Master Collateralized Murabahah Agreement
Operational Guidance Memorandum

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In the Name of Allah, the Most Gracious, the Most Merciful
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1. **Introduction**

In tandem with the widening international outreach, there has been a steady increase in product innovation in Islamic finance. The product range has now expanded into an extensive spectrum of retail financing and sophisticated financial products such as Islamic liquidity management instruments etc. and certainly, the dynamism of *Shari‘ah* has been also an important driving force in contributing to the accelerated pace of innovation in Islamic finance.

IIFM is focused on the Islamic Capital & Money Market segment of the Islamic finance industry. Its primary focus lies in the standardization of Islamic financial products, documentation and related processes at the global level. In its continued efforts to find alternative liquidity management solution for IFIs, IIFM has aimed, through this Master Collateralized *Murabahah* Agreement (MCM) to address the issues and diversity in practices around Collateralized *Murabahah* transactions, as especially, there is a near consensus among the Shari‘ah scholars that the conventional repo as a liquidity management and credit-risk mitigation instruments cannot be replicated in Islamic Finance because of its non Shari‘ah compliance features such as buying and selling with the same counterparty, reuse of the collateral by the creditor.

The repo is a collateralized transaction whereby securities are transferred from one party to another as collateral for financing. In an event of default the seller may fail to repurchase the securities sold at the maturity date. Consequently, the buyer may keep or liquidate the securities delivered as collateral in order to recover the financing amount. These securities, however, may have lost value since the outset of the transaction as the securities are subject to market movements. To mitigate this risk, repos are often over-collateralized as well as being subject to daily mark-to-market with margin calls while the credit exposure is maintained with an agreed threshold.

This financing and collateral method has made the conventional repo arrangements not in conformity with the Shari‘ah principles, hence, finding a Shari‘ah compliant alternative has become something absolutely essential and very imperative in order to meet the urgent needs and requirements of the IFSI.
2. **Objective of this operational guidance memorandum**

The purpose of this operational guidance memorandum is to highlight and provide clarification on the key operational aspects of the IIFM Collateralized Murabahah Agreement (the “MCM Agreement”) for use by Islamic financial services industry (IFSI) participants. The analysis provided in this explanatory memorandum will, in many cases, help to identify the key issues that may need further consideration by the counterparties to the contract.

The defined terms used and the references made in this explanatory memorandum are to be read in conjunction with the definitions and the detailed clauses contained in the MCM Agreement. However, further analysis and interpretation will be needed in order for any potential user of the MCM agreement to consider the potential impact of this guidance memorandum in the context of each IFSI’s own circumstances, the legal and regulatory environment under which it is operating and the particular facts of individual transactions.
3. **Need for the standard documentation on liquidity management instrument**

   **Why IIFM, based on the market consultation, decided to develop Shari ‘ah compliant standard documentation on Collateralized Murabahah (CM)?**

   Liquidity management instruments are a very important tool that can be used to facilitate and manage the liquidity of financial institutions, allowing it to operate at its optimal level and keeping the overall banking system running smoothly. It is specifically used to absorb surplus or add liquidity in the market. Previously, most of the Islamic liquidity management instruments had no alternative but to carry market or credit risk through transaction structures based on Murabahah, Mudaraba, Restricted Wakalah and in recent times Unrestricted Wakalah. There was a further proposal in the market to introduce liquidity management instruments based on clean and interest free loan between Islamic financial institutions while reducing credit and market risk management. In response to this, in order to fulfill the need of short-term liquidity shortage, an additional instrument for managing liquidity in the Islamic financial system was called for.

   IIFM, in its continued efforts to find alternative liquidity management solution for IFSIs, has aimed to address the issues and diversity in practices around Shari’ah liquidity management transactions. Through its research and industry consultation process in this regard IIFM has developed this Master Collateralized Murabahah Agreement that have been designed in order to meet the urgent requirements of the IFSI in this regard.
4. General

4.1 - Definition

Murabahah Contract in respect of this MCM Agreement

What is Murabahah Contract in respect of this MCM Agreement?

"Murabahah Contract" means, in respect of a Collateralized Murabahah Transaction, an individual contract made pursuant to Clause 2 (Collateralized Murabahah Trading) by the exchange of an Offer Notice and a corresponding Acceptance Notice between the Seller/Secured Party/Al-Murtahin and the Buyer/Chargor/Arrahin.

4.2 - Collateral/Mortgage /Arrahn

What is collateral/mortgage /Arrahn?

In the context of Islamic finance, collateral/rahn refers to a contract of security. And conceptually, it means requiring a particular asset to be made subject to security for a financing or loan so that in the event of default by the financing receiver i.e. debtor, the financing or the debt may be satisfied out of the value of the security or the financed asset.

Mortgage /Arrahn is defined as: “to make financial asset or the like tied to a debt so that the asset or its value is used for repayment of the debt in case of default”. (See AAOIFI Shari ‘ah Standard no 39 “Mortgage and its Contemporary Applications”, Item 2 “Definition of Mortgage”.

It is an arrangement whereby a valuable asset is placed as collateral for a debt. The collateral may be disposed of in the event of a default.

4.3 - Use of Sukuk as collateral (Collateral Type)

Is it permissible to use Sukuk and securities etc as collateral?

Yes. “it is permissible to mortgage the financial papers and Sukuk which can be issued and transacted according to Shari ‘ah, such as Islamic Sukuk and shares of Islamic financial institutions. The shares of the companies whose original activities are permissible can also be added to this category” (See AAOIFI Shari ‘ah Standard No. 39 and No.21).

It further said: “It is permissible to mortgage usufruct-based Sukuk which represent common shares in the usufructs of specific assets, or assets in the form of a specific indebtedness. This should be taken with due consideration to Shari ‘ah Standard No.17, on Investment Sukuk, items 5/1/5/2”.

4.4 - Use of non Shari ‘ah compliant financial papers as collateral (Collateral Type)

Is it permissible to use non Shari ‘ah compliant financial papers as collateral?

No. According to the AAOIFI Shari ‘ah Standards: “It is impermissible to mortgage the financial papers and Sukuk that should not be issued or transacted according to Shari ‘ah, such as interest-based bonds, preference shares and enjoyment shares” (see Shari ‘ah Standard No. 21, on Financial papers: Shares and Bonds, items 2/6 and 2/7). Such financial papers include also traditional investment certificates, certificates of traditional investment deposits and shares of the companies that pursue Shari ‘ah-banned activities like manufacturing of alcohols, swine trade and dealing in Riba” (see Shari ‘ah Standard No. 21, on Financial papers: Shares and Bonds, item 2/1 and Shari ‘ah Standard No. 14, on Documentary Credits, items 3/4/1 and 3/4/2). Among these financial papers also are shares of traditional financial institutions, shares of traditional financial companies, shares of traditional insurance companies and shares of companies which originally pursue permissible activities, yet Riba-based and other prohibited dealings constituting a predominant part of their activities”.

So it is permissible in Shari ‘ah to use Shari ‘ah compliant tradable instruments such as equities and Sukuk be it International or Domestic, as collateral. Whereas it is not permitted to under any circumstances in Shari ‘ah to mortgage several things of which include, interest based bonds, preference shares, non Shari ‘ah compliant investment certificates, shares of a company where its activities are non Shari ‘ah compliant such as dealing and trading in Riba, alcohols, swine etc.
5. **IIFM Master Collateralized Murabahah Agreement (MCM)**

### 5.1 - Master Collateralized Murabahah Agreement

**What is the IIF Master Collateralized Murabahah Agreement?**

The MCM Agreement is a master agreement or framework agreement which sets out terms upon which the parties to the MCM Agreement (Parties) can subsequently enter liquidity management arrangements.

### 5.2 - Purpose of the MCM Agreement

**What is the purpose of this MCM Agreement?**

The purpose of the MCM Agreement and each subsequent Collateralized Murabahah Transaction is to allow a Buyer an opportunity to raise liquidity by creating security over its Shar 'ah compliant assets.

### 5.3 - Entering into the MCM Agreement

**Does entering into this MCM Agreement give rise to any transactions?**

No. Entering into the MCM Agreement does not give rise to any transactions. After the Parties have entered into the MCM Agreement, they may subsequently enter into further arrangements which will be subject to, and governed by, the MCM Agreement.

### 5.4 - Signing of the MCM Agreement

**After the signing of this MCM Agreement are there any further arrangements the Parties may subsequently enter into?**

Yes. The further arrangements the Parties may subsequently enter into will be single or multiple Murabahah transactions (otherwise known as cost plus profit financings) under which the financier (Seller) buys the asset from the third party broker or supplier at market value (cost) for spot delivery and spot payment and immediately sells this asset to the customer (Buyer) for the agreed marked up price (cost plus profit) to the customer on a spot delivery and deferred payment basis. The terms of the sale of the assets between the Seller and the Buyer are documented as a *Murabahah Contract*.

The deferred payment obligation(s) of the Buyer under (each of) the Murabahah Contracts(s) are collateralized by the Buyer (as Chargor) granting a security interest to the Seller (as Secured Party) over certain Shari ‘ah compliant assets (which may
include, without limitation, Sukuk, cash, and Shari ‘ah compliant securities) (Collateral).

Each Murabahah Contract shall, together with the granting of a security interest under the MCM Agreement, form a Collateralized Murabahah Transaction.

5.5 - Parties to the MCM Agreement

What is the role of each Party to this MCM Agreement?

One Party to the MCM Agreement will be the Seller/Secured Party/Al-murtahin who shall be the seller of commodities/goods under the Murabahah Contracts. It shall also have security granted in its favour in relation to the deferred payment due under such Murabahah Contracts by the buyer.

The other Party to the MCM Agreement will be the Buyer/Chargor/Arrahin who shall be the buyer of commodities/goods under the Murabahah Contracts and shall have a deferred payment obligation. It shall grant a security interest in favour of the Seller/Secured Party/Al-murtahin in relation to its deferred payment obligations under such Murabahah Contracts.

So, one Party shall always be Seller/Secured Party/Al-murtahin and the other Buyer/Chargor/Arrahin.

5.6 - Reverse of the Parties roles

Is it possible to reverse the roles of Parties to this MCM Agreement?

The MCM Agreement is generally intended to be applied between parties in the capacities in which they entered in to it on execution.

If the Parties wish to reverse the parties roles but, in order to reverse these roles (i.e. shifting from being the Seller/Secured Party/Al-murtahin to being the Buyer/Chargor/Arrahin), a separate MCM Agreement would have to be entered into with separate security arrangements.

5.7 - Single Agreement

What does single agreement mean as per the section 1.3 of this MCM Agreement?

Single Agreement as per the section 1.3 (Single Agreement) means that the MCM Agreement is a master or framework agreement. When individual liquidity arrangements are subsequently entered into, i.e. a Collateralized Murabahah Transaction entered into by way of a Murabahah Contract and the granting of
security, the MCM Agreement will apply to those arrangements. So, although the Murabahah Contract for each such Collateralized Murabahah Transaction will be a separate scheduled document, the Collateralized Murabahah Transaction will be regarded as entered into upon the terms set out in the MCM Agreement and covered by the framework created by the MCM Agreement.

5.8 - Governing law of the MCM Agreement

What is the governing law of this MCM Agreement?

The governing law of this MCM Agreement is at the option of the Parties. The template MCM Agreement has, however, been based on the assumption that the governing law will be English law and, therefore, the Parties should make investigations as to what amendments may be required to reflect the governing law of their choice. Each Party will represent to the other that, if Shari ‘ah compliance is relevant for its purpose, then it has satisfied itself as to the Shari ‘ah compliance of the Collateralized Murabahah Transactions entered into by it under the MCM Agreement.

5.9 - Process flow of entry into a Bilateral Collateralized Murabahah Contract

Initiation of the discussions

Either Party to this MCM Agreement may initiate discussions to enter into a Murabahah Contract with the other. Following such discussions, the following steps are taken in order to conclude entry into a Murabahah Contract:
Bilateral Collateralized *Murabahah* Transaction

1. **Seller/Secured Party** /Al-Murtinn submit a Purchase Instruction with Promise to Purchase

2. **Buyer/Chargor/Arrahin**

3. **Seller/Secured Party** purchase the commodities/Goods on receipt of the acknowledgment.

4. **Seller/Secured Party** send an offer notice following a complete possession of the commodities/Goods

   - Offer notice must contain detailed information on the commodities
     - As well as the details of the Initial Collateral
     - Alongside any requested Initial Collateral

5. **Buyer/Chargor** deliver the Acceptance notice to the seller

6. **Seller/Secured Party** deliver the commodities/Goods constructively or physically.

   - To the
   - Buyer/Chargor

   - Buyer/Chargor pay the commodities price on deferred payment date.

   - To the
   - Buyer/Chargor/Arrahin

   - Send back to the
   - Buyer/Chargor

   - From
   - Seller/Secured Party

   - A third party Broker/Supplier

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(1) Seller/Secured Party

(2) Buyer/Chargor

(3) Seller/Secured Party

(4) Seller/Secured Party

(5) Buyer/Chargor

(6) Seller/Secured Party
- The Process flow explanation as follows:

1. **Purchase Instruction with Promise to Purchase**

Seller/Secured Party/Al-Murtahin may submit a Purchase Instruction with Promise to Purchase to the Buyer/Chargor/Arrahin.

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1 AAOIFI Shari’ah Standards No. (8) Murabaha to the Purchase Orderer “2. Procedures prior to the contract of Murabaha”.

2/1 The customer’s expression of his wish to acquire an item through the institution

2/1/1 It is permissible for the institution to purchase the item only in response to its customer’s wish and application, as long as this practice is compatible with the Shari’ah precepts for the contract of sale.

2/1/2 With due consideration to item 2/2/3, it is permissible for the customer to request the institution to purchase the item from a particular source of supply. However, the institution is entitled to decline to carry out the transaction if the customer refuses offers from other sources of supply that are more suitable for the institution.

2/1/3 The customer’s wish to acquire the item does not constitute a promise or commitment except when it has been expressed in due form. It is permissible to prepare a single set of documentation to include both the customer’s stated wish that the institution should buy the item from the supplier and a promise to buy the item from the institution, which the customer signs. It is permissible for the customer to prepare such a document, or it may be a standard application form prepared by the institution to be signed by the customer.
The Purchase Instruction with Promise to Purchase shall contain the main details of the proposed Murabahah Contract including the commodities/goods which are the subject of the proposed Murabaha Contract and detail any conditions precedent that are required to be delivered by the Buyer before entry into the Murabahah Contract.

Commodities/Goods may comprise of any Shari’ah compliant commodities/goods such as, base metals, platinum group metals, palm oil, natural gas, crude oil but excluding gold, silver and currencies.

(2) Acknowledgment

The Buyer/Chargor may sign the Acknowledgment which is attached to the Purchase Instruction with Promise to Purchase by which they will undertake to purchase the Commodities/Goods which are the subject of the proposed Murabahah Contract and indemnify the Seller/Secured Party on any failure to purchase.

(3) Purchase of Commodities/Goods from a third party Broker/Supplier

On receipt of the Acknowledgment by the Seller/Secured Party from the Buyer/Chargor, the Seller/Secured Party shall purchase Commodities/Goods from a third party Broker/Supplier and have physical or constructive possession of such Commodities/Goods.

(4) Offer Notice

After it has purchased Commodities/Goods from a third party Broker/Supplier the Seller/Secured Party shall send to the Buyer/Chargor an Offer Notice which includes the following details:

(a) a general description of the Commodities/Goods correlating to the Commodities/Goods which were the subject of the relevant Purchase Instruction with Promise to Purchase;

2 Ibid. 2/1/3 The customer’s wish to acquire the item does not constitute a promise or commitment except when it has been expressed in due form. It is permissible to prepare a single set of documentation to include both the customer’s stated wish that the institution should buy the item from the supplier and a promise to buy the item from the institution, which the customer signs. It is permissible for the customer to prepare such a document, or it may be a standard application form prepared by the institution to be signed by the customer.

2./3 The promise from the costomer” 2/3/2 : The customer’s promise to purchase, and the related contractual framework, are not integral to a Murabaha transaction, but are intended to provide assurance that the customer will complete the transaction after the item has been acquired by the institution. If the institution has other opportunities to sell the item, then it may not need such a promise or contractual framework.
(b) Holding Certificate Number;
(c) Commodities/Goods location;
(d) Cost Price;
(e) Settlement Date;
(f) Murabahah Profit;
(g) Deferred Payment Price;
(h) Deferred Payment Date;
(i) if applicable, place of delivery; and
(j) if applicable, delivery costs.

The Offer Notice shall also contain details of any Initial Collateral to be delivered to the Seller/Secured Party as a condition to the effectiveness of the proposed Murabahah Contract.

(5) Acceptance Notice

Should the Buyer/Chargor wish to enter into the proposed Murabahah Contract detailed in the Offer Notice it shall deliver to the Seller/Secured Party the Acceptance which is attached to the Offer Notice alongside any requested Initial Collateral and conditions precedent. However, if no Acceptance is received within a certain timeframe, the Offer Notice shall be deemed void and the Buyer/Chargor under the terms of the indemnity set out in the Acknowledgment.

On the occurrence of a failure to deliver an Acceptance within a specified timeframe, the Buyer/Chargor will be liable to the Seller/Secured Party for any actual losses the Seller/Secured Party has incurred.

(6) Commodities/Goods delivery be it constructively or physically

On receipt of the Acceptance and the Initial Collateral, the Murabahah Contract (documented by the Offer Notice and Acceptance and incorporating the terms of the MCM Agreement) shall be effective and accordingly:

(a) the Seller/Secured Party shall constructively or physically deliver the Commodities/Goods to the Buyer/Chargor; and

(b) the Buyer/Chargor shall pay the Deferred Payment Price on the Deferred Payment Date.
- Matters relating to the *Murabahah* transaction

**Deferred Payment Price**

**What is the Deferred Payment Price under a *Murabahah* Contract**

Deferred Payment Price means the aggregate of the *Cost Price* (being the amount payable by the Seller/Secured Party for the purchase of the Commodities/Goods from the third party buyer or supplier) and the *Murabahah* Profit payable at a future date (an amount agreed between the Parties (which may be linked to a fixed or floating rate per annum).

**Constructive or physical delivery of Commodities/Goods**

**What is meant by delivery in this MCM Agreement?**

It is at the option of the Buyer/Chargor. Constructive delivery can be effected through book entries of the Seller/Secured Party and Buyer/Chargor, their agents and the third party brokers and suppliers they buy from and sell to. Where physical delivery is requested, additional conditions must be met which relate to the regulations of the country into which, and from which, the Commodities/Goods are to be delivered and associated costs.

**Agency**

**Can either of the Parties to this MCM Agreement appoint an agent to act on its behalf?**

Yes. The Seller/Secured Party and/or the Buyer/Chargor can appoint an agent (which can be a third party) to carry out the pre-purchase of Commodity/Goods from a third party, the sale (as Seller) or purchase (as Buyer) to the other Party of Commodity/Goods and/or on-sale of Commodity/Goods to a third party. The Parties to this MCM Agreement can elect to enter into an agency arrangement for the buying and selling of commodities/goods by signing separately the IIFM Master Agency Agreement for the Purchase of Commodities.
6. **Collateralization**

**Creation of security and maintenance of collateral**

- **Initial Collateral**

  Initial Collateral will be identified in the Offer Notice along with delivery details and will be transferred to the Seller/Secured Party before a *Murabahah* Contract becomes effective (or in parallel with the *Murabahah* contract). Once delivered, it will become **Posted Collateral** and a Security Interest will be created over it under the terms of the MCM Agreement.

- **Security Interest**

  **What it means?**

  Security Interest is the term used to describe the interest granted, by way of security, by the Buyer/Chargor in the Collateral delivered to the Seller/Secured Party as a condition to the effectiveness of a *Murabahah* Contract. However, the charging clause set out in Clause 3.1(b) of the MCM Agreement is based on an English law charging clause and should be reviewed in relation to the governing law of the MCM Agreement and the law under which security is to be granted.

  The taking of a Security Interest over the Posted Collateral differs from the title transfer structure used in conventional repo where the lender takes ownership of the collateral and agrees to return the collateral (or equivalent collateral) on maturity. On event of default, the lender's obligation to return the collateral is extinguished and the value of the collateral is set off against the value of the financing due from the borrower. Under a security interest, ownership of the collateral remains with the borrower and on an event of default, in order to realise the value of the collateral, the lender has to enforce under the security and use its remedies to sell or appropriate.

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3 AAOIFI *Shari'ah* Standard No.(8), “Murabahah to the Purchase Orderer”, Clause 5 “Guarantees and treatment of Murabahah receivables”: Item 5.5 “In the case of the institution receiving a pledge from the customer, the institution is entitled to stipulate that the customer should make an assignment to the institution to enable it to sell the pledged asset for the purpose of recovering the amount due from the customer without recourse to the judiciary”. (2010 edition), pp. 123-124.
Use of the Posted Collateral (Re-hypothecation)

Can the Seller/Secured Party use the Posted Collateral?

The Posted Collateral shall be held in a segregated and identifiable account and there shall be no use of the Posted Collateral by the Seller/Secured Party.

In the conventional repo, the lender has an ability to make use of the collateral in its own business, which adds to the economic value of the repo to the buyer. However, in Shari’ah it has been emphasized that collateral taker should not benefit from any financial gain for keeping the collateral except for actual expenses under certain agreements. Under Shari’ah the pledged collateral will remain the beneficial property of the buyer/Arrahin.

Utilization of pledged Sukuk profit or pledged equities dividend.

Is it permissible to make use of the pledged Sukuk profit or pledged equities dividend by the Chargor/Buyer to partly pay the Deferred Payment amount?

From the Shari’ah standpoint the owner of collateralized asset as the financing receiver in a collateral contract is entitled to any profit accrued from the collateralized asset throughout the contract tenure because the collateral contract does not involve transfer of ownership of the collateralized asset from the collateral giver to the receiver. Hence, any profit including dividends as well as rights or bonus issues accrued from collateralized asset throughout the contract tenure belongs to the owner of the collateral which is the financing receiver.

Profit or dividend can be used by the Chargor/Buyer to partly pay the Deferred Payment Price. Operationally Custodian or collateral management service provider can perform this function.

Collateral Substitution/replacement

Is it possible to substitute/replace the collateral mortgaged asset with other with the same specifications as the first one placed?

AAIOFI Shari’ah Standard No.5, “Guarantees”, it’s permissible for Buyer/Chargor to use the collateral with the consent and permission of the Seller/Secured Party.

Ibid. It’s not permitted for the Seller/Secured Party to use the collateral at all even if the Buyer/Chargor has permitted him to do so. Item 4/6 “utilization of a pledged asset”, (2010 edition) p 64.
Yes. The Buyer/Chargor may also elect to substitute, in certain conditions, Posted Collateral and the conditions attached to such substitution shall be agreed by the Parties prior to such substitution.

7. **Margin Maintenance (Mark to Market of the Collateral Pool)**

The Posted Collateral which has been delivered under each *Murabahah* Contract is held together to collateralise the Buyer’s obligations under each Collateralized *Murabahah* Transaction.

On each Business Day, the Valuation Agent (which can be the Seller/Secured Party, the Buyer/Chargor or a third party appointed by both Parties) shall calculate:

(a) the Aggregate Outstanding Deferred Payment Price (being the aggregate Deferred Payment Prices of all Outstanding Collateralized *Murabahah* Transactions); and

(b) the aggregate **Value** of the all Posted Collateral,

and send a Valuation Notice to the Seller/Secured Party and the Buyer/Chargor.

The Value of the Posted Collateral may depend on what **Valuation Percentages** (i.e. a haircut or percentage discount) have been allocated to particular types of Collateral by the Parties. This could vary depending on the rating, issuer or maturity of a certain sukuk or security.

The Parties shall agree an overall **Threshold Percentages** and or a **Required Minimum** in relation to the Value of the Posted Collateral compared to the Aggregate Outstanding Deferred Payment Price. If the Value is below a Threshold Percentage, then an additional amount of Collateral at least equal to the Required Minimum shall be delivered by the Buyer / Chargor. If the Value is above a Threshold Percentage, on request by the Buyer/ Chargor, the Seller/Secured Party shall release an amount of Collateral at least equal to the Required Minimum.
8. **Collateral management and custody services**

There are two possibilities for Collateral management (Monitoring the Collateral conditions, Marking to Market the collateral, moving collateral back and forth, reporting etc):

(a) **Bi Lateral Management by each of the Parties**

One of the Parties to a MCM Agreement providing collateral and custody services i.e. where one of them (the institution or the bank) provides collateral custody services to the other party.

(b) **Tri-Party Custodian**

Use of independent third party for collateral management and custody services. (Tri-Party) Internationally listed Sukuk are mostly in custody of international collateral management service providers (such as Euroclear or Clearstream) and they can act as an independent third party for purposes of collateral management under the MCM Agreement;

The MCM agreement does carry a reference to Tri-Party. However, the actual contractual agreement of the TRI-Party is a separate Service Agreement which needs to be executed with the Tri-Party service provider. There are many Tri-Party services providers. Eg, Clearstream, Euroclear, Bony, Standard Chart etc

Tri-Party is simple an operational facility and does not impact the *Murabahah* transaction flow. Once the *Murabahah* transaction is executed the Operational facility then comes into play to move the Collateral into a separate segregated account.

**What is the essential difference between the Bi Lateral and Tri-Party Murabahah arrangements?**

The difference between the two is outside of the context of the *Murabahah* Contract and is in the context of the overall collateral management and Mark to Market function.

In the bilateral the function of collateral management is carried out by the in house operation department of both parties. Whereas, in the Tri-Party, this function is outsourced to an independent third party who can be responsible for of all collateral management including substitution to ensure other *Sukuk transactions* do settle on its settlement date. In addition it will independently mark the *Sukuk* to current market price and work out daily the overall
exposure and report to both parties. The relevant Parties take necessary actions to rectify the exposure to the level agreed as per the Collateral Agreement. Where services are provided whether provided by a Tri-Party Agent or by a provider that is related to one of the parties or otherwise, normally the provider will expect to charge a fee for its services.

Tri – Party process flow structure

Step 5 is Collateral Management function by Tri-party Agent and the Collateral Management Agent receives a fee for its services of independently monitoring the Collateral
This Memorandum does not consider Triparty arrangements further. Where the parties wished to engage an independent Triparty service provider or where one of the parties or a related entity is to provide services, the parties should ensure they have evaluated the documentation, operational arrangements and costs involved in setting up the necessary arrangements.

**Are these two arrangements acceptable in Shari ‘ah?**

It is permissible to appoint an independent third party custodian to hold the Posted Collateral for a fee. The Seller/Secured Party in this case may appoint a Custodian to hold the Posted Collateral on its behalf and the Seller/Secured Party and Buyer/Chargor may agree any conditions for the holding of such Posted Collateral. The Posted Collateral shall be held in a segregated and identifiable account and there shall be no use of the Posted Collateral by the Seller/Secured Party.

It is also permissible for one party who has or provide a safe keeping services to enter into a separate unconditional agreement with another party to keep the mortgaged under safe keeping services independent arrangement and process for a fee as services charges (The Shari’ah board of the two institutions should be consulted in this regard).

9. **Other issues related to collateral asset**

   - **Remedies on an event of default**

     On sending an of Acceleration Notice following an event of default, the Seller/Secured Party has the right to enforce its rights under the security granted to it, including, but not limited to the:

     (a) power to sale;
     
     (b) right to appropriate;
     
     (c) right to set-off; and
     
     (d) ability to convert to certain currencies,

     to the extent permitted by the applicable law.

   - **Sale of Posted Collateral in the event of default by financing receiver to pay the financing amount to financier**

     The permissibility of sale or liquidation of security in the event of default whereby the financing receiver has failed to pay the financing amount to the financier within the agreed period is in line with the objectives and basic features of charge in Islam. The
financier may stipulate a condition requesting the financing receiver to appoint the former or a specified individual to sell the collateralized asset in order to settle the outstanding financing amount without the need to refer to court.

10. Some general Shari‘ah provisions on collateral.

10.1 Legitimacy of pledges/collaterals

It is permissible for an institution to stipulate that at or before the conclusion of the contract of a credit transaction the customer shall provide a pledge of security to secure payment, and that possession of the asset so pledged will not prevent or from demanding payment when the payment of the debt falls due. (See AAOIFI Shari‘a Standard No. (5) Guarantees). PLEDGES

10.2 Conditions relating to a pledged/ collateralized asset

A pledged asset must be a valuable asset that can be lawfully owned and sold. It should be subject to identification by sign, name or description, and capable of being delivered to the creditor. Hence, property held in common may be produced as a pledge provided the pledged percentage of it is specified, such as pledge of shares. It is permissible to grant more than one pledge on the same property, on the condition that the subsequent pledgee/Al-Murtahin should be aware of the previous pledges, in which case such pledges would rank equally if all were registered on the same date. In this case, the recovery of their debts from the value of the pledge may take place on a pro rata basis. But if the pledges were registered at different dates, then their priority to recover the amount of their debts would be determined according to date of registration. (See AAOIFI Shari‘a Standard No. (5) Guarantees). PLEDGES.

Possession and ownership of the pledged/collateralized asset

The pledged asset remains the property of the pledgor/Arrahin so far as it continues to be subject of pledge. In principle, the pledged asset should be in the possession of the creditor/Al-Murtahin (possessory pledge). However, it is permissible that it be left in the possession of the debtor/Arrahin (security or registered pledge) and all the rules governing pledges remain applicable to such a pledge. It is also permissible that the debtor pledges an asset of a third party with the permission of the owner (“borrowed pledge”). Possession of the documents of title to goods or equipment held in warehouses or at ports is considered to be possession of the assets they represent. It is also permissible that the pledged asset is retained in the possession of a trustworthy third party, known as ‘adl’, and in this case the pledgor/Arrahin cannot discharge him as the holder of the pledge or recover the pledged asset from him before fulfillment of the debt. It is permissible for the pledgor to authorize the pledge/Al-Murtahin or any other person to sell the asset and to settle the debt from the value thereof (See AAOIFI Shari‘a Standard No. (5) Guarantees). PLEDGES.
**Actual expenses relating to tangible pledges/collaterals**

All actual expenses relating to tangible pledges, excluding the expenses incurred for the safekeeping of the pledge, are to be borne by the pledgor. If the pledge pays for such expenses with the permission of the pledgor, he is then entitled to claim such expenses from the pledgor or to use up to the amount of the expenses incurred. (See AAOIFI Shari'a Standard No. (5) Guarantees). PLEDGES.

**Enforcement of a Pledge/collateral**

The effect of the pledge of security is that the creditor is entitled, if the debtor fails to pay the debt on time, to demand the sale of the pledged asset in order to recover the amount of the debt from the sale proceeds, and to return any surplus proceeds to the debtor. Where the proceeds fail to cover the amount of the debt, the remaining balance is treated as an ordinary unsecured debt. If the debtor is declared bankrupt, the creditor possessing a pledge of security has a prior claim over other creditors to the pledged asset, and in case of a shortfall, the pledgee merely ranks as an ordinary unsecured creditor in respect to the remaining balance of his debt.

The creditor (the pledgee) is not entitled to obtain ownership of the pledged asset in consideration for his debt (i.e. to foreclose on the pledge), unless the debtor has agreed to sell the asset to the creditor and an agreement has been reached for the set-off of the sale proceeds and the amount of the debt.

A seller is not entitled to stipulate, after conclusion of a sale contract, a right to retain an asset sold on a deferred sale basis, as security for payment. This is because the legal effect of a sale contract is the transfer of ownership of the asset sold. However, it is permissible for the seller to stipulate that the buyer should release the sold asset into the seller’s custody as a pledge of security so as to ensure recovery of the remaining deferred instalments. It is also permissible for the buyer to retain an asset sold on an immediate payment basis until the consideration for the asset is paid.

The creditor is entitled to stipulate that the debtor should authorize him to sell the pledge asset when the debt falls due in order to recover what is due to him from the sale proceeds, without recourse to the courts.

The pledgor (the debtor) bears the expenses incurred for documentation, safekeeping, and any sale of the pledged asset. (See AAOIFI Shari'a Standard No. (5) Guarantees). PLEDGES.

**10.3 Redemption of the pledge**

The creditor (the pledgee) is entitled to retain the entire pledge for any part of the debt, unless he has agreed to a partial redemption. However, the creditor is not entitled, after the payment of the relevant debt, to retain the pledge for another unsecured debt,
if this was not agreed earlier. Nonetheless, both the creditor and the debtor may agree, after the payment of the amount of the debt, to regard the released pledged asset as security for any debt that may be created between them within a subsequent specified time period. (See AAOIFI Shari'a Standard No. (5) Guarantees). PLEDGES.

10.4 Destruction of (or loss of, or damage to) a pledged asset

A pledged asset is held by the pledgee on a trust basis. Hence, its destruction, loss or damage while in the possession of the pledgee does not affect the debt obligation. If it is destroyed, lost or damaged without any misconduct or negligence on the part of the pledgee or a trustworthy third party holding the pledge for the parties (the ‘adl’), then they are not liable for such destruction, loss or damage. However, if it is destroyed, lost or damaged by either of them as a result of misconduct or negligence, the person responsible shall be liable for compensating the owner, while the debt remains outstanding. Nevertheless, the two parties are entitled to agree on a set-off between the outstanding debt and the amount of compensation due in respect of the pledged asset that has been destroyed, lost or damaged. (See AAOIFI Shari'a Standard No. (5) Guarantees). PLEDGES.