

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

Islamic Banks Treasuries & *Tahawwut* Master Agreement

➤ Significance of Treasury – *key risk mitigation functions*

☐ Asset & Liability management

- Liquidity mismatches
- Rate of Return mismatches

☐ Foreign Exchange

- Open position
- Cross Currency mismatches

Documentation & Product Standardization

- The key benefits of standardization of documentation and products are:
 - I. Reduces cost of evaluating and negotiation of documentation
 - II. Provides balance and fairness
 - III. Increases efficiency, liquidity and certainty
 - IV. Benchmark to provide a reference point
 - V. Reduces the price divergence between Islamic hedging and conventional counterparts

Hedging Master Agreement

Background

- Although in recent years Islamic hedging market has grown, however, it is still in the development phase. The first pro-forma regional Islamic Hedging Master Agreement was executed in Malaysia in 2006
- At the same time, IIFM and ISDA decided to combine their respective strengths and started work on developing a framework or governing document for Islamic hedging which is absolutely necessary for the orderly development of hedging or *Tahawwut* segment of IFSI
- In Q3 2006, the MoU between IIFM and ISDA was finalized with the aim to develop a new market standard master agreement

Hedging Master Agreement

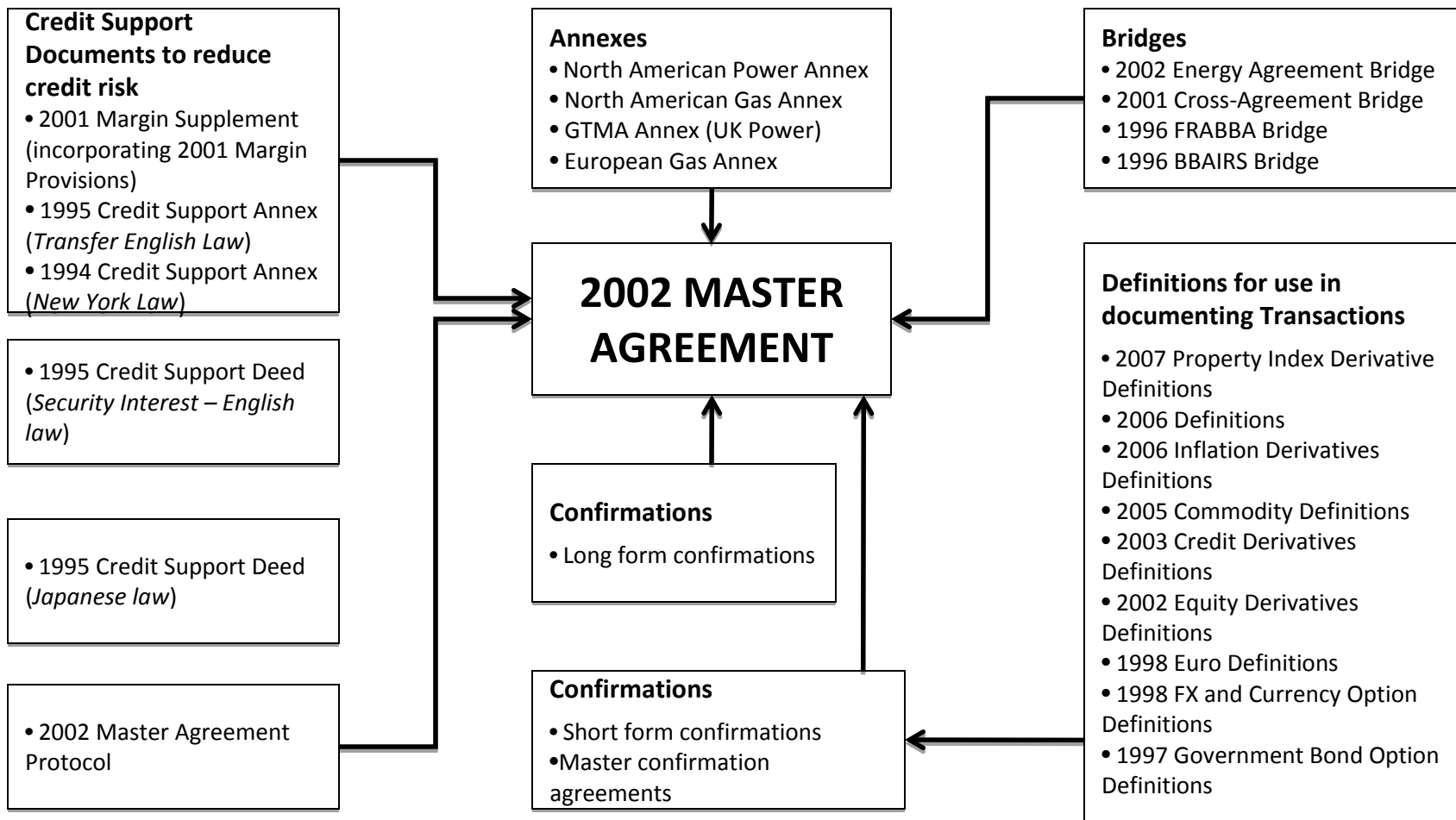
Risk Management Perspective – Need for a Framework Agreement



Third Level	Framework – Counterparty Relationships	Shari'ah Implications	✓
Second Level	Usage and Structure of Hedges	Shari'ah Implications	X
First Level	Risk arising from Assets and Liabilities	Shari'ah Implications	X

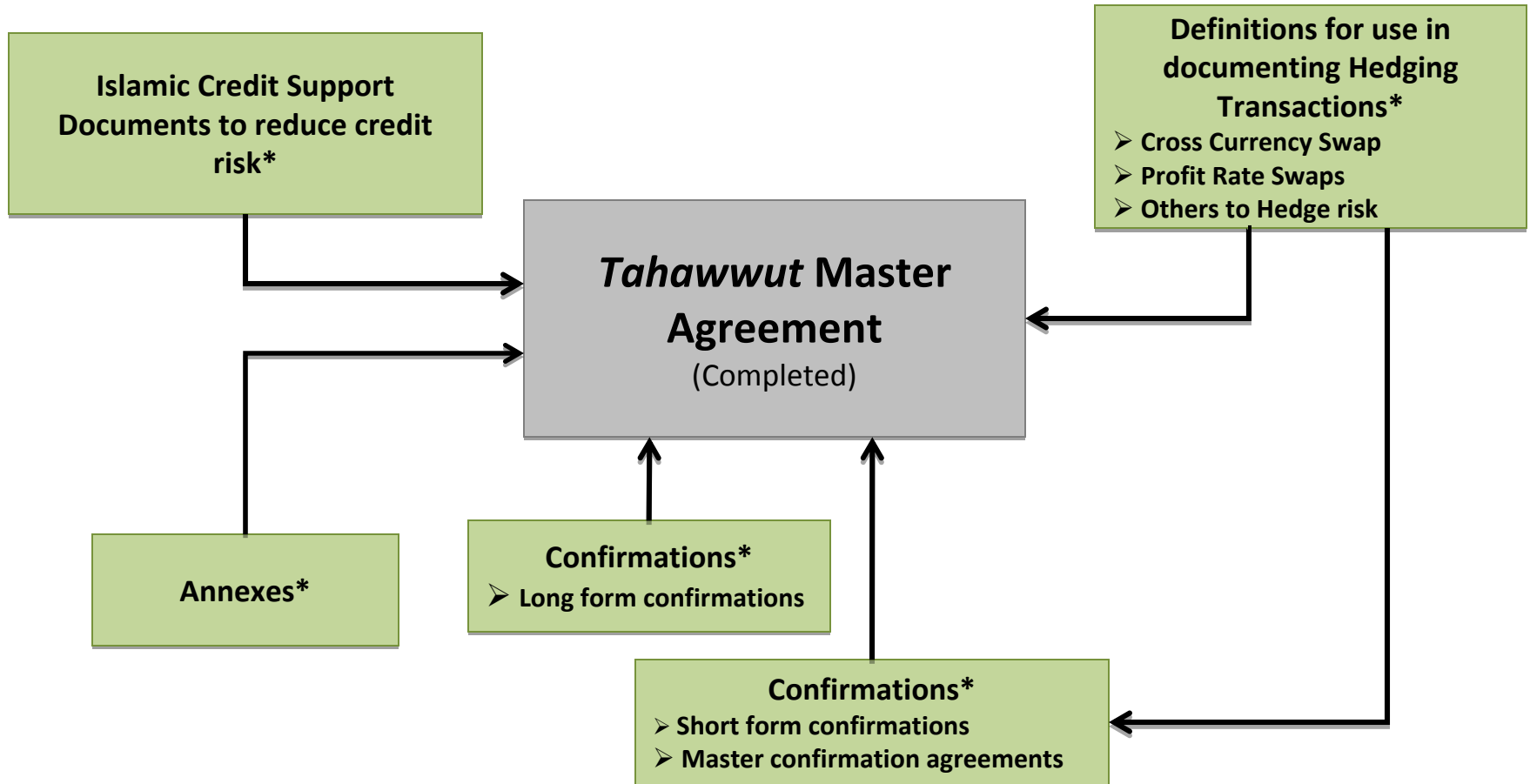
***Tahawwut* Master Agreement covers primarily the third level of risk management, covering relationship framework, events of early termination, early termination netting mechanisms, representations**

Conventional ISDA Agreement Structure



Source: ISDA

Tahawwut Master Agreement Documentation Architecture



*** Standardization aim for robust risk mitigation**

Comparison between 2002 ISDA Master Agreement & ISDA/IIFM *Tahawwut* Master Agreement



The Agreement is a new market document and, in preparing it, we have sought, where practical, to be consistent with other market standard documentation (especially the structure of the 2002 ISDA Master Agreement)

1. ISDA architecture (confirmations, single agreement, flawed asset concept)
2. Additional Representations as to *Shari'ah* compliance
3. Early Termination
4. No compensation or interest on defaulted or deferred payments and deliveries
5. No interest payable
6. Governing law and dispute resolution
7. Dual close-out mechanism
8. Set-off and netting mechanics

Tahawwut Master Agreement Architecture

- Multiproduct Agreement (all *Murabaha*, *Musawama* and *Wa'ad* based products)
- Available for use by all market participants, in all geographical regions
- Not part of ISDA modular library
- New concept hard-wired throughout the Agreement
 - Transactions: Live transactions (concluded transactions) – “Confirmation”
 - Transactions: Designated Future transactions (non-concluded transactions) – “DFT Terms Agreement”, “DFT Terms confirmation”
- Both Transactions and DFT Terms Agreements fall within the scope of:
 - “Single Agreement” (*Section (1)(c)*)
 - Flawed asset provision (*Section 3*)
 - Undertakings (*Section 4*)
 - Relevant Events of Default and Termination Events (*Section 5*)

Tahawwut Master Agreement Architecture

Explanatory Memorandum

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

- Transactions entered into under the *Tahawwut* Master Agreement should only be for the purpose of hedging actual risks of the relevant parts
- Transactions should not be entered into under the *Tahawwut* Master Agreement which are for the purposes of Speculation
- Transactions must be real transactions, involving the actual transfer of ownership or real assets, actual risk and real settlement
- The Asset itself must be *Halal*
- Interest must not be chargeable under the transaction

Tahawwut Master Agreement *Significance*

➤ Key benefits

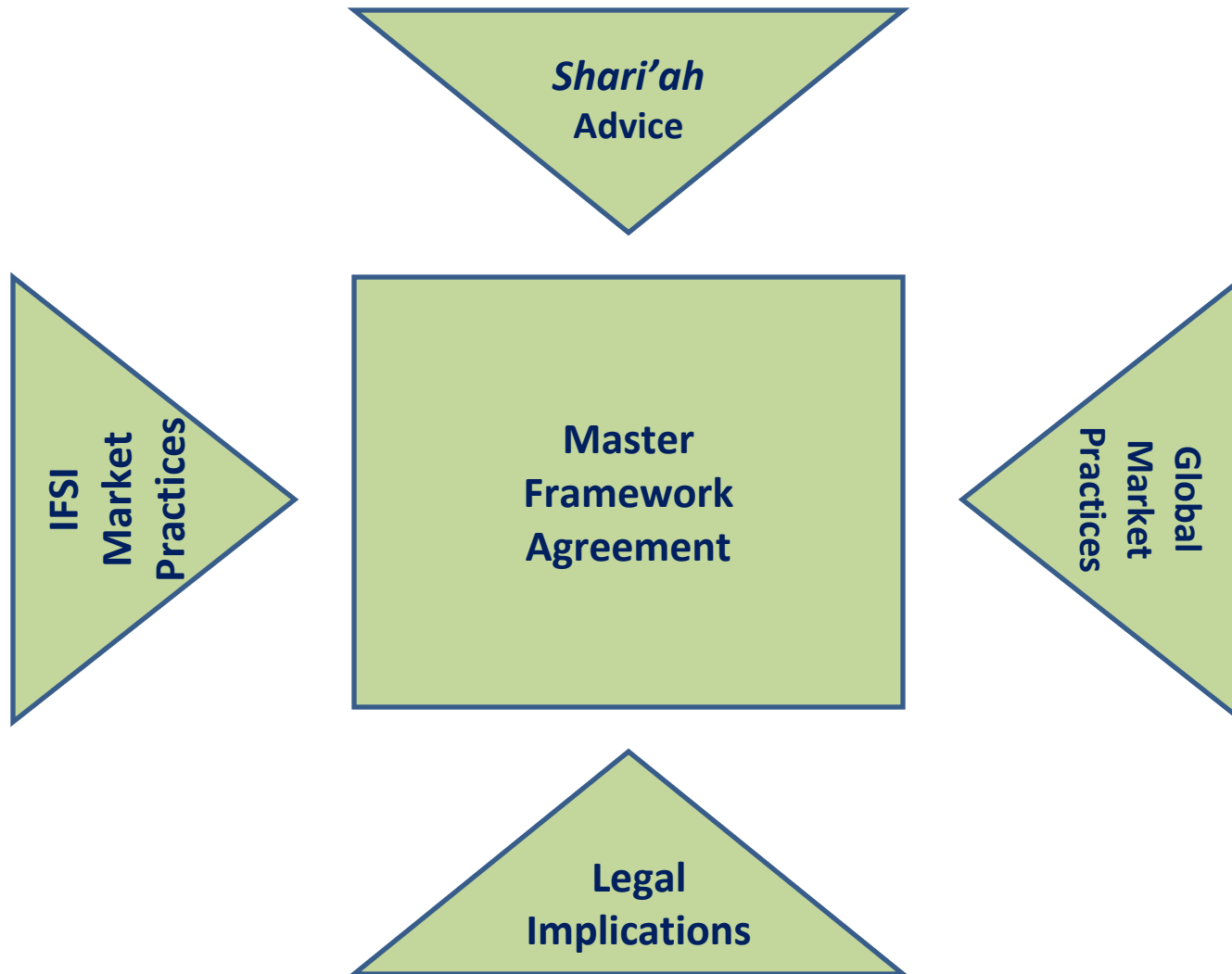
- Global Islamic closeout mechanism
- Multi hedging products
- Closeout netting & legal opinions

➤ Most used contract & principle in Islamic Risk mitigation

- Murabaha*
- Wa'ad*

Tahawwut Master Agreement

A Detailed Deliberation Process



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 Panel
- Special attention is given to covering all the scenarios which may exist in case of early termination. One example is concluded *Murabaha*, fully delivered terminated transactions, non-fully delivered terminated transactions

Tahawwut Master Agreement Documentation

The published documents are:

- **ISDA/IIFM *Tahawwut* Master Agreement (TMA)**

TMA is a framework document for hedging transactions and is developed for the entire Islamic finance industry especially for Islamic financial institutions (IFI's) as well as for Islamic windows. It is a new document for IFI's and their understanding and adoption of this document will play a crucial role in the development of hedging or risk-mitigation segment of the industry

- **TMA Explanatory Memorandum**

In order to provide information on key features of TMA and how these can be applied, a detailed Explanatory Memorandum is also part of the publication

Shari'ah principles on which the TMA is based

□ *Murabaha*

- Treatment is defined based on use of *Murabaha* under the institution's product structure
- No discounting and claim for full amount
- Fully delivered terminated transactions treatment (*Murabaha*)
- Non-fully delivered terminated transactions treatment [Designated Future Transaction (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

Shari'ah principles on which the TMA is based – Designated Future Transaction (DFT)

- ❑ Upon Early Termination, an Index must be calculated
- ❑ Each party has given an undertaking (*Wa'ad*) to enter into a *Musawama* if called upon to do so following calculation of the Index
- ❑ The Index measures the replacement cost (or gain) of entering into replacement transactions
- ❑ Index Amount means, with respect to each DFT or each group of DFT's, 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 or group of DFT's
- ❑ Calculation may take into account market quotations or prices received from market makers (replacement of hedges)

Shari'ah principles on which the TMA is based – *Designated Future Transaction (DFT)*

❑ **Musawama Sequence – Early Termination**

- Step 1 – Establish market reference on the basis of replacement transaction
- Step 2 – Exercise *Wa'ad* based on whether the Index is positive or negative
- Step 3 – Enter into *Musawama* based on replacement quotation (real transaction)

❑ **Non-Affected Party Time-Limit**

- One year time-limit for non-affected counterparty to carry out real transaction for its in the money position i.e. unutilized hedges

❑ **Footnotes**

- Footnotes are provided for extensive and extra guidance

Disclaimer

Potential users of the ISDA/IIFM *Tahawwut* Master Agreement should note that, when entering into Transactions or DFT Terms Agreements under it or credit support arrangements in relation to it, or making any amendment or addition to it they must first take all action required to satisfy themselves as to the *Shari'ah* compliance of such Transactions, DFT Terms Agreements, credit support arrangements, amendments or additions and of the *Shari'ah* compliance of such Transactions, DFT Terms Agreements or credit support arrangements when taken together with the ISDA/IIFM *Tahawwut* Master Agreement and of the ISDA/IIFM *Tahawwut* Master Agreement incorporating such amendment or addition. No *Shari'ah* approval is given by the IIFM *Shari'ah* Advisory Panel with respect to any Transactions, DFT Terms Agreements or credit support arrangements or any amendment or addition to the ISDA/IIFM *Tahawwut* Master Agreement.

TMA Market Adaptation Process

- Internal review and approval by credit, *Shari'ah*, operation departments
- Bilateral negotiation
- Transactions

Thank You

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