

The Tahawwut Master Agreement and Islamic Hedging Product Standards – Purpose and Overview

Workshop on IIFM Standards

Islamic Hedging and Liquidity Management – A Practical Approach

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Islamic Hedging

Seven Standard Documentation Published

Standards are jointly published in association with ISDA and fall under existing practice and innovation strategy. So far 7 standards related to Islamic hedging have been published as follows:

1. Tahawwut (Hedging) Master Agreement (TMA)
2. Islamic Profit Rate Swap (IPRS) - Single Sale
3. Islamic Profit Rate Swap (IPRS) - Two Sale
4. Islamic Cross-Currency Swap (ICRCS)
5. Islamic Foreign Exchange Forward (IFX Forward) – Single Binding Wa’ad based
6. Islamic Foreign Exchange Forward (IFX Forward) – Two Unilateral and Independent Wa’ad based
7. Islamic Credit Support Deed for Cash Collateral (VM)

Key Take Aways

Why Murabahah and Wa'ad are used in the standards?

- Most widely used contract and principle used in the Islamic hedging segment
- Temporary absence of other working structuring alternatives

Value Addition/Impact

- TMA is becoming the Master Agreement of choice and its use is increasing with publication of products standards and soon to be published Islamic Credit Support Deed
- Implemented in Saudi Arabia, Bahrain due to regulatory support and institutions preference

Why these Standards are well received in the market?

- Strong and well established documentation architecture (no other master agreement of matching TMA quality)
- Wider Shari'ah acceptability and innovation such as Index based close-out netting mechanism, unilateral Wa'ad concept
- Law reforms and recommendation for close-out netting law for Islamic transactions

Islamic Hedging

Structuring Alternatives

❑ Murabahah

- In TMA the treatment of Murabahah is defined
- No discounting and claim for full amount
- Fully delivered terminated transactions treatment (Murabahah)
- Non-fully delivered terminated transactions treatment (Designated Future Transactions)

❑ 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

Islamic Profit Rate Swap (*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.

Islamic Cross Currency Swap (ICRCS)

Himaayah Min Taqallub As 'aar Assarf

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 are in the currency of its home jurisdiction, the ICRCS provides mechanism to hedge its foreign currency requirements into the currency of its home jurisdiction.

Islamic Cross Currency Swap (ICRCS)

Himaayah Min Taqallub As 'aar Assarf

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.

Islamic Cross Currency Swap (ICRCS)

Himaayah Min Taqallub As 'aar Assarf

Use of *Wa'ad* leading to *Murabahah* Sale

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.

Islamic Foreign Exchange Forward (IFX)

Wiqayah Min Taqallub As'aar Assarf

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) otherwise 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.

Islamic Foreign Exchange Forward (IFX)

Wiqayah Min Taqallub As'aar Assarf

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.

Islamic Foreign Exchange Forward (IFX)

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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.

Islamic Foreign Exchange Forward (IFX)

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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 or 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

Shari'ah Approval and Guidelines

While IIFM's *Shari'ah* Board has approved the Hedging Product templates after extensive consideration, it is always the responsibility of each of the parties entering to the ICRCs, IPRS or IFX Forward 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.

Thank You