Developments in Islamic Hedging Segment

12:30 – 13:30 Session 3: Developments in Sukuk Market
IIFM Workshop on Islamic Finance (Standard Documents and Product Templates)
Tuesday, 10th May 2016, Sasana Kijang, Kuala Lumpur (Day 1 of GIFF 5.0)

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1) Introduction to IIFM

by

Mr. Ijlal Ahmed Alvi
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IIFM Profile

IIFM is a standard-setting organization for the Islamic Financial Services Industry focusing on standardization of Islamic financial contracts and product templates relating to the Capital & Money Market, Corporate Finance and Trade Finance segments of the industry.

IIFM’s market unification efforts are directed towards creation of a robust, transparent and efficient Islamic finance industry by developing best practices at the global level and achieving Shari’ah harmonization.

It was founded in 2002 by the collective efforts of the Islamic Development Bank, Autoriti Monetari Brunei Darussalam, Bank Indonesia, Central Bank of Bahrain, Central Bank of Sudan and the Bank Negara Malaysia (delegated to Labuan Financial Services Authority) as a neutral and non-profit organization. Besides the founding members, IIFM is also supported as member by certain regulatory and government bodies such as State Bank of Pakistan, Dubai International Financial Centre, Indonesia Financial Services Authority, The National Bank of Kazakhstan, and by a number of international and regional financial institutions and other market participants.

Given IIFM growing presence as a key standard-setting body, IIFM Board of Directors (BoD) in its 31st board meeting held during 2014, made a strategic decision to expand IIFM scope of work as it is the only organization which develops standardized Islamic financial contracts and product templates. The BoD approved the inclusion of Corporate Finance & Trade Finance segment in addition to existing focus of Capital & Money Market standard agreements and products templates. This to further enhance the development of Islamic financial industry globally through its documentation and Islamic products unification efforts which are much needed for a robust, transparent and vibrant industry.

IIFM is also in the process of developing several important documentation and product standards related to the Islamic financial market. It has also published global Sukuk reports (five editions) and organizes a number of industry awareness seminars and workshops.
## IIFM Mandate

In the Islamic Financial Services Industry there are four main standard-setting bodies with clear mandate for each.

- No overlapping in their mandates
- They complement one another through a constructive cooperation and collective action as the basis of the relationship between them. The Institutions are as follows:

<table>
<thead>
<tr>
<th>Name of Institution</th>
<th>Headquarter/Office</th>
<th>Date of establishment</th>
<th>Mandate</th>
</tr>
</thead>
<tbody>
<tr>
<td>3 IIFM: International Islamic Financial Market</td>
<td>Manama, Kingdom of Bahrain</td>
<td>Became officially operational on April 1, 2002.</td>
<td>Product and documentation standardization of all financial contracts particularly relating to Islamic Capital &amp; Money Market, Corporate Finance &amp; Trade Finance.</td>
</tr>
<tr>
<td>4 CIBAFI: General Council for Islamic Banks And Financial Institution</td>
<td>Manama, Kingdom of Bahrain</td>
<td>Established in 2001.</td>
<td>Representing the Islamic financial services industry globally, defending and protecting its role.</td>
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## IIFM Published Standards

### IIFM Standard No. 07
**Islamic Cross Currency Swap (Himaayah Min Taqallub As‘aar Assarf) Standard Product Template (ICRCS)**

The ICRCS standard template was published on 26th November 2015 as the second hedging product template under the TMA. With ICRCS the Islamic financial institutions can manage risk in transactions exposed to fluctuations in currencies and rate-of-return mismatches.

The ICRCS standard template also includes a product description for guidance purposes.

### IIFM Standard No. 06
**Master Collateralized Murabahah Agreement (MCMA)**

MCMA was published on 16th November 2014 and it provides a mechanism for access to liquidity on a collateralized basis (based on the Shari‘ah principle of Rahn) utilizing Sukuk and other Islamic securities portfolio as collateral. It is an important new tool for IFI’s as they seek to address the increased global regulatory focus on liquidity and collateral.

Moreover, the collateralized transactions based on Murabahah are approved by various regulators in providing level playing field to Islamic institutions by giving them option to tap funds from central banks in case of liquidity short fall.

The MCMA is accompanied by an operational guidance memorandum which covers the operational procedures which may be implemented by potential users of the MCMA.
IIFM Published Standards (cont...)

IIFM Standard No. 05
Inter-Bank Unrestricted Master Investment Wakalah Agreement (UMWA)
Launched on 3rd June 2013, the inter-bank UMWA has been specifically designed to provide alternate liquidity management product to the Islamic finance industry in order to reduce over reliance on commodity Murabahah based transactions.

The important features of this standard documentation is Wakil’s discretion to invest the funds, use of general treasury pool (segregated and un-segregated asset pool), anticipated profit, early termination, replacement of asset, on-balance sheet accounting assessment etc.,

The Unrestricted Wakalah standard includes a detailed operational guidance memorandum on the mechanics of this agreement as well as how it should be applied by the transacting parties. In addition, the operational guidance memo also provides valuable recommendations to be taken into the consideration at the time of entering into unrestricted Wakalah investment transactions.

IIFM Standard No. 03 and 04
Islamic Profit Rate Swap (Mubadalatul Arbaah) Standard Product Templates (IPRS)
In March 2012, in its efforts to accelerate the use of TMA, IIFM & ISDA jointly published the first hedging product template. The IPRS provides the industry access to robust and well developed product documentation under the TMA. It provides protection of IFI’s balance-sheet from wide swings in fixed and floating profit rates as well as enabling the IFI’s to manage its cash flow risk for various Islamic capital market instruments such as Sukuk. Two sets of PRS templates (four standard schedules in total) have been published, as follows:

- One set of PRS templates that are Wa’ad based and involve a Two Sales structure
- Another set of PRS template that are Wa’ad based and involve a Single Sale structure

The IPRS standard templates also includes explanatory memorandum for guidance purposes.

IIFM Published Standards (cont...)

IIFM Standard No. 02
ISDA/IIFM Tahawwut (Hedging) Master Agreement (TMA)
In March 2010, the TMA was jointly published by IIFM & ISDA and marked the introduction of the first globally standardized documentation for OTC Islamic hedging products. TMA is a framework document that provides a globally standardized early termination and close-out mechanism and other legal and Shari’ah provisions for privately negociated and widely accepted Islamic hedging products. The master agreement is designed to facilitate the risk management function of IFI’s including providing a legal framework. In order to provide clarity and transparency the TMA publication includes an Explanatory Memorandum.

Under TMA, as a framework document, the Islamic hedging products relating to rate of return mismatch, Foreign Exchange Forward & FX Swap can be transacted.

IIFM aim is to develop the key Islamic hedging standard product templates under TMA. Moreover, credit support arrangement and related documentation will also be developed.

IIFM Standard No. 01
Master Agreements for Treasury Placement (MATP)
This was the first ever global standard documentation published in Islamic Finance for liquidity management purpose. The MATP comprises of standalone Master Murabahah Agreement & Master Agency Agreement. The standard documentation involves Commodity Murabahah based on two structures namely: (i) Commodity Murabahah under Agency Agreement, and (ii) Commodity Murabahah based Principle to Principle.

The Agreement was published in 2008 and based on IIFM recent survey MATP is widely used in Islamic inter-bank market particularly involving cross-border trades.
IIFM Standards under Finalization

IIFM Standard No. 08 and 09

Islamic Foreign Exchange Forward (IFX Forward)
IFX Forward product template will be the third hedging product template under the TMA. The objective of IFX Forward is to minimize exposure of Islamic financial institutions to currency rate which is volatile and fluctuating. The development work on this standard template is in progress and the publication is expected in Q2 2016.

IIFM Standards under Development/Consultation

IIFM Standard No. 10

Islamic Credit Support Deed (ICSD)
ICSD is part of Islamic hedging and will fall under TMA. The purpose of ICSD is to manage the risk arising from Islamic hedging transactions of the counterparty by providing collateral and margin maintenance requirements. The project is currently under development phase.

IIFM Standard No. 11

Risk Participation Agreement
This project is part of IIFM Board’s recent strategic decision to expand IIFM scope of work to include corporate finance and trade finance financial contracts standardization. The objective is to standardize risk participation of funded and unfunded transactions. This project is currently under consultation phase and development work will commence soon.

IIFM Standard No. 12

Sukuk Standardization
As per IIFM consultation process the Sukuk standardization project will involve the development of specific guidelines and standard documentation on Ijarah Sukuk.
2 (a) Shari’ah Guidelines (Parameters)

Islamic Hedging

Shari’ah Parameters

The Origin

➢ Financial swap mechanisms are of conventional origin
➢ These mechanisms have been used for long time. In the seventies, the nineties, to the present day

Purpose of Swaps

➢ To hedge, mitigate and minimize risks in the assets values etc. (interest rate swap mechanism is invented and used to achieve that)
➢ To hedge against fluctuations in the value of currencies and cash flow (Currency swap mechanism is invented and used to achieve that)
➢ Foreign Exchange Forward to mitigate future currency volatility risk

These conventional mechanisms is considered a non Shari’ah compliant transactions. Because it involved Riba, Gharar, gambling and other irregularities with regard to Shari’ah principles which make it not acceptable.
Question Arises

- Are Islamic institutions in need of this type of transaction?
- Are Islamic institutions needed to be protected against the real risks in their dealings?
- The answer is definitely Yes
- Then what would the Islamic financial institutions do in this situation?
- Here one can mention one of the great Islamic maxim:

> الحكم على الشيء فرع عن تصوره

Judgment is to be based on knowledge and understanding

Steps taken for Islamization

To address these conventional mechanisms and its violations of the Shari’ah principles, the following steps were taken:

- Islamization of the conventional mechanisms.
- Invention of new structures to comply with Shari’ah principles (i.e. freed from Riba, Gharar and Gambling).
- Most importantly, It must be the primary objective in the use of these mechanisms is to hedge against the real risks of price fluctuations etc.
**Shari’ah Compliant Mechanisms**

- Using *Murabahah* contracts between the contracting parties.
- Selling of *Shari’ah* compliant assets for immediate delivery and differed payments.
- This is designed to meet the *Shari’ah* principles and rulings requirements.
- From business perspective *Murabahah* is credit intensive in nature hence used in transactions like PRS & ICCS which are generally for a number of years.

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**Two Important Things To Be Noted**

When dealing with this mechanism two important things should be noted:

- **First,** *Murabahah* is used in this transaction to generate a fixed and floating payments (this includes: cost price and fixed or floating profits)
  
  Normally series of reverse *Murabahah* is used in this transaction to generate profit payments

- **Secondly,** It is structured on *Wa’ad* basis where each of the contracting parties undertakes to the other, to swap fixed profits and floating profits payments at a particular time and date in the future.
  
  The *Wa’ad* are unilateral and totally independent
Combination of Contracts
(As per the AAIOFI Shari’ah Standard 25)

The Concept
➢ Combination of contracts is a process that takes place between two parties or more, and involves the simultaneous conclusion of more than one contract at one set/time. Example: Lease to Sale contract...

Shari’ah Ruling
It is permissible in Shari’ah to combine more than one contract in one set, without:
➢ Imposing one contract as a condition in the other, and
➢ Provided that each contract is permissible on its own.

As long as no Shari’ah restriction that entails its prohibition on exceptional basis, hence, it is allowed.

Combination of Contracts
(As per the AAIOFI Shari’ah Standard 25) continued

Shari’ah Guidelines on Contracts’ Combination
➢ It is not allowed to combine Sale and lending (i.e. Al-Ba’i wa Assalaf) in one contract. (This is clearly banned in Shari’ah). Example: I will sell this asset to you 100 provided you lend me 100.

➢ It is not allowed to use it as a trick or excuse for taking or accepting interest (Riba). Example: sale and buy back sale according the majority.

➢ It is not allowed to combine a lending contract with some personal gain, such as:

Stipulating in the contract that the borrower should offer accommodation in his house to the lender or should grant him a present or imposing excess repayment in terms of quantity or quality on the borrower.

➢ It is not allowed to combine contracts with different underlying Shari’ah rulings and ultimate goals. Such as: combining Mudarabah with lending the Mudarabah capital to the Mudarib.
Contemporary Applications for Combination of Contracts

*Murabahah* on Order of Purchase, 
*Ijara Ending with Ownership*, 
or *Diminishing Musharakah*, 

Contractual arrangements which comprise a number of contracts and pledges in one set are most distinguishable forms of contemporary Islamic financial transactions.

General *Shari‘ah* rulings with regard to structure, requirements and conditions should be observed in order to be *Shari‘ah* compliant,

Pledges contained in such combined contract sets are binding to their respective parties.

Failure to honor contractual commitments from any party to the contract gives the other party right of claiming indemnity for the actual loss encountered.

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Some *Shari‘ah* Guidelines on the IIFM Islamic Hedging Products as per the recommendation of the IIFM *Shari‘ah* Scholars

- The primary objectives of the Islamic hedging mechanisms are similar to the primary goals of the conventional financial institutions

- But the Islamic mechanisms have been Islamized through commendable efforts of our honorable contemporary Scholars who restructured the whole process to conform to the *Shari‘ah* principles.
Some *Shari’ah* Guidelines on the IIFM Islamic Hedging Products as per the recommendation of the IIFM *Shari’ah* Scholars *(Continued)*

- Stick to the purposes and principles of *Shari’ah* in these transactions. (i.e. protection of wealth........).
- Purpose of entering into these transactions must be for a real hedge against unexpected risks to both sides.
- Interring into these transactions should not be for the purpose speculation.
- Actual payments and settlement of assets between the two parties must take place and not be a sham.
- Cash settlement without going into the actual transaction where there is delivery and receipt of assets, is not permitted Islamically.
- Assets that are exchanged between the contracting parties must be *Shari'ah* compliant.
- No interest should be paid or took by any party under these transactions/ agreements.
- Provisions related to the sale of exchange must be applied throughout the life of the transaction, especially in cross currency and FX forward, as they take the rule of sale exchange. So when it got delayed or postponed in receipt and delivery. That will certainly affect its validity.

Finally

It was said before hundreds of years ago that:

الحكمة ضالة المؤمن أني وجدها أخذها

A believer/Muslim is encouraged to acquire and take Wisdom from whomever as long as it does not contradict the principle Islamic teachings.
2 (b) Hedging in Islamic Finance

Hedging & Islamic Finance

- The consensus is now developing in the Islamic Financial Services Industry on the requirement for risk mitigating/hedging tools, as the institutions operating on Shari’ah principles can no longer afford to leave their positions un-hedged.

- Hence, we are now seeing some key hedging products becoming common across Islamic jurisdictions.
Need for Islamic Hedging Standards

Key risk mitigation functions

- Asset & Liability management
  - Liquidity mismatches
  - Rate of Return mismatches

- Foreign Exchange
  - Open position
  - Cross Currency mismatches

- Treasury, Trade Finance and Corporate Finance

IIFM Hedging Standards
Risk Mitigation Perspective – Need for a Framework Agreement

Third Level
- Framework – Counterparty Relationships (Tahawwut Master Agreement)
- Shari’ah Implications

Second Level
- Usage and Structure of Hedges (Product Templates)
- Shari’ah Implications

First Level
- Risk Arising From Transactions

Tahawwut Master Agreement and Hedging Products are for risk mitigation purpose
Tahawwut Master Agreement

Significance

➢ TMA key benefits
  ❑ Global Islamic Close-out Mechanism
  ❑ Multi Hedging Products
  ❑ Close-out Netting and Legal Opinions

➢ Most used contract & principle in structuring of Islamic Risk mitigation Products
  ❑ Murabahah
  ❑ Wa’ad

IIFM Standard Agreements

A Detailed Deliberation Process

Master Framework Agreement

IFSFI Market Practices

Global Market Practices

Shari’ah Advice

Legal Implications
Tahawwut Master Agreement
Deliberation & Shari’ah Guidance Process

- The process involved several steps such as formation of joint Working Group (WG), deliberation with the WG, receiving comments from the institutions, market consultation, preparing drafts based on comments for Shari’ah guidance, presenting the recommendations for Shari’ah consideration on early termination, close-out mechanism and other issues and obtaining Shari’ah guidance from scholars on IIFM Shari’ah Advisory Board

- Special attention is given to covering all the scenarios which may exist

Islamic Hedging
Structuring Alternatives

- **Murabahah**
  - Treatment is defined based on use of Murabahah under the institution’s product structure
  - No discounting and claim for full amount
  - Fully delivered terminated transactions treatment (Murabahah)
  - Non-fully delivered terminated transactions treatment (DFT)

- **Wa’ad**
  - Both parties will exchange Wa’ad at the time of entering into the transactions e.g. Profit Rate Swap
  - Only one Wa’ad is exercisable
  - In case of two Wa’ad, the Wa’ad are unilateral and totally separate/independent
3(a) Islamic Hedging Framework
Legal Aspects

by
Mr. Habib Motani
Partner, Clifford Chance LLP, London

Tahawwut Master Agreement
Documentation Architecture
Tahawwut Master Agreement

Architecture
- Multiproduct Agreement
- Not specific to types of parties or regions

The Risk Management Approach
And Value Of The Master Agreement
- Framework agreement covering all trades between the parties
- Incorporates the three pillars designed to ensure that in the event of a default or termination the exposures of the parties under all outstanding transactions are aggregated and netted, in particular in order to stop an insolvency practitioner from cherry picking, that is enforcing profitable ("in the money") transactions entered into under the Agreement and leaving unprofitable ("out of the money") transactions as claims in the insolvency.
  - Single Agreement
  - Flawed Asset and Conditionality
  - Close-Out and Netting
Transactions/DFT Terms Agreements

• Under the Agreement, you can enter into
  – Transactions
  – DFT Terms Agreements

• Example: agreement to enter into Murabahah annually over five years
  – First Murabahah entered into immediately – Transaction
  – The agreement to enter into those Murabahah to be entered into on the first, second, third and fourth anniversaries is a DFT Terms Agreement

Section 1(c) - Single agreement

- Master Agreement, the Schedule and all confirmations together form one single agreement between the parties. The result is that there is a contractual interdependence between what might otherwise seem to be independent transactions

- Because the transactions under the Master Agreement collectively constitute one agreement, all transactions have to be dealt with and individual transactions cannot be cherry picked

- However, not every jurisdiction accepts this concept so legal position needs to be checked
Section 2(a)(iii) – Flawed Asset or Conditionality Provision

- A party has no obligation to make any payments or deliveries under a particular transaction when there is an Event of Default or Potential Event of Default with respect to the other party
- Liquidator attempting to cherry pick profitable contracts will be met by the response that the Non-defaulting Party has no obligation to perform the profitable contract as the Agreement expressly provides that no monies are due to the Defaulting Party in the circumstances
- In the ISDA/IIFM Tahawwut Master Agreement this condition applies to all obligations to pay, all obligations to deliver assets and all obligations to enter into Transactions in accordance with the requirements of DFT Terms Agreements

Section 3 - Representations

New Representations

- Satisfaction as to compliance with Shari’ah – Section 3(h)

Each party represents it has satisfied itself as to the Shari’ah-compliance of the Agreement, each Transaction, each DFT Terms Agreement (and each Designated Future Transaction under it)

Note: “Insofar as it wishes or is required for any reason to enter ....”

- Non-reliance – Section 3(i)

Each Party represents that it has not relied on the other party or on any documents (including a pronouncement/fatwa) prepared by or on behalf of the other party for the purposes of determining whether the Agreement, each Transaction, each DFT Terms Agreement (and each Designated Future transactions under it) is Shari’ah-compliant
Section 5 – Events of Default and Termination Events

- **New Event of Default – section 5(a)(ii)(3) of the Agreement**
  Failure to enter into a Designated Future transaction, if such failure is not remedied on or before the first Local Business Day after notice of such failure is given to the relevant party, constitutes an Event of Default

- **Cross Default**
  Cross default revised so that default under either an Islamic financing or a conventional financing can trigger an Event of Default

- **Note in connection with Section 5(b)(i) – Illegality** that definition of “law” does not include principles of Shari’ah, hence “unlawful” means contrary to a secular law as opposed to contrary to Shari’ah

Section 9 – Miscellaneous

- **Section 9(h) - No Compensation or Interest on Defaulted or Deferred Payments and Deliveries**
  - Parties cannot recover amounts for any cost of funding they incur as a result of any late payment or delivery; however the possibility of this leading to an EOD under the Agreement is in itself a deterrent

- **Section 9(h) - No Interest Payable**
  - As is to be expected, all references to "interest" have been deleted due to interest / *riba* being *haram* and thus forbidden under Shari’ah principles
  - Section 9(h) of the ISDA/IIFM Tahawwut Master Agreement is essentially a waiver of the right to interest arising as a result of any arbitral or judicial award or by operation of law
  - In the event that interest is "payable or receivable under or in connection with the Agreement" ................. then such interest will be donated by the recipient to an officially recognised or registered charity
  - Similarly there is no interest element (*the Applicable Close-out Rate which is usually different for the Defaulting and Non-defaulting Party*) on the calculation of Unpaid Amounts
Section 13 – Governing Law and Dispute Resolution

- No reference to Shari’ah in the governing law clause
- Parties may elect either English law or the laws of the State of New York as the governing law of the Agreement and each Transaction and Designated Future transaction made thereunder
- Both parties at the outset have the flexibility to elect whether dispute resolution should take place through the courts or through arbitration

Section 6 - Early Termination – Terminated Transactions Procedure

- Fully Delivered Terminated Transactions:
  - (section 6(d)): accelerate all payments due after the Early Termination Date (Close-out Amount)
  - (Section 6(e)): add unpaid amounts
- Non-Fully Delivered Terminated Transactions:
  - (section 6(e)): add unpaid amounts to Fully Delivered Transactions amount
  - (section 6(f)): treat not made deliveries and future payments like a DFT Terms Agreement
- Payable on day on which notice of amount payable is effective if Event of Default or 2 Local Business days after notice if Termination Event
Section 6 - Early Termination – DFT Terms Agreements

- For terminated DFT Terms Agreements, calculate the cost of replacement hedges (section 6(h))
- Do the same for not made deliveries and future payments under Non-Fully Delivered Terminated Transactions
- Result may be positive or negative
  - positive where a cost
  - negative where a gain
- Becomes value of Relevant Index
- Index Amount means, with respect to each DFT Terms Agreement or each group of DFT Terms Agreements, the amount of the losses or costs that would be incurred or gains that would be realised in replacing, the material terms of that DFT Terms Agreement or group of DFT Terms Agreements
- Note: no additional “compensation”, only the cost or gain of replacement hedges

Section 6 - Early Termination - Musawama

- Section 6(f)(v): if Relevant Index is positive (replacement hedges will be a cost for the Determining Party), Determining Party can exercise the section 2(e) Wa’ad of counterparty requiring counterparty to enter into Musawama and purchase asset from Determining Party at the Positive Indexed Value
- Section 6(f)(v): if Relevant Index is negative (replacement hedges will be a gain for the Determining Party) other party can exercise the section 2(e) Wa’ad of the Determining Party requiring the Determining Party to purchase asset from the other party at the Negative Indexed Value
- Need for real transaction with real assets
- Supported by set off (section6(h))
- The Musawama price is expressed as a single number (actually calculated by adding cost of asset to Relevant Index Value plus applicable VAT or similar taxes)
- The type and quantity of the asset to be the subject of the Musawama will be fixed and specified in the Schedule at the outset (minimises Gharar)
Section 6 - Early Termination – Musawama (continued)

• The party exercising the Wa’ad following an Event of Default may be the Defaulting Party if the Non-Defaulting Party calculates the Relevant Index as being negative (i.e. the Non-Defaulting Party would make a gain on replacement). Recognising that the Defaulting Party may be insolvent and unable to act swiftly, the TMA allows the party with the right to exercise this Wa’ad up to one year in which to exercise the Wa’ad.

• Where a party fails or is unwilling to comply with its obligation to purchase the Designated Assets, the party who exercised the Wa’ad is discharged from its obligation to deliver the Designated Assets and is entitled, by way of liquidated damages, to payment of an amount equal to the value of the Relevant Index.

• A party will be deemed unwilling to comply with its obligation to purchase the Designated Assets if within one Local Delivery Day it does not give written notice to the party who exercised the Wa’ad that it will purchase the Designated Assets on the date specified in the exercise notice.

Section 6(h) – Set-Off

■ In the ISDA/IIFM Tahawwut Master Agreement, following the occurrence of an Early Termination Date, the Agreement provides for two separate payment amounts:
  – Early Termination Amount
  – Positive Indexed Value/Negative Indexed Value

■ Once determined and payable, these two amounts (Early Termination Amount and Positive/Negative Indexed Value) can be set-off against one another pursuant to Section 6(h) of the Agreement

■ To avoid Non-defaulting Party having to pay Early Termination Amount before any reciprocal claim to payment of the Positive/Negative Indexed value has become payable, Non-defaulting Party can defer payment of relevant proportion of Early Termination Amount until reciprocal claim becomes payable
Explanatory Memorandum

Guidelines regarding the sorts of transaction that may be entered into under the ISDA/IIFM *Tahawwut* Master Agreement. For the purposes of *Shari’ah* compliance:

- Transactions entered into under the ISDA/IIFM *Tahawwut* Master Agreement should only be for the purpose of hedging actual risks of the relevant party.
- Transactions should not be entered into under the ISDA/IIFM *Tahawwut* Master Agreement which are for the purposes of speculation.
- Transactions must be real transactions, involving the actual transfer of ownership of real assets, actual risk and real settlement.
- The asset itself must be *halal*.
- Interest must not be chargeable under the transaction.

3(b) Islamic Hedging Products

by

Mr. Khurram Hilal

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Standard Chartered Saadiq, Dubai
Islamic Profit Rate Swap
*(Mubadalatul Arbaah)*

In its efforts to accelerate the use of the *Tahawwut* Master Agreement, IIFM in association with ISDA published the first standard product template, the Islamic Profit Rate Swap (IPRS), or *Mubadalatul Arbaah*.

The IPRS provides the industry access to robust and well developed product documentation under the master agreement. It provides protection to the Islamic financial institution’s balance-sheet from wide swings in fixed and floating profit rates and enables them to manage their cash-flow risk for various Islamic capital market instruments such as *Sukuk*. When dealing with the IPRS mechanism, two important points should be noted:

- *Murabahah* is used in this transaction to generate a fixed and floating payments (this includes: cost price and fixed or floating profits).
- It is structured on a *Wa’ad* basis where each of the contracting parties undertake the swapping of fixed and floating profit payments at a particular time and date in the future.

Normally a series of reverse *Murabahah* is used in this transaction to generate profit payments.

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The *Mubadalatul Arbaah (IPRS)* Documentation

- Party A and Party B have already entered into a *Tahawwut* Master Agreement
- To enter into the PRS, Party A and Party B enter into two separate *DFT Term Agreements* (each of which is documented in a separate *DFT Terms confirmation*: one in respect of the fixed rate leg of the PRS and one in respect of the floating rate leg of the PRS)
- Each DFT Terms confirmation contains a *Wa’ad* (undertaking) to enter into one or more Designated Future transactions (if the *Wa’ad* is exercised)
IPRS Templates - Process

- Schedule
- Fixed Rate Leg DFT Terms confirmation (Wa‘ad)
- Floating Rate Leg DFT Terms confirmation (Wa‘ad)
- Exercise leads to
  - entry into Murohabah (Transaction Confirmation)
  - delivery of asset
  - payment (deferred or spot basis)

Two Sales Structure
documentation architecture
Single Sale Structure documentation architecture

Islamic Profit Rate Swap (Single Sale Structure):
- DFT Terms confirmation (Wa‘ad) – Fixed Profit Rate/FPR Leg
- DFT Terms confirmation (Wa‘ad) – Floating Profit Rate /FLPR Leg
- Exercise Notice in relation to undertaking where Exercise Condition is met
- Murabahah Sale

Example: Timeline of entry into Murabahah Sale at the start of each Calculation Period

- Purchase Date at start of Calculation Period
- Payment Date at end of Calculation Period

This diagram illustrates an example of entry into Murabahah Sale at the start of each Calculation Period:

- Trade Date: entry into DFT Terms Agreement
- Effective Date: DFT Terms Agreement becomes "live"
- Payment Date: payment of Cost + Profit by Buyer
- Exercise Date: Entry into Murabahah Sale
- Purchase Date: Delivery of Assets by Seller

February, March, April
Example: Timeline of entry into Murabahah Sale at the end of each Calculation Period

- This diagram illustrates an example of entry into Murabahah Sale at the end of each Calculation Period:
  - Purchase Date at end of Calculation Period
  - Payment Date at end of Calculation Period

Trade Date: entry into DFT Terms Agreement
Effective Date: DFT Terms Agreement becomes "live"

- Exercise Date
- Purchase Date: Delivery of Assets by Seller
- Payment Date: payment of Cost + Profit by Buyer

- End of First Calculation Period
- End of Second Calculation Period
- End of Third Calculation Period

- Start of First Calculation Period
- Start of Second Calculation Period
- Start of Third Calculation Period
- Start of Fourth Calculation Period

- Exercise Date
- Purchase Date: Delivery of Assets by Seller
- Payment Date: payment of Cost + Profit by Buyer

February
March
April

Conditions precedent satisfied

Islamic Cross Currency Swap (ICRCS) Product Purpose

An ICRCS enables parties to hedge currency risk and the profit rate risk associated with a given currency. For example, where a party has an investment in one jurisdiction in relation to which it has obtained funding denominated in the currency of that jurisdiction (for example where the party has issued Sukuk in the relevant currency and it will have to make regular payments in that currency with respect to the Sukuk), but the party accounts in the currency of its home jurisdiction, the ICRCS provides it with the potential to hedge its foreign currency requirements into the currency of its home jurisdiction.
Islamic Cross Currency Swap (ICRCS)
Product Description

The DFT Terms confirmation relates to *Himaayah Min Taqallub As ‘aar Assarf* or “Islamic Cross Currency Swap” (ICRCS) implemented through arrangements whereby each party simultaneously grants to the other party a *Wa’ad* (undertaking) to purchase *Shari’ah* compliant assets from such other party on one or more specified future dates on the basis of *Murabahah* transactions to be entered into on each exercise of the *Wa’ad* (undertaking) by such other party and where the purchase price payable in respect of such *Murabahah* transaction is to be determined on the basis of the cost price of the purchased *Shari’ah* compliant assets plus a profit amount, with the purchase price payable by one party being denominated in one of the two currencies the subject of such Islamic cross-currency swap and the purchase price payable by the other party being denominated in the other of the two currencies the subject of such Islamic cross-currency swap. This DFT Terms confirmation contains a *Wa’ad* (undertaking) granted by Party A to Party B. Under a Related DFT Terms Agreement, Party B grants a *Wa’ad* (undertaking) to Party A. This DFT Terms Agreement and the Related DFT Terms Agreement together form an Islamic Cross Currency Swap.

Islamic Cross Currency Swap (ICRCS)
Two Sales Structure

The ICRCS assumes a Two Sales Structure ICRCS. For each Calculation Period in relation to the ICRCS, the two *Wa’ad*’s set out in the DFT Terms confirmations for the First Leg and for the Second Leg, respectively, will be exercisable and exercised against the undertaking party (i.e. the Buyer) by the exercising party (the Seller). Therefore, two *Murabahah* Sales will be entered into between the parties; one in relation to the First Leg and one in relation to the Second Leg. Accordingly, there will be two asset-flows and two cash-flows (in two different currencies) between the parties in relation to each Calculation Period for the ICRCS.
ICRCS Two Sales Structure documentation architecture

ICRCS – Use of *Wa’ad* leading to *Murabahah* Sale

The ICRCS templates use a *Wa’ad* (or undertaking) structure, as is now increasingly common in Islamic finance transactions.

*A Wa’ad* is an undertaking or promise made by one party (the Buyer of assets) to the other party (the Seller of assets) that, if required by the Seller (usually called exercise of the undertaking or *Wa’ad*), the Buyer will fulfil its promise, in this case, to enter into a *Murabahah* (or sale and purchase) contract under which it will buy from the Seller an agreed quantity of agreed *Shari’ah* compliant assets at an agreed price (which may be determined by applying an agreed formula for calculating a price) on the relevant exercise date.

If and when the Buyer’s *Wa’ad* (or undertaking) is exercised by the Seller on an Exercise Date, the Buyer is required to purchase specified assets under a *Murabahah* contract with the Seller and execute a *Murabahah Asset Sale Confirmation*. A *Murabahah* Sale entered into between the parties constitutes a Transaction under the TMA.
Agency/brokerage

The template DFT Terms confirmations anticipate that the parties may wish to appoint an agent or broker to deliver, buy, sell or receive delivery of assets on its behalf. In these cases, the views of Shari’ah advisers should be sought to ensure that the use of the agent/broker and the relevant agency/brokerage procedures in the context of the particular ICRCS transaction do not fall foul of restrictions such as the prohibition on Bai Al Inah.

Execution as a Deed

The usual practice in the Islamic finance market is that a Wa’ad (or undertaking) is evidenced or confirmed using a deed and, therefore, the DFT Terms confirmations provide for the Buyer to enter into a DFT Terms Agreement as a deed. The parties will need to satisfy themselves as to the correct form of words to be used in the place designated for signature by the Buyer to ensure that the DFT Terms Agreement is properly executed as a deed.

ICRCS Product

Shari’ah Approval and Guidelines

While IIFM’s Shari’ah Board has approved the ICRCS templates after extensive consideration, it is always the responsibility of each of the parties entering to the ICRCS to ensure that, to the extent that Shari’ah compliance is relevant to its dealings and corporate governance, its use of the documents in the context of the transactions which it enters into satisfies its own Shari’ah advisers that the relevant hedging transaction is Shari’ah compliant and that the documents are suitable for, and are being used appropriately in, the context of that particular hedging transaction.

In order to assist market participants with regard to the DFT Terms confirmation provided to market participants by ISDA and IIFM, the IIFM Shari’ah Board have provide the following guidelines regarding Shari’ah compliance:

- Transactions should be entered into only for the purpose of hedging actual risks of the relevant party.
- Transactions should not be entered into for purposes of speculation, i.e. actual settlements of assets and payments must take place. No cash settlements without concluding actual transaction on deliverable assets.
- The asset must be Islamically lawful (i.e. Halal).
- No interest (whether called interest or an alternative name but which represents interest) is to be chargeable under a transaction.
Exercise of *Wa’ad* in Two Sale Structure: *Murabahah* Sale

Exercise of the *Wo’ad* under the First Leg requires Party A and Party B to enter into a *Murabahah* Sale, (i.e. Party B sells SC Assets to Party A at a purchase price consisting of Cost Price + Profit).

Delivery of assets: Party B (the Seller) delivers the SC Assets (copper) to Party A on the Purchase Date, which, in this example, falls at the start of each Calculation Period.

Payment of purchase price: Party A (the Buyer) pays the deferred purchase price of Cost + Profit on the Payment Date, which, in this example, falls at the end of the each Calculation Period.

- Cost Price under First Leg is the cost of the SC Assets (copper) to the Seller.
- Profit is determined by reference to the Profit Type:
  - Initial Exchange = Profit Type 1 (Capital Amount of USD)
  - Interim Exchange = Profit Type 2 – Fixed Profit Rate of Euro
    \[\text{Capital Amount} \times \text{FPR} \times \text{FPR Day Count Fraction}\]
  - Final Exchange = Profit Type 1 (Capital Amount of Euro) + Profit Type 2 - Fixed Profit Rate of Euro

Exercise of the *Wo’ad* under the Second Leg requires Party A and Party B to enter into a *Murabahah* Sale, (i.e. Party A sells SC Assets to Party B at a purchase price consisting of Cost Price + Profit).

Delivery of assets: Party A (the Seller) delivers the SC Assets (zinc) to Party B on the Purchase Date, which, in this example, falls at the start of each Calculation Period.

- Payment of purchase price: Party B (the Buyer) pays the deferred purchase price of Cost + Profit on the Payment Date, which, in this example, falls at the end of the each Calculation Period.
- Cost Price under First Leg is the cost of the SC Assets (zinc) to the Seller.
Islamic Foreign Exchange Forward (IFX)

Islamic FX Definition

Islamic Foreign Exchange (IFX) is a contract that is designed as a hedging mechanism to minimize market participants’ exposure to market currency exchange rates which is volatile and fluctuating.

IFX Forward Structures

There are two structures which are commonly used in the market for Shari’ah compliant IFX hedging arrangements namely:

- Single binding Wa’ad based structure
- Two unilateral Wa’ad based structure

It is worth noting that the single binding Wa’ad and the two unilateral Wa’ad based structures are the most preferred in terms of consensus amongst Shari’ah scholars as well as market participants.

Forward IFX essentially involves two dissimilar currencies. According to Islamic Law the exchange of two dissimilar currencies / counter values must be spot or simultaneous (i.e. hand to hand) as it is considered to be interest based items (i.e. Ribawi).

In the IFX Forward transaction as it is being practice in the current IFX market, the rate of exchange will be locked in the day of the contract (i.e. today) but the delivery of the two dissimilar currencies will be deferred to a future date. It is important to point out here, in this regard, that Shari’ah does not prohibit a promise to buy and sell currencies on one date with delivery to be made on another date because the proper contract only concludes on the day of delivery.

Under the single binding Wa’ad structure a binding promise will be applied whereby the party who promised to buy or sell, as the case may be, is obliged to fulfil that promise.

For clarification, according to Shari’ah, a binding promise from only one party is not deemed as a contract. Thus, this can make the process of the Islamic FX contracts as they are currently being applied in market acceptable from Shari’ah perspective.

Under the two unilateral Wa’ad structure, each party to the agreement unilaterally will give an independent promise (undertaking) to exchange currencies against another currency, as the case may be, on a future date at a specified amount. Each promise will contain a different set of conditions such that only one of the promises can be exercised on the settlement date with no further obligations arising under the other promise.
IFX Single *Wa‘ad* Based Structure

The IFX single binding *Wa‘ad* based structure involves one party which is looking for a hedge to purchase a specific currency at a future date based on the rate determined today providing a *Wa‘ad* (promise / undertaking) to purchase such currency.

In this transaction the party who is looking for a hedge will identify his requirement, for instance, he has surplus funds denominated in currency (a) (let us say USD) and wishes to invest in currency (b) (let us say Euro), but he is concerned that the exchange rate fluctuation of currency (a) and currency (b) may expose him to cash flow uncertainty and therefore wishes to mitigate this risk.

Explanation

1. **Bank and a Customer: Master Agreement.**
   The parties to this transaction, being a bank and its customer, will enter into a Master Agreement. The master agreement will be the ISDA/IIFM *Tahawwut* Master Agreement (TMA).

2. **Bank and a Customer: Commercial terms agreement.**
   Bank and the Customer will agree on the commercial terms of the foreign exchange transaction, such as the currency, purchase price, current spot exchange rate, etc. These terms will be documented under the DFT Terms Confirmation which supplements the ISDA/IIFM *Tahawwut* Master Agreement (TMA).

3. **Promise to Purchase. The transaction will be executed as follows:**
   - The Customer will, by executing the DFT Terms Confirmation/Agreement, promise to Bank to purchase currency (b) on a specified future date (the Purchase Date) on the terms and conditions outlined in the ISDA/IIFM *Tahawwut* Master Agreement (TMA) and the DFT Terms Confirmation/Agreement.
   - Bank acknowledges the promise by signing the DFT Terms Confirmation/Agreement.
   - On the agreed Purchase Date, the customer will send to Bank an Offer to Purchase whereby he offers to purchase from Bank currency (b) for currency (a) for settlement on the Purchase Date at a predetermined rate.
   - Following that the Bank will send to the customer an Acceptance Notice accepting his Offer to Purchase.
   - On the Settlement Date, the customer will remit to Bank’s designated account currency (a) and the Bank will remit currency (b) to the customer A’s designated account.
Shari‘ah-Compliant IFX
Single Binding Wa‘ad based transaction

1. Wa‘ad
   - Promises to purchase currency \( b \) for currency \( a \) at a predetermined rate

2. Sale of currencies (buy‘ al-sarf) at the settlement date
   - Customer \( \rightarrow \) Currency \( a \) \( \rightarrow \) Bank
   - Currency \( b \) \( \rightarrow \) Customer

Two Unilateral Wa‘ad Based Structure

The main difference between the binding single Wa‘ad based structure and the two unilateral Wa‘ad based structure is that under the two unilateral Wa‘ad based structure, each party to the agreement unilaterally gives an independent promise (undertaking) to exchange currencies against another currency on a future date at a specified amount. Each promise will contain a different set of conditions such that only one of the promises can be exercised on the settlement date with no further obligations arising under the other promise. To elaborate further on this structure:

Where Customer has surplus funds denominated in currency \( a \) (being USD) and wishes to invest/hedge in currency \( b \) (being Euro), each of the Customer and the Bank will provide a unilateral undertaking. The customer will undertake to purchase from Bank currency \( b \) for currency \( a \) for settlement on the Purchase Date if the USD/EUR exchange rate is equal to below a pre-determined rate. The bank will undertake to purchase from Customer currency \( a \) for currency \( b \) for settlement on the Purchase Date if the USD/EUR exchange rate is above a pre-determined rate. These will be documented as two separate and distinct unilateral undertakings with different conditions such that only one of the undertakings can be exercised at any one time. On the Purchase Date, the Party that is in the money will exercise the relevant Wa‘ad.

Other terms such as Trade Date, Effective Date, Purchase Date, Strike Rate, Spot Rate, Currency and Amounts will remain consistent between the two promises.
Explanation

1. **Bank and a Customer: ISDA/IIFM TMA (the Master Agreement).**
   The parties to this transaction, being a bank and its customer, will enter into the ISDA/IIFM TMA (the Master Agreement).

2. **Bank and a Customer: Commercial terms agreement.**
   Bank and the customer will agree on the commercial terms of the foreign exchange transaction, such as the currency, purchase price, current spot exchange rate etc. These terms will be documented under a DFT Terms Agreement/Confirmation which supplements the ISDA/IIFM TMA (the Master Agreement). There will be two DFT Terms Agreement/Confirmations – one which documents the Customer’s undertaking and another which documents the Bank’s undertaking.

3. **Promise to Purchase.** The transaction will be executed as follows:
   - The Customer will, by executing a DFT terms Agreement/Confirmation, promise to Bank to purchase currency (b) on the Purchase Date on the terms and conditions outlined in the ISDA/IIFM TMA (the Master Agreement) and the DFT Terms Agreement/Confirmation.
   - Bank acknowledges the promise by signing the DFT Terms Agreement/Confirmation.
   - The Bank will, by executing a separate DFT Terms Agreement/Confirmation, promise to Customer to purchase currency (a) on the Purchase Date on the terms and conditions outlined in the ISDA/IIFM TMA (the Master Agreement) and the DFT Terms Agreement/Confirmation.
   - Customer acknowledges the promise by signing the DFT Terms Agreement/Confirmation.
   - On the agreed Purchase Date, depending on what the USD/EUR spot exchange rate is at the time, the condition specified in one of the undertakings will have been satisfied.
   - On the agreed Purchase Date, the Customer or Bank (depending on which undertaking has been satisfied) will send to the other an Offer to Purchase whereby he offers to purchase currency (b) for currency (a) (if the Customer is sending the Offer to Purchase) or currency (a) for currency (b) (if the Bank is sending the Offer to Purchase) for settlement on the Purchase Date at a pre-determined rate.
   - Following that the Bank or the Customer, as applicable, will send to the other an Acceptance Notice accepting his Offer to Purchase.
   - On the Settlement Date, the customer will remit to Bank’s designated account currency (a) and the Bank will remit currency (b) to the customer A’s designated account.

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**Shari‘ah-Compliant Two Unilateral FX Based Wa‘ad Transaction**

1. **Wa‘ad 1**
   - Promises to purchase currency (b) for currency (a) at a pre-determined rate
   

2. **Wa‘ad 2**
   - Promises to purchase currency (a) for currency (b) at a pre-determined rate

3. **Sale of currencies (bay‘ al-sarf) at the settlement date**
   - Currency (a)  
   - Currency (b)
Finally, as indicated above, the documentation architecture is to cater for both the binding single *Wa’ad* and the two unilateral *Wa’ad* structures.

For the binding single *Wa’ad* structure, **only one DFT Terms Agreement/ Confirmation containing the relevant undertaking would be executed.**

For the two unilateral *Wa’ad* structure, **two DFT Terms Agreements/ Confirmations (each containing a separate unilateral undertaking from the relevant party) would be executed.**

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**Other Hedging Standards Under Consultation**

- **Islamic Credit Support Deed (ICSD)**
  
  ICSD is one of the key documentations for risk management where counter-parties transactional risk is managed through collateral and margin maintenance mechanism under the already published *Tahawwut* Master Agreement for Islamic hedging transactions. There is a growing requirement for ICSD in the GCC, Europe, Far East and other regions.

- **Other IFX Products (maybe considered)**
4) Law Reform and Regulatory Framework

by
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The Need for Law Reform

• The development and use of derivatives products has become ubiquitous spreading around the world
• This includes the Islamic finance sector (ISDA/IIFM Tahawwut Master Agreement)
• Effective risk management requires legal certainty. In the ISDA context this means:
  – Enforceability of derivatives contracts
  – Clarity of insolvency law and enforceability of netting provisions
  – Clarity regarding the treatment of collateral
The Need for Law Reform

- Significant variation in national insolvency and property laws around the world affects the enforceability of derivatives transactions under industry standard netting and collateral agreements (e.g., ISDA Master Agreements for global cross-border transactions, local master agreements).

- Industry’s law reform efforts aim at addressing these concerns, working with multinational organizations as well as national authorities.

Financial Market Law Reform: Key Questions

- Knowing where you stand: the practical value of increasing legal certainty
  - An abstract goal, but with concrete results: increased market confidence, more liquidity, greater financial stability

- Key questions:
  - Will my agreement be respected and enforced by a court or arbitration tribunal?
  - Will foreign law governed contracts and foreign based counterparties be treated equally?
  - Will it be enforced as written, both before and after my counterparty’s insolvency?
  - How can I protect against the risk of my counterparty’s insolvency?
    - Early termination and close-out netting under a master agreement
    - Set-off rights
    - Financial collateral arrangements and other forms of security
    - Guarantees, letters of credit, insurance, credit derivatives
Law Reform Efforts in Emerging Markets

- Crucial role of intergovernmental organizations in enhancing legal certainty by promoting harmonization of capital markets legislation
- Equally relevant to Islamic financial institutions
- Involve IFSB, multilateral development banks
- Global legal instruments: UNIDROIT Netting Principles; Geneva Securities Convention, Hague Securities Convention; UNCITRAL Legislative Guides
- Since 1987 ISDA has been developing standard contracts, recommendations and model laws on netting and for collateral transactions
  - ISDA netting legislation initiatives in EMEA, LatAm, Asia-Pac
  - ISDA Model Netting Act and Memorandum on Implementation of Netting Legislation (latest version published October 2007)
  - ISDA Master Agreements and supplemental standard documentation (collateral; clearing)
  - Positive industry legal opinions to obtain regulatory capital approval (Basel Capital Accords)

Legal opinions for ISDA/IIFM Tahawwut Master Agreement

Netting legislation:
- Malaysia, Singapore, Thailand, Indonesia, India, Hong Kong, Philippines etc (covered by regular ISDA opinions)
- Bahrain (enacted in Dec 2014)
- UAE free zones (DIFC and ADGM have enacted specific laws in Dec 2014, mid-2015)
- UAE federal law level and Saudi draft law on insolvency
- Pakistan (draft legislation pending)
- What about collateral (eg, GSC; collateralized Murabahah)?

TMA Legal Opinions:
- Malaysian TMA Legal opinion
- Singapore TMA Legal opinion
- English Law revised TMA legal opinion
Collateral arrangements
(Chapter V Geneva Securities Convention)

Questions regarding scope
- Types of counterparties
- Relevant financial obligations
- Financial collateral
- Safe harbour provisions from insolvency rules (impact and policy justification)

Types of collateral agreements
- Security collateral agreement
- Title transfer collateral agreement
- Including close-out netting provision

International new regulatory reforms
- Basel Committee margin requirements (WGMR)
- EU Infrastructure Market Reform (EMIR)
- Dodd-Frank Act (US law reform)

Thank You