IIFM-BAFT Islamic Trade Finance Standards

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Multi Function Room, 3rd Floor, Building B, Bank Indonesia, Jakarta

Ijlal Ahmed Alvi
Chief Executive Officer
IIFM

IIFM-BAFT Master Unfunded Participation Agreement (MUPA) for Trade Finance Transactions

Objective

To provide solution to the problem of lack of credit line.

Improvement of risk coverage capacity and optimization of asset portfolio.

Assistance in expanding business within local and international network of banks and financial institutions.

Year of publication 2019

Use: Published 23 January 2019, and hence no usage survey conducted on it yet though IIFM is in receipt of interest from some

Key Features

1. The Agreement: Is master agreements in nature and provide mechanism to include general and specific terms and conditions to be entered into between Grantor and Participant.

It is not a transaction or product specific documents, but it is framework agreements to document multiple unfunded and funded participation transactions between parties.

Transaction documentation is not part of this Participation Agreement.

2. **Agency (Wakalah) based structure:** Between the grantor (as agent) and the participant (as principal) prior to entering into a participation transaction.

3. **Four parties involved in a participation transaction:** The grantor, the participant, the obligor and the beneficiary/ the supplier of goods.

4. **Permitted trade finance instruments for unfunded participation:** Letters of credit, excluding any discounting arrangement. confirmations or guarantees of letters of credit. irrevocable reimbursement undertakings, letters of indemnity, letter of guarantees or similar instruments. advance payment guarantees etc. Any other trade

finance instrument which is in conformity with the principles and rules of Shari'ah will be acceptable subject-matter for an unfunded participation transaction under this IIFM-BAFT (MUPA).

5. **Justifications for the participant's share in participation service fee and upfront fee:** Examining transaction documents. Advising the grantor of any discrepancies. Preparation or issuance of any documents, reports or feasibility studies.. .....

6. **Amendment and restructuring:** Assignment and transfer must be in compliance with the principles and rules of Shari'ah.

7. **Governing law and jurisdiction:** English law and English courts will have jurisdiction along with arbitration at the London Court of International Arbitration or the Dubai International Islamic Centre for Reconciliation and Arbitration. However, the governing law and choice of dispute resolution forum of this Agreement are at the option of the parties.

8. **Footnotes & Shari'ah Approval:** Extensive footnotes are included to provide guidance and explanatory information to the users. Such footnotes do not form part of the terms of the contract between the parties. It is approved by the IIFM Shari' Board.

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4. **Permitted trade finance techniques for funded participation:** A trade finance transaction in compliance with any type of Shari'ah compliant modes of financing such as, Mudarabah, Musharakah, Ijarah, Murabahah, Musawamah, Salam, Istisna'a and Wakalah is acceptable as the subject-matter of a funded participation transaction under this IIFM-BAFT (MFPA).

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IIFM-BAFT Master Unfunded and Funded Participation Agreements for Trade Finance Transactions

Participation Arrangement for Islamic Trade Finance Business

The participation, in the context of Islamic trade finance transactions, is when a arranging financial institution ‘Grantor’ invite other financial institution(s) ‘Participant(s)’ to take part in the unfunded or funded transaction on a risk sharing basis where both the arranger and participant(s) take obligor’s risk.

The parties execute a participation agreement pursuant to which the financial institution offering the risk participation in its capacity as grantor sells part of its exposure under the transaction documentation to another financial institution which is accepting such participation in its capacity as participant.

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IIFM Standards consists of two separate Participation Agreements for trade finance transactions as follows:

a) **Unfunded Participation:** The Parties wish, from time to time and in accordance with Wakalah (agency) arrangement, to enter into trade participation transactions on an unfunded basis (LC confirmation, Letter of Guarantee) where the fee to the participant will be for providing certain services. The participant, under a separate arrangement, as guarantor (Kafil) will bear the risk of obligor's default up to his share of participation

b) **Funded Participation:** The Parties wish, from time to time and in accordance with Wakalah (agency) arrangement, to enter into trade participation transactions on funded basis where profit will be shared between the Grantor & Participant. The up-front fee, if any, to the participant will be for providing certain services. The participant through its participation takes credit risk of the obligor(s).

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Difference between a Conventional and an Islamic Participation

Conventional sub-participation/participation	Islamic participation
1. Participant in a conventional participation transaction becomes a creditor of the grantor	1. Both participant and grantor are obligor's creditors as grantor acts as participant's agent
2. Participant takes a double credit risk, against the borrower and the grantor. Participant's return is conditional on the borrower complying with its payment obligations under the loan agreement and on the grantor complying with its payment obligations under the participation agreement	2. Since grantor acts as participant's agent, participant does not take grantor's credit risk
3. Participant does not benefit from security the borrower has granted the lender, unless otherwise agreed.	3. Grantor enters into the transaction documents on its behalf and on behalf of participant. As such, participant fully enjoys benefits from security provided by obligor

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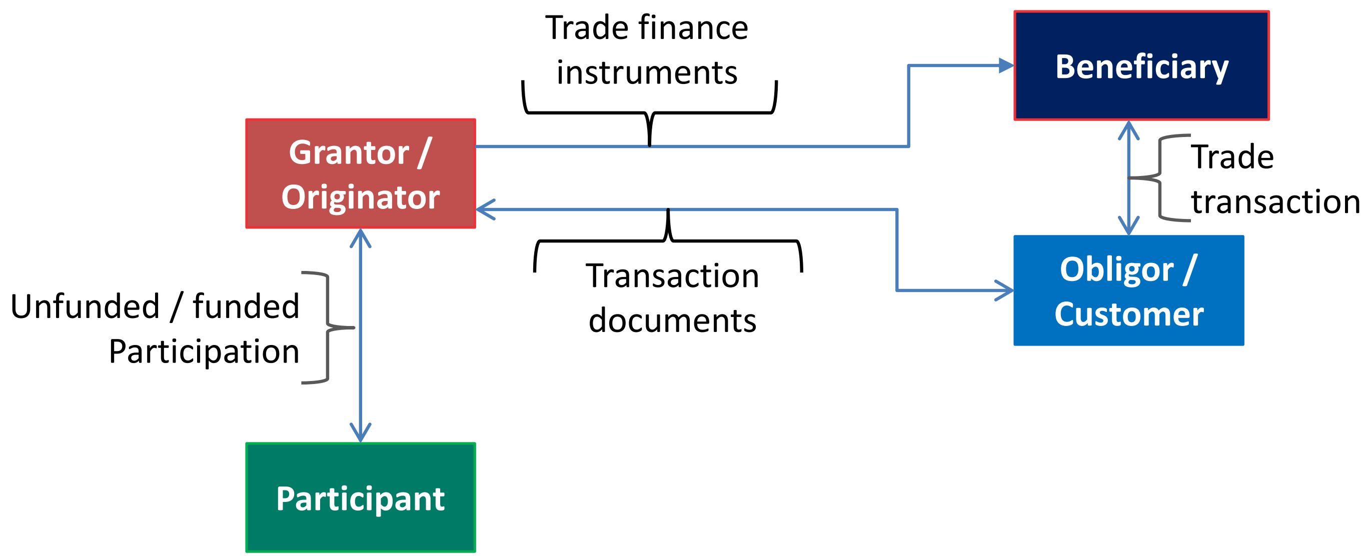
Parties in an Unfunded/Funded Participation



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General Shari'ah Ruling

a) In principle, risk participation agreements must not create any Shari'ah repugnant obligation on any party, such as entitlement of penalty interest in case of default. While it is permissible to subscribe to an Islamic insurance coverage as security for debt obligations, it is contrary to the principles and rules of Shari'ah that debts are insured on a conventional insurance basis though in absence of Takaful, subject to internal Shariah approval, the parties may agree to insurance

b) **Unfunded transaction** - As per Shari'ah principles it is allowed for two or more parties to jointly guarantee any Shari'ah compliant obligation through a Shari'ah compliant mechanism. Therefore, it is permissible for an Islamic bank to share part of its risk exposure under an LC or LG etc., with Islamic or conventional banks, taking into consideration the following:

i. Risk participation agreement must not create any Shari'ah repugnant obligation on any party, such as entitlement of penalty interest in case of delay by the client in funding any claim under LG or LC; and

ii. Since an LC or LG is to be issued only in the name of the Grantor, the Grantor shall sign an agency agreement with other participating banks whereby the other banks will appoint the Grantor as their collective agent to issue the LC or LG in its name under the facility. In this case, an LC or LG shall be issued by the Grantor on its own behalf for its own share in the relevant LC or LG and on behalf of the other participating banks as an agent for their respective share in such LC or LG.

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General Shari’ah Ruling

c) **Funded transaction** - Funded trade finance transaction is generally financed through a Murabahah structure whereby an Islamic bank, based on a facility request and promise to purchase from a customer, purchases the relevant goods from a supplier and subsequently sells the same to the customer with a sale price which comprises of procurement cost plus pre-agreed profit.

So, the standard Shari’ah practice for financing the goods through Murabahah is that the bank first purchases the goods directly from a supplier; which fact is evidenced by the commercial invoice issued by the supplier in the name of the bank and then sells the same to the customer by way of Murabahah.

As per the Shari’ah principles it is allowed for two or more parties to participate in any Shari’ah compliant obligation through a Shari’ah compliant mechanism. Therefore, it is permissible for an Islamic bank to share part of its risk exposure under a funded risk participation arrangement with one or more Islamic or conventional banks.

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Kafalah General Ruling

As per the AAOIFI *Shari'ah* Standard No. 5 (*Guarantees*):

a) It is not permissible to combine agency and personal guarantees in one contract at the same time (i.e. the same party acting in the capacity of an agent on one hand and acting as a guarantor on the other hand), because such a combination conflicts with the nature of these contracts. In addition, a guarantee given by a party acting as an agent in respect of an investment turns the transaction into an interest-based loan, since the capital of the investment is guaranteed in addition to the proceeds of the investment, (i.e. as though the investment agent had taken a loan and repaid it with an additional sum which is tantamount to riba). But if a guarantee is not stipulated in the agency contract and the agent voluntarily provides a guarantee to his clients independently of the agency contract, the agent becomes a guarantor in a different capacity from that of agent. In this case, such an agent will remain liable as guarantor even if he is discharged from acting as agent.

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Role of Kafil (Guarantor)

The participant plays the role of a third-party guarantor (kafil) to the debtor (Obligor) in IIFM BAFT Unfunded Standard which is as per the AAOIFI Shari'ah Standard No. 5 (Guarantees)

Agency Arrangement

In relation to an unfunded and funded participation, a Participant will appoint the Grantor as its Wakil (agent) and the Grantor will accept such appointment to act as a Wakil (agent) of the Participant in accordance with the terms of the relevant participation agreement.

A form of agency agreement is appended to each of the IIFM-BAFT Participation Agreements (for Shari'ah reasoning, the form of agency agreement is not part of the IIFM-BAFT Participation Agreements but only for the information/reference purpose). Before entering into an agency agreement, the parties should consider whether the underlying principal-agent relationship between the Grantor (as agent) and the Participant (as principal) would raise any local law issues.

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Unfunded Transactions

Remuneration for issuing a Letter of Guarantee:

i. Letters of guarantee: As per the AAOIFI Shari'ah Standard No. 5 (Guarantees), it is not permissible to take remuneration for issuing a letter of guarantee, whether is with cover or without cover, if the remuneration is intended as consideration for the guarantee per se, since the amount guaranteed and the duration of the guarantee are usually taken into consideration in computing remuneration.

ii. Bearing administrative expenses by an applicant: Asking an applicant for a letter of guarantee to bear administrative expenses incurred in issuing a letter of guarantee of either type (i.e. preliminary or final) is permissible in Shari'ah, provided the remuneration for such expenses do not exceed the commission that others would charge for such services. Where full of partial cover is provided, it is permissible, in estimating the expenses for issuing a letter of guarantee, to take into account anything that will reflect the actual service to be rendered in providing a cover for the transaction.

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Fees and Commission (Profit, Rental Payment Fees and Recoveries)

Clause 6.1 (Payment of Commission and Fees) of the IIFM-BAFT master unfunded participation agreement and Clause 6.1 (Payment of Profit or Rental or Fees) of the IIFM-BAFT master funded participation agreement:

a) The fees payable to the Participant shall be solely for the direct services provided by the Participant including, but not limited to, an assessment of the Transaction, assessment of the Obligors and verification of documentation, or for indirect services. All fees will be commensurate to real operative market rates with any fees not deemed Shari'ah compliant (as determined by the Shari'ah board of the Participant) not being payable to the Participant.

b) All commissions and fees payable by the Grantor to the Participant will be generated from the Participated Transaction.

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Assignment and Sub-Participation

Assignment and Transfer

a) Subject to compliance with the principles and rules of Shari'ah and in remote possibility of an assignment or transfer. a Party may assign or transfer any of its rights or obligations under this Agreement or under any Participation Agreement.

b) Unless expressly state to the contrary in the Participation Agreement, the Participant may enter into sub-participations with third parties in respect of participation Agreements without the consent of, and without giving notice to, the Grantor provided that sub-participation shall be in compliance with the principles and rules of Shari'ah.

Additional Duties of the Grantor

a) The Grantor may enter into other participations with third parties in respect of Participated Transactions provided that the Grantor retains the Retention Share stipulated in the relevant Offer (if any). If no Retention Share is stipulated in the relevant Offer, then the Grantor shall not be obliged to retain any Retention Share in that Participated Transaction.

b) The Grantor shall administer the Participated Transaction with the same degree of care which the Grantor normally exercises in administering Transactions in which no participation has been granted even in the case the Grantor holds no Retention Share in the Participated Transaction.

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Termination of the Agreements under Clause 19

a) Each party may terminate an unfunded or funded participation agreement by giving a written notice for an agreed period to the other Party. Notwithstanding any such termination: (i) an unfunded or funded participation agreement shall continue to govern before termination and (b) such termination will be without prejudice to any rights or obligations accrued prior to the date such termination takes effect.

b) The parties may negotiate, upon termination of an unfunded or funded participation agreement, whether any rebate of profit or rental payment relating to the relevant participation agreement shall be applicable in relation to the payment of profit or rental payment to the Participant under such participation agreement, provided always that any rebate shall be at the sole discretion of the Participant subject to any applicable regulations.

As per the AAOIFI Shari'ah Standard No. 23 (Agency and the Act of an Uncommissioned Agent (Fuduli)), paragraph 4/3 "Binding agency" states that "Agency is, basically, not binding, because each of the two parties has the right to revoke the contract without denying its effects that may continue after revocation. However, agency becomes binding under paragraph 4/3/2 when agency is a paid agency." Therefore, in the case of a paid agency arrangement between the Participant (as principal (Muwakkil)) and the Grantor (as agent (Wakil)), the parties may not terminate a participation agreement entered into hereunder without mutual consent or agreement of both Parties.

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Use of Reference Rates

AAOIFI Shari'ah Standard No. (47): Rules for Calculating Profit in Financial Transactions:

10. It Is Permissible to Adopt Shari'ah-Compliant Customary Accounting Practices to Calculate Profit based on the length of the financing period such as a calculation method that determines profit for the entire period on the basis of an annualised percentage of the total amount of financing provided or a calculation method that determines profit on the basis of an annualised percentage of the amount of financing outstanding according to an amortised payment schedule, provided that it does so transparently and with full disclosure and that the total sale price is stated as a fixed amount.

6. Determining Profit in Amounts or Percentages
6/2 It is permissible to resort to a well-established benchmark/index mutually agreed upon between the parties in determining the profit during the undertaking stage (Wa'ad) or when concluding the transaction. In all cases, the total price, the dates and amounts of the instalments, if any, must be stipulated and must not vary with the movement of the benchmark/index. [see Shari'ah Standard No. (8) on Murabahah, item 4/6]

Shukran
Wassalamu 'Alaikum

International Islamic Financial Market (IIFM)
Office 72, 7th Floor, Zamil Tower , Government Avenue, P.O. Box: 11454, Manama, Kingdom of Bahrain
Tel: +973 17500161 , Fax: +973 17500171, Email: info@iifm.net, Website: www.iifm.net