

**9th Annual**

# **Islamic Finance Summit**

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The potential contribution of the ISDA/IIFM Ta'hawwut Master Agreement

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## Background

Given the core Shari'a tenets one might conclude that derivative transactions may contravene the prohibitions of *gharar* (uncertainty), *maisir* (speculation) and *riba* (interest)

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## Background

- However, we have been witnessing the embryonic stage of an OTC Islamic derivatives market. For example, in November 2006 Bank Islam Berhad and Bank Mumalat Malaysia Berhad agreed to execute a pro-forma derivative Master Agreement for documentation of Islamic derivative transactions in the region
- **The most common forms of derivative transactions used by Islamic banks and corporations are cross-currency swaps, profit rate swaps, total return swaps and commodity index-linked derivatives**
- Many Shari'a scholars now accept the use of hedging as a tool of prudence and risk management
- Recent and current market volatility have increased awareness of the need for hedging market risk and demand for products is growing accordingly
- There is increasing recognition of the risk management contribution that master documentation can make
- Many houses have developed bespoke documentation to generate cash flows having a similar economic profile to some conventional derivatives but in a Shari'a-compliant manner

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## The value of standardisation

- A proliferation of bespoke documentation constrains the market
  - Cost of evaluating and negotiating documentation
  - Documentation not likely to be balanced
  - Basis risk
- This contributed to the signing of MoU between ISDA (International Swaps and Derivatives Association, Inc) and IIFM (International Islamic Financial Market ) and their collaboration in developing a market standard document to be called the ISDA/IIFM Ta'hawwut Master Agreement

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## Introduction

- The Purpose and Value of the Master Agreement
- The Scope of the Master Agreement
- Shari'a Aspects and Guidelines
- How the Master Agreement will work
- The Net Risk Management Advantage
- Early Termination

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## The Purpose and Value of the Master Agreement

- Will provide the market with a standardised, easily recognisable, master document for Islamic hedging products
- Will allow parties to focus their attention on key commercial terms of individual transactions (*reducing risks posed by delays in negotiation/too much focus on what should be standard terms*)

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## The Purpose and Value of the Master Agreement (cont)

- It will facilitate netting and support net risk management
  - *recognition of the Master Agreement for regulatory capital purposes is an objective, but jurisdictional recognition of netting is a critical pre-condition*
- Working from a standard base will encourage and allow innovation
- Help deepen liquidity in this market

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## The Scope of the Master Agreement

- The Master Agreement will be a master or framework agreement
- Will set out general terms on the basis of which the parties may enter into individual transactions
- Entering into the Master Agreement will enable the parties to agree upfront, inter alia:
  - The identity and location of the parties
  - The governing law
  - Certain additional representations to be given to each other
  - The events of default and early termination events, the occurrence of which will permit early termination
  - In the event of early termination how early termination shall be processed and effected, the objective being to minimise the loss caused by early termination to both parties and
  - Whether dispute resolution will be through the courts or arbitration

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## Shari'a Aspects

Great care has been taken to ensure that the Master Agreement will be Shari'a-compliant:

- The IIFM Shari'a Advisory Panel has extensively discussed the issues raised
- However, the Master Agreement will be used with transactions and individual institutions will be responsible for ensuring, with their own Shari'a Board or Adviser, the Shari'a compliance of the transactions, and the Master Agreement taken together with those transactions, in particular for compliance with their own internal Shari'a approval procedures
- There will be guidelines published regarding the sorts of transaction that may be entered into under the Master Agreement. They will say for example that for the purposes of Shari'a compliance:
  - *Transactions entered into under the Master Agreement should only be for the purpose of hedging actual risks of the relevant party*
  - *Transactions should not be entered into under the 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*

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## Shari'a Aspects (cont)

- The governing law of the Master Agreement will be English or New York law
  - There will be no reference to Shari'a in the governing law clause
  - Parties will choose at the outset whether dispute resolution should take place through the courts or through arbitration

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## How the Master Agreement Will Work

- The specific terms relating to an individual transaction will be set out in the Confirmation or similar document entered into under the framework of the Master Agreement:
  - for example, the parties may enter into a murabaha transaction under which one party sells an asset to the other, and the details of the asset, the price, payment date etc. will be set out in the Confirmation
  - all transactions giving rise to actual obligations to make a payment or deliver an asset are referred to as a “Transaction” and will be documented under a “Confirmation” (concluded transactions)
  - all arrangements under which the parties will or may in the future enter into a transaction giving rise to actual obligations to make a payment or deliver an asset are referred to as DFT Terms Agreements (DFT meaning Designated Future transaction) and will be documented under a “DFT Terms confirmation” (DFTs)

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## Net Risk Management

- If certain events occur, it is in the interests of the parties to early terminate the Master Agreement and the transactions entered into under it and to minimise the loss that either will suffer as a result of the early termination by netting or setting off the respective obligations of the parties to each other
- This ability to early terminate and net out on early termination
  - allows each party to limit its credit risk on the counterparty to the net exposure
  - is potentially a basis on which reduced regulatory capital requirements can be sought from the regulators

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## Early Termination – when will it apply?

### ■ Early Termination Events will include

- A party fails to pay or deliver when obliged to do so
- A party fails to comply with its other obligations
- Cross default
- Insolvency/bankruptcy
- Changes in taxation
- Illegality or force majeure
- One party merges with another entity and the credit risk of the new entity is worse than that of the original party

### ■ NB not all early termination events involve default

### ■ The right to early terminate or close out is a right exercisable by the other party if it wishes: no compulsion on it to do so

### ■ The early termination calculations process will be applied separately to concluded transactions and DFTs, but set off between the two resulting amounts is provided for

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## Comparison between ISDA/IIFM Ta'hawwut Agreement and Other Standard Market Agreements

The Master Agreement will be a new market document. In preparing it, we have sought, where practical, to be consistent with other market standard documentation.

- 1.Documentation architecture similar to that of ISDA 2002 Master Agreement
- 2.No compensation or interest on defaulted or deferred payments and deliveries
- 3.No interest payable
- 4.Additional representations as to Shari'a compliance
- 5.Governing law and dispute resolution
- 6.Early termination
- 7.Dual close-out mechanism
- 8.Set-off and netting mechanics

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