this policy and approach, the IIFM Board of Directors decided to organize a market consultative meeting between IIFM *Shari'ah* Scholars and practioners where the all issues covered in this concept paper with regard to Unrestricted (On-Balance Sheet) Master *Wakalah* Agreement are presented and feedback from institutions and *Shari'ah* guidance can be obtained. (**IIFM is in the process of organizing the above mentioned Consultative Meeting in the near future**).

(d) Invitation of law firms

At times IIFM appoints top law firms to act as an external legal counsel to its standardization efforts. In this respect, IIFM has invited all the top law firms active in Islamic finance, including from Malaysia, to submit their proposals for *Wakalah* standardization initiative. IIFM received good response from most of the invited firms.

4. *Wakalah* Definition

Wakalah is defined as: *"the act of one party delegating the other to act on its behalf in what can be subject matter of delegation and it is, thus permissible"*[1]. Its basic elements include the form, the subject matter and the two parties in the contract. In general terms it is a non-binding contract for both the parties but in certain cases it may become a binding contract[2].

Wakalah Agreement can be explained under the *Shari'ah* principles as an agency agreement whereby the *Wakil* acts as agent for the *Muwakkil* in accordance with the provisions/conditions of the *Wakalah* contract[3]. Among the provisions/conditions of the *Wakalah* contract is that the subject matter of the agency and the obligations/commitments of the *Wakil* and *Muwakkil* should be known and defined and should not contravene *Shari'ah* principles[4]. An action performed by the *Wakil* as an agent on behalf of the *Muwakkil* is deemed an action by the *Muwakkil* himself.

5. Common *Wakalah* Structure and the Types of its Contract

5.1 Common *Wakalah* structure

The common *Wakalah* structure can be explained briefly as follows:

(a) Restricted *Wakalah* contract, in this contract the *Wakil* (agent) will invest the *Muwakkil's* (principal) funds in pre-agreed asset classes for the period of *Wakalah* and the risk of the asset is transferred to the *Muwakkil*.

(b) Unrestricted *Wakalah* contract (*the main focus of this concept paper*); this product funds the treasury pool which in turn invests in any of the assets on the balance sheet. According to market participants and working team, Unrestricted *Wakalah* tends to be more attractive for on-balance sheet liquidity management.

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[1] Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) *Shari'ah* Standard no.23 (Agency) 2010, clause2/1/1, p.413

[2] *Ibid*. clause2/1/2, p.413.

[3] See AAOIFI *Shari'ah* Standard no.23 (Agency) 2010, clause3, p.414.

[4] *Ibid*, clause5, pp417-418.

5.2 Types of *Wakalah* Contract

There are various types of *Wakalah* used in Islamic finance; the most common is service agency for the management of funds (*Wakala al-istithmar*). In return for undertaking investment services, IFIs are paid a pre-agreed agency fee for carrying out investments under *Wakalah* agreement on the basis of sharing in the profit and loss in the investment. According to AAIOFI *Shari'ah* standards, *Wakalah* contract may take the following forms[5]:

(a) Specific versus General *Wakalah*.
(b) Limited versus Absolute *Wakalah* (restricted versus unrestricted[6])
(c) Paid versus Non–Paid *Wakalah*[7]
(d) Binding versus Non–Binding *Wakalah*[8]
(e) Temporary versus Continuous *Wakalah*.

6. Inter-Bank Unrestricted *Wakalah* Agreement based on On-Balance Sheet treatment

6.1 Inter-Bank Unrestricted (On-Balance Sheet) *Wakalah* Agreement

When presented with the *Wakalah* concept (based on the typical documentation and structure used by most institutions), some argue that it displays the characteristic of a fund management activity. Their primary concern revolves around the customer bearing the risk of loss arising from the underlying *Wakalah* pool of assets and therefore lacking capital certainty. Consequently, there is an argument that deposits taken under classical *Wakalah* need to be recognized as "client money" and accounted for and reported accordingly and that, although suitable for some applications, it is flawed under this interpretation as a money market instrument. Therefore, it is crucial that an appropriate *Wakalah* money market solution comprising of the following two

[5] See for details AAOIFI *Shari'ah* Standard no.23 (Agency) 2010, clause4, pp.415-417.
[6] Unrestricted *Wakalah* Agreement for Islamic Inter-bank market based on On-Balance Sheet treatment is the main focus of this concept paper.
[7] *Ibid*, p415.
[8] *Ibid*, p416.

distinct parts: (i) Legal and (ii) operations/risk management be developed as a standard in addition to Master *Wakalah* Agreement.

(a) Legal

When restructuring the classical *Wakalah* arrangement, the challenge is therefore to transform the risk of *Wakalah* to rank *pari passu* with a normal senior unsecured obligation of the deposit-taking institution while retaining the key *Shari'ah* feature of no explicit capital guarantee. This could be achieved by amending the *Wakalah* agreement to incorporate the following features:

(i) Undertakings by the deposit-taking institution relating to the basis on which funds are received and will be dealt with, including early termination if at any time the deposit-taking institution believes that the expected maturity proceeds may be lower than that indicated to the client, i.e. the *Wakalah* becomes immediately repayable (placement amount plus accrued profit) if the there is reduction in the credit quality of one or more assets in *Wakalah* portfolio or if returns are too low to meet the target profit rate; and

(ii) Compensation to the client for any loss he may suffer due to the deposit-taking institution's failure to comply with the terms of the agreement, including circumstance where it negligently fails to adhere to (i) above.

It's suggested to change the wording of the feature (ii) into two parts as follows:

Part 1:

"Deposit taking institution is not entitled to get his fee due to its failure to comply with the terms of the agreement, including circumstance where it negligently fails to adhere to (i) above"

Muwakil may ask wakil to compensate loss, if and only if, wakil acts beyond the authority which has given to him by Muwakil. Hence wakil is not responsible to compensate loss due to low return thus the term "including circumstance where it negligently fails to adhere to (i) above" is unacceptable. Moreover, the term "any loss he may suffer" is unacceptable and must be stated in certain limit of responsibility. Hence:

Part 2:
"Compensation to the client for any loss he may suffer at maximum of XXX due to the deposit-taking institution's failure to comply with the terms of the agreement".

(b) Proposed Operations/Risk Management Framework

It is essential that a comprehensive operational risk process is put in place for on-balance sheet unrestricted *Wakalah* for Islamic inter-bank market.

It is proposed that the deposit taking institution implement robust front and middle office systems to monitor compliance with the legal structure and to achieve internal objectives of not having to repay the deposit early thereby adversely impacting on liquidity.

As a *Wakalah* deposit is held against a portfolio of assets, it is necessary first to determine whether the portfolio should target absolute returns or returns as a spread against a benchmark index. Longer term assets in general produce a higher absolute return than short term assets. At the outset it is imperative that the deposit taking institution formally confirm and record amongst others the following policy decisions through its relevant sanctioning authorities, i.e.

(i) All "debt" like transactions is automatically deemed components of the *Wakalah* pool unless specifically excluded. Therefore, the pool typically comprises *Sukuk*, term financings and money market placements but excludes real estate, equity and quasi equity.

(ii) The decision to honor "indicative" profit rates should the *Wakalah* portfolio return fall below the rate indicated on any *Wakalah*, whilst recognizing that it would be objectionable to *Shari'ah* for this to be a condition of the placement.

It's proposed to change/rewording this term (ii) as follows:

"Deposit-taking institutions may have internal policy to honor "indicative" profit rates should the Wakalah portfolio return fall below the rate indicated on any Wakalah, whilst recognizing that it would be objectionable to Sharia for this to be communicated to any external parties nor as a condition of the placement"

(iii) Mandate and delegate authorities to a designated individuals and committees, e.g. the Treasurer and Asset & Liability Management Committee (ALCO) to monitor the portfolio daily (Treasurer) and weekly (ALCO) and consider the constituent components (assets and liabilities) of the *Wakalah* portfolio:

a) Include new assets entered into, for example day's Commodity *Murabahah* and *Wakalah* money market transactions.

b) Exclude any transactions (assets) where repayment is doubtful or likely to become doubtful. Advisable to agree mark to market thresholds on assets as indicators/guidelines.

c) The portfolio return is compared to the returns indicated. If indicated returns fall below the portfolio return this is flagged and a specific decision noted to honor indicative returns. This decision should be post event communicated to the deposit-taking institution's *Shari'ah* supervisory body for recording.

As can be derived from the above, it is recommended that a relative return for *Wakalah* deposits be decided upon. This means that if, say, a 3 month deposit is taken under *Wakalah* at a spread of Libor + 10, as long as the average return of each portfolio asset is greater than Libor + 10 for each asset's maturity date, the target return is being achieved for the portfolio as a whole.

For example, the deposit-taking institution has a counterparty looking to invest US$40 million for 2 months and has the following assets:

Wakala Asset Portfolio				
Asset	**Amount**	**Tenor**	**Profit Rate**	**Libor**
Asset A	$20,000,000	1 week	1.25%	1.00%
Asset B	$10,000,000	1 month	2.05%	2.00%
Asset C	$10,000,000	3 months	3.10%	3.00%
	$40,000,000			
Average profit rate			2.13%	
Average Libor			2.00%	
Spread to Libor			0.13%	
2 month US$ Libor			2.05%	

The deposit taking institution's *Wakalah* portfolio produces an average return of 2.13%. If the deposit-taking institution offers the customer this return for 2 months, the customer is likely to transact, especially if the customer is another bank. The spread to 2 month Libor of the *Wakalah* portfolio is 8bp (0.08%). By benchmarking against the average spread to Libor of its assets, the deposit-taking institution can now target a return of up to 2.13% without breaching its portfolio returns. This calculation is undertaken each time a new asset or liability as added to or removed from the portfolio (this is just an example)

It is important to recognize that the value of assets in the *Wakalah* portfolio must at all time equal or exceed the value of *Wakalah* deposits.

Constant monitoring to the portfolio for any material deterioration in asset quality is essential and required in this process. These deterioration assets should be excluded from the portfolio before losses are sustained.

6.2 Scenario Analysis:

Problem	Solution
(i) Asset quality questionable – possibility of default becomes a concern	Remove questionable asset from portfolio.
(ii) Portfolio rate falls below indicated rate	Honor target rate indicated. Reduce target returns for new customers. Advise *Shari'ah* Supervisory Board.
(iii) Portfolio size is not sufficient to cover total nominal value of deposits	Either (a) allocate sufficient assets to portfolio; or (b) do not renew maturing *Wakalah* deposits.

The proposed operational process, subject to further development, is key element of making the unrestricted *Wakalah* as on-balance sheet product. The collective investment scheme may be taken as a reference.

7. Other Issues Requiring Market Feedback and *Shari'ah* Guidance

7.1 Indicative Rate of Return and Guarantee on Return

It is important to emphasize here that the *Wakalah* by nature is an agency agreement and not a conventional deposit account arrangement that guarantees a fixed return. Therefore, it is a basic principle of *Wakalah* investment under the *Shari'ah* that the amounts invested and the returns on such investment cannot be guaranteed by the *Wakil*. Hence, any *Wakalah* agreements contain provisions that aim to guarantee the *Muwakkil* a certain profit or a minimum return on the principal amount will be considered as violation of *Shari'ah* principles. Under a *Wakalah* agreement, the principal (*Muwakkil)* and the agent (*Wakil*) both share in the profit and the risk of loss. The expected profits specified in a *Wakalah* agreement are indicative only and do not constitute a guarantee of the return. **"If the Wakil makes a profit by the maturity date, the profits belong to Muwakil, and Wakil is entitled for Wakalah fee in pre-agreed amount or pre-agreed percentage of asset under management. Conversely, if a loss is made this loss is borne by the Muwakil in the absence of gross negligence, fraud or willful default by the Wakil"**

In the *Wakalah* arrangement, the agent (*Wakil*) is often required to present a business plan or a feasibility report/study to the principal (*Muwakkil*) before the *Muwakkil* agrees on investing its money with the *wakil*. Such business plan is often indicative of the returns that the *Wakil* expects to make on the investment. In a normal market, feasibility reports may be relied on by the *Muwakkil* in order to decide whether to invest with the *wakil* or not, however where the market is volatile relying on such reports may be a problem. Where the economy is witnessing a downturn, ***it becomes difficult to rely on predicted rate of return; hence, a methodology based on operational process mentioned earlier could be incorporated to overcome this issue.***

7.2 Capacity Investment Risk in *Wakalah* transactions

The issue of guaranteeing a minimum return on the *Muwakkil*'s investment raises further questions in relation to the capacity of the *Wakil* to give such guarantees and whether or not the *Wakil* can renounce his obligations under the *Wakalah* agreement on the basis of lack of capacity. This is the exact point highlighted in the case of the Kuwait-based company The Investment Dar (TID) and BLOM Development Bank SAL of Lebanon (Blom Bank). This case, however, highlighted the issue of capacity risk and has caused Islamic finance institutions to come under scrutiny by rating agencies that are now prompted to evaluate additional risks when assessing such transactions. For this reason, it is recommended that measures are taken such as representations and warranties be included in *Wakalah* arrangements to underpin capacity and *Shari'ah* compliance and to provide expressly that neither *Wakil* nor *Muwakkil* can renege/default on their stated contractual obligations on the basis of non-compliance with *Shari'ah* etc. (as per our research most of the institutions are now including the capacity risk clause as a standard clause in their master agreement).

7.3 Mixing of Funds versus Insolvency

Based on general market practice, when a *Muwakkil* invests money with the *Wakil* under a *Wakalah*, such money is usually mixed with the *Wakil*'s own pool of funds. In the event that the *Wakil* becomes insolvent, the *Muwakkil*'s money will be mixed with the *Wakil*'s other money and may well be treated by the liquidator in certain jurisdiction's law governed insolvency as part of the *Wakil*'s liquidation assets. For this reason, in some jurisdictions, where there is an absent insolvency remote trust laws, investors are advised to consider this risk when investing their funds under a *Wakalah* agreement. Due to this reason it is recommended that a reference pool of assets is created and should be managed as per the proposed *Wakalah* operational process.

7.4 Changing of the Reference Asset Pool

Changing of the reference asset pool as and when required under operational process guidelines (may have legal implications e.g. under U.A.E. law this can be categorized as discretionary investment rather than a deposit). ***Moreover, it is proposed that the pool of assets to be treated as reference pool and not investment pool.***

The proposed wording as follows:
"Moreover, it is proposed that deposit-taking institutions may have several pool of asset and may have a certain pre-agreed method / formula to calculate Muwakil's return from those several pool of asset. Return to Muwakil must be based on actual investment pool with flexibility on calculation method.

7.5 Honoring an Indicated Profit Rate versus Low Return of Portfolio

A policy of honoring an indicated profit rate, in the event the portfolio return is lower than the indicated profit rate or certain assets from the reference pool need to be taken out due to not meeting the criteria under the operational process, may have *Shari'ah*, legal, accounting treatment and shareholders implications and this need to be addressed.

On the other hand the requirement of taking *Shari'ah* approval on each instance will become cumbersome and if in principle an Islamic bank's *Shari'ah* board allows it then it doesn't need to approve individual transactions.

Proposed wording for the above paragraph (On the other hand the requirement of taking……..) as follows:

"Deposit-taking institutions may have internal policy to honor "indicative" profit rates should the Wakalah portfolio return fall below the rate indicated on any Wakalah, whilst recognizing that it would be objectionable to Shari'ha for this to be communicated to any external parties nor as a condition of the placement"

8. Issues to Be Researched

(a) What will be required to make the *Wakalah* standard agreement comply with laws of jurisdictions where Islamic finance is practiced?

(b) Issues related to central bank regulations, accounting treatment, capital allocation need to be studied extensively.

(c) Should operating standard be made as compulsory for using the *Wakalah* document?

(d) Transfer of risk from fund placing institution back to fund taking institution and its impact to shareholders equity is a critical factor to be addressed in light of *Shari'ah* and also its legal implications.

(e) The possibility of funds taking entity to be able to disclose the asset pool, if required, to the *Muwakkil* in order to address the issue of transparency in most of the *Wakalah* arrangement.

9. Conclusion

The International Islamic Financial Market (IIFM) as always strives to bring a very strong combination of expertise to enhance its global standardization efforts.

The IIFM Board of Directors and its members provide valuable advice and guidance, while other institutions from the industry also contribute tremendously in IIFM efforts to develop the industry.

This team spirit collaboration created the ground-breaking Islamic hedging product document, which has added tremendous value to the industry. With the backing of IIFM founding members, permanent and non permanent members and the market participants, IIFM will continue to pilot more documentation initiatives for the industry, a focused strategic working plan that will help to produce more genuine, comprehensive standardized Master Agreements for the Islamic and non Islamic global financial industry. This concept paper is an example of the IIFM efforts in this regard. Hence, the general objective of this paper is in line with IIFM efforts to increase the awareness of Islamic banking products and documentation standardization and its importance to the industry development and integration.

This paper is put together by IIFM, based on Wakalah working team guidance and contribution. As identified by the working team, the Inter-Bank Unrestricted On-Balance Sheet *Wakalah* is quite often used by Islamic Banks for meeting their money market liquidity requirements and based on initial assessment standard Inter-bank Wakalah agreement will assist the Islamic banks in meeting these requirements.