

ISDA-IIFM Islamic Hedging Standards

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Islamic Hedging - Key Considerations

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 product confirmation standards and Islamic Credit Support Deed for Cash Collateral
- Implemented in Saudi Arabia, Bahrain due to regulatory support and institutions preference while implementation in a number of other jurisdictions such as Malaysia, UAE etc., is taking place

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

ISDA/IIFM Tahawwut (Hedging) Master Agreement (TMA)



Objective:

Designed to facilitate the risk management function of Islamic financial institutions including providing a legal framework.

Year of Publication 2010

Use: Widely used in Islamic inter-bank market as per the IIFM recent survey, as well as the gathered information during personal meetings by the IIFM Secretariat with banks and financial institutions globally.

Key Features:

1. First ever globally standardized documentation for OTC Islamic hedging products.

2. Framework Agreement: TMA is a master framework agreement that contains the general terms and conditions agreed between the parties and under which parties may enter into "Transactions" and/or "DFT Terms Agreements" relating to "Designated Future transactions".

It is designed for use with Shari 'ah-compliant genuine hedging transactions that use Murabahah contracts based on Wa 'ad or only single & two unilateral wa'ad .

Each time that a transaction is entered into, the terms of the TMA do not need to be re-negotiated and apply automatically.

3. Distinction: TMA draws a distinction between "Transactions" that have been entered into between the parties and "Designated Future transactions" that will or may be entered into between the parties in the future.

This is an important distinction which is key to the different close-out mechanisms which apply to these two types of arrangement.

TMA arrangements will be either:

(a) Actual transactions (e.g. a Murabahah transaction through Confirmation), or

(b) Undertakings (Wa 'ad) or agreements to enter into a transaction in the future through DFT Terms confirmation (i.e. Designated Future transaction).

4. TMA contemplates two distinct sets of Wa'ad or undertaking:

One will be the Wa'ad to enter into Designated Future transactions.

The other is the Wa'ad to enter into a Musawamah upon the occurrence or effective designation of an Early Termination.



ISDA/IIFM Tahawwut (Hedging) Master Agreement (TMA)

- Transactions/DFT Terms Agreements

Under the Agreement, the transacting parties can enter into:

- Transactions
- DFT Terms Agreements



ISDA/IIFM Tahawwut (Hedging) Master Agreement (TMA)

Further Features & Clarification:

Musawamah concept is introduced as a last resort upon the occurrence or effective designation of an Early Termination event as a result of breach of the terms of the TMA.

This Early Termination clause is the one through which net risk management is effected. It allows all Transactions and DFT Terms Agreements to be terminated. Broadly speaking, the Transactions (which are the concluded transactions) under which no deliveries remain to be made will be replaced by the obligation to pay an Early Termination Amount (See Sections 6(c)(ii) and 6(e)).

In relation to the DFT Terms Agreements and Transactions under which deliveries remain to be made, the Relevant Index will be calculated and the Wa'ad to enter into a Musawamah transaction will provide the mechanism for a net amount in respect of those DFT Terms Agreements and those Non-Fully Delivered Terminated Transactions to be paid (See Section 6(f)(v)).

The intention is that where a payment is to be made by one party in respect of the concluded transactions and a payment is to be made by the other party in respect of the Musawamah entered into, those payments should be capable of being set-off.

- Close-Out and Netting - Section 6 - Early Termination

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



ISDA/IIFM Tahawwut (Hedging) Master Agreement (TMA)

Close-Out and Netting - Section 6 - Early Termination – DFT Terms Agreements

- Calculate Market Quotation (or Loss) (section 6(h))
- Result may be positive or negative
- 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



ISDA/IIFM Tahawwut (Hedging) Master Agreement (TMA)

Section 6 - Early Termination - Musawamah

- Section 6(f)(v): if Relevant Index is positive (Determining Party is in the money), Determining Party can exercise the section 2(e) Wa'ad of counterparty requiring counterparty to enter into Musawamah and purchase asset from Determining Party at the Positive Indexed Value
- Section 6(f)(v): if Relevant Index is negative (Determining Party is out of the money) 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 (section 6(h))
- The Musawamah 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 Musawamah will be fixed and specified in the Schedule at the outset (minimises Gharar)
- One year time limit for Defaulting party in the money transactions as all transactions need to be included from close-out netting perspective

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



السوق المالية
الإسلامية الدولية
International Islamic
Financial Market

ISDA-IIFM Islamic Credit Support Deed for Cash Collateral (Variation Margin) Relating to the ISDA-IIFM Tahawwut Master Agreement

ISDA-IIFM Islamic Credit Support Deed for Cash Collateral (VM) Relating to the ISDA-IIFM Tahawwut Master Agreement



السوق المالية
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Objective:

To create a security in respect of cash collateral posted by the collateral provider to secure sums owed by it to the secured party.

Year of Publication 2017 under TMA

Use: Reasonably used in Islamic inter-bank market as per the IIFM recent survey, as well as the gathered information during personal meetings by the IIFM Secretariat with banks and financial institutions globally.

Further Features & Clarification: The Delivery Amount is calculated by reference to the Secured Party's net Exposure: a point to bear in mind when determining haircuts, particularly if netting is not robust in the relevant jurisdiction. It governs the exchange of collateral for hedging transactions under the TMA and follows the rollout of variation margin requirements for non-cleared transactions in multiple jurisdictions from March 1, 2017. The regulatory push for initial and variation margin exchange is part of G20 commitment to make global financial markets safer and more resilient. IIFM's Shari'ah Board has approved it. The approval does not extend to any specific transactions between the parties or to any amendments or additions made to the TMA CSD.

Key Features

1. CSD: Is a standalone security document, providing for the creation of security in respect of cash collateral posted by the collateral provider to secure sums owed by it to the secured party under the TMA.

It is a two-way document, meaning that either party may be the party granting security and either party may be the secured party.

2. Variation Margin Calculation: Calculation is made by reference to a marking to market of each party's exposure.

Each party's exposure is reduced by the amount of any collateral then held by it so as to determine the collateral amount (the Delivery Amount) which it can call for from the other party.

3. Enforcement: The security under the TMA becomes enforceable upon the occurrence of an Event of Default under the TMA (with a two Local Business Day grace period for remedying such failure).

A failure of a party to pay a called for collateral amount or a failure to perform any other obligation under the CSD (with a thirty Local Business Day grace period for remedying such failure).

4. Returns on Posted Cash Collateral: No accrual or payment of profit amounts on Posted Cash Collateral provided in the CSD.

The parties may enter into a separate agreement to provide "Investment Returns" on any Posted Cash Collateral. The terms of any such separate agreement should be documented between the parties in consultation with their own Shari'ah advisors.

5. Legal Ineligibility: The collateral provided for is limited to cash, a provision is included allowing a Secured Party to call for cash in an alternative currency if the first currency ceases to be eligible under applicable regulatory requirements.

6. Governing Law and Jurisdiction: It is an English Law deed.

The parties may choose to apply other rules of arbitration if they prefer, but are reminded of the value of being consistent with their choice under the related TMA.



ISDA-IIFM Islamic Credit Support Deed for Cash Collateral (VM) Relating to the ISDA-IIFM Tahawwut Master Agreement

Key Elements

- **English law charge** – the security interest clause in the ICSD as an English law charging clause
 - » local law considerations will apply if Posted Cash Collateral is held outside of England and Wales
 - » perfection requirements will need to be considered depending on counterparties' jurisdiction
 - » collateral posting and collection arrangements need to be considered
- **Variation margin calculation** – on net exposures of either party under trades or types of trades under the TMA which are designated as “Covered Items” in the Annex
 - » haircuts on collateral may apply depending on currency of Eligible Collateral and if a party is in a robust netting jurisdiction
 - » additional provisions need to be added if collateral needs to be collected or posted in gross exposures
- **Enforcement** – if there is an early termination under the TMA, security enforcement takes place on the Posted Cash Collateral against the amounts owed by the chargor-party
- **Returns on Posted Cash Collateral** – not in ICSD, but parties can agree further arrangements to pay Investment Returns on Posted Cash Collateral

ISDA-IIFM Wiqayah Min Taqallub As'aar Assarf (Islamic Foreign Exchange Forward)

- Single Binding Wa'ad based IFX Forwards and**
- Two Unilateral & Independent Wa'ad based IFX Forwards**

ISDA-IIFM Wiqayah Min Taqallub As'aar Assarf (Islamic Foreign Exchange Forward) - Single Binding Wa'ad based Structure

Objective

To minimize currency rate volatility and fluctuation especially under present global economic uncertainties.

Year of Publication 2016 under TMA

Use: Reasonably used in Islamic inter-bank market as per the IIFM recent survey, as well as the gathered information during personal meetings by the IIFM Secretariat with banks and financial institutions globally.

Further Features & Clarification: In the Single Wa'ad Structure IFX, only the buyer grants a Wa'ad in favour of the seller at the outset of a trade. The Buyer's Wa'ad will be exercisable and exercised by the Seller on a given exercise date through the Seller delivering to the Buyer an exercise notice together with an offer. Following the Buyer's acceptance of such offer, the parties will enter into a Sale Transaction under which the Buyer will transfer a second currency amount in the second currency in exchange for transfer of a first currency amount in the first currency by the Seller.

Key Features

1. IFX Forward templates: Are designed to be used for bilateral deliverable FX forward transactions subject to a TMA entered into between the parties.

Use of Wa'ad leading to a Transaction for the exchange of currencies.

In the Single Binding Wa'ad Structure: only one party is the buyer who grants the Wa'ad in favour of the other party.

No Murabahah is required or needed in this transaction.

2. Single Binding Wa'ad structure IFX: only the buyer grants a Wa'ad in favour of the seller party at the outset of a trade, The Buyer's Wa'ad will be exercised by the Seller on a given exercise date through an exercise notice together with an offer.

3. Definitions: New terminology has been introduced to make the document more accessible to those parties who may not have a detailed knowledge of the terminology used in the hedging market, as well as those which are specific to the Wa'ad structure of the IFX product **(both versions)**

4. Footnote guidance: Extensive footnotes are included throughout the IFX templates to provide guidance to the parties (in particular in respect of the some important Shari'ah considerations) but these do not form part of the terms of the contract between the parties **(both versions)**

5. Gharar: To provide certainty of subject matter the parties should agree and describe in detail the relevant Sale Transaction contemplated in each DFT Terms confirmation to an IFX trade at the outset of that IFX trade (i.e. by filling in the missing information – in particular the First Currency Amount, the Second Currency Amount and, for Two Wa'ad Structures, the Spot Rate and the Forward Rate – in the form of undertaking(s) of the template DFT Terms confirmation as part of the DFT Terms Agreement) and, prior to entry into a Sale Transaction, the Offer and Acceptance. **(both Ver)**

6. Other annexed pro-forma documents: A form of Exercise Notice is included in the IFX templates. The form of Exercise Notice is intended to be extracted, completed and used by the Exercising Party (the Seller) when it wishes to exercise the Undertaking Party's (the Buyer's) Wa'ad on an Exercise Date. This form is not to be completed upon entry into the DFT Terms Agreement at the outset of an IFX trade. **(both Ver)**



ISDA-IIFM Wiqayah Min Taqallub As'aar Assarf (Islamic Foreign Exchange Forward) - Two Unilateral and Independent Wa'ad based Structure

Objective

To minimize currency rate volatility and fluctuation especially under present global economic uncertainties.

Year of Publication 2016 under TMA

Use: Reasonably used in Islamic inter-bank market as per the IIFM recent survey, as well as the gathered information during personal meetings by the IIFM Secretariat with banks and financial institutions globally.

Key Features

1. IFX Forward templates: Are designed to be used for bilateral deliverable FX forward transactions subject to a TMA entered into between the parties.

Use of Wa'ad leading to a Transaction for the exchange of currencies.

In the two Wa'ad Structure IFX, two unilateral and independent Wa'ads will be granted in respect of each IFX trade.

No Murabahah is required or needed in this transaction.

2. Two Wa'ad structure IFX: Each party grants a Wa'ad in favour of the other party at the outset of a trade whereby, the exercise of a party's Wa'ad on a given exercise date is conditional upon the satisfaction of the exercise condition.

Only one Wa'ad will be exercisable on an exercise date and there will only be one Sale of currency Transaction under each pair of Wa'ads.

3. The exercise condition: Party A's Wa'ad: Spot Rate is less than or equal to the Forward Rate. Party B's Wa'ad: Forward Rate is greater than the Spot Rate.

Exercise Condition is always different across both Wa'ads in a Two Wa'ad Structure IFX trade.

4. Spot rate determination: Is determined by the Calculation Agent who will usually be one of either Party A or Party B.

5. Gharar: To provide certainty of subject matter the parties should agree and describe in detail the relevant Sale Transaction contemplated in each DFT Terms confirmation to an IFX trade at the outset of that IFX trade (i.e. by filling in the missing information – in particular the First Currency Amount, the Second Currency Amount and, for Two Wa'ad Structures, the Spot Rate and the Forward Rate – in the form of undertaking(s) of the template DFT Terms confirmation as part of the DFT Terms Agreement) and, prior to entry into a Sale Transaction, the Offer and Acceptance.

ISDA-IIFM Wiqayah Min Taqallub As'aar Assarf (Islamic Foreign Exchange Forward)

- Single Binding Wa'ad based Structure and Two Unilateral & Independent Wa'ad based Structure IFX Forwards

Standard Confirmations

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)

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.



ISDA-IIFM Wiqayah Min Taqallub As'aar Assarf (Islamic Foreign Exchange Forward)

- Single Binding Wa'ad based Structure and Two Unilateral & Independent Wa'ad based Structure IFX Forwards

Standard Confirmations

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.

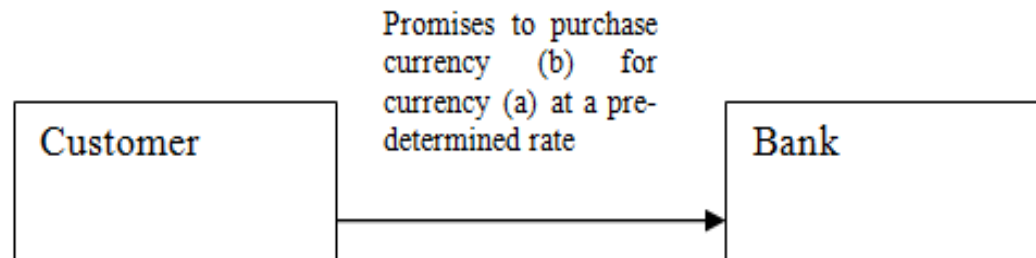
Under the two unilateral Wa'ad structure, each party to the agreement unilaterally will give an independent promise (undertaking) to exchange currencies against another currency, as the case may be, on a future date at a specified amount. Each promise will contain a different set of conditions such that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



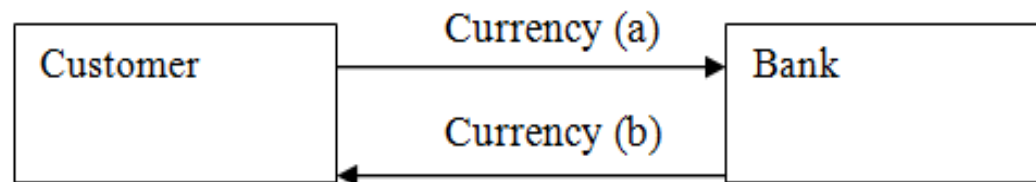
ISDA-IIFM Wiqayah Min Taqallub As'aar Assarf (Islamic Foreign Exchange Forward)

- Single Binding Wa'ad based Transaction

1. Wa 'ad



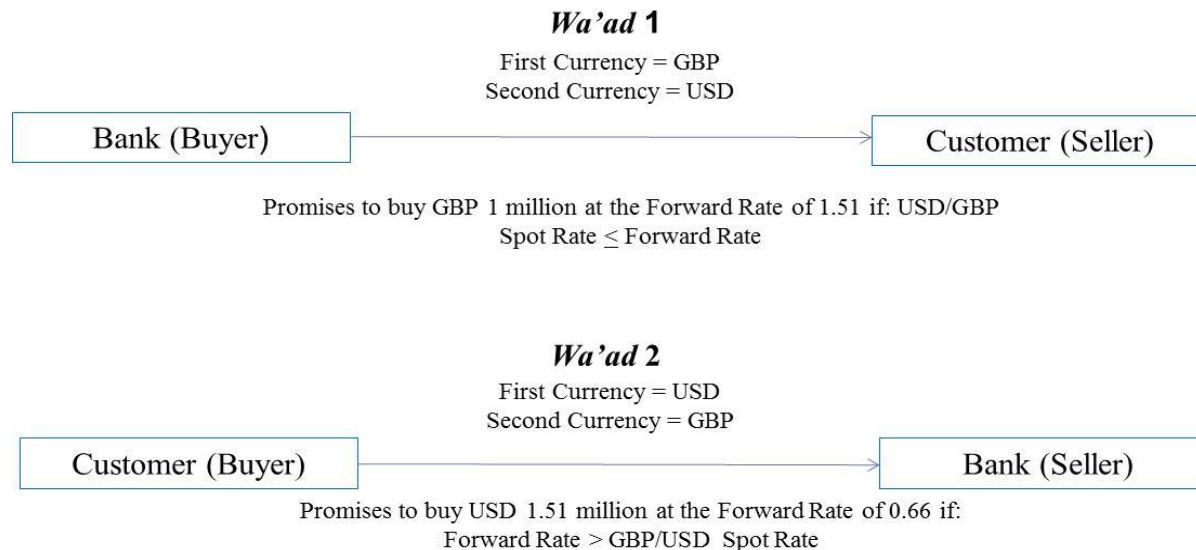
2. Sale of currencies (*bay` al-sarf*) at the settlement date





ISDA-IIFM Wiqayah Min Taqallub As'aar Assarf (Islamic Foreign Exchange Forward) - Two Unilateral and Independent Wa'ad based Structure

APPENDIX 1 – ILLUSTRATIVE EXAMPLE IN RELATION TO THE TWO UNILATERAL WA'AD STRUCTURE



Scenario 1: on the Exercise Date if USD/GBP Spot Rate is ≤ 1.51 , the Customer exercises its rights under *Wa'ad 1*, so that on the Settlement Date, the Bank buys GBP 1 million in exchange for USD 1.51 million.

Scenario 2: on the Exercise Date, if USD/GBP Spot Rate is > 1.51 (i.e. Forward Rate of 0.66 $>$ GBP/USD Spot Rate), the Bank exercises its rights under *Wa'ad 2*, so that on the Settlement Date, the Customer buys USD 1.51 million for GBP 1 million.

Shukran Wassalamu 'Alaikum

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