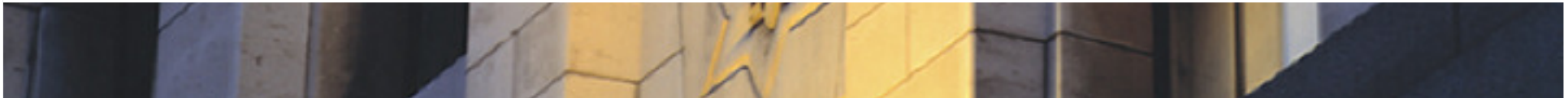




Introduction to the ISDA/IIFM *Tahawwut* Master Agreement

Tariq Zafar Rasheed



Overview

- **Background to the ISDA/IIFM *Tahawwut* Master Agreement (TMA)**
- ***Shari'ah* Principles**
- **TMA Documentation Architecture**
- **Example *Mubadalatul Arbaah* (Profit Rate Swap)**
- **Key Differences with 2002 ISDA Master Agreement**
- **Early Termination and Close-Out upon Default**
- **Miscellaneous**

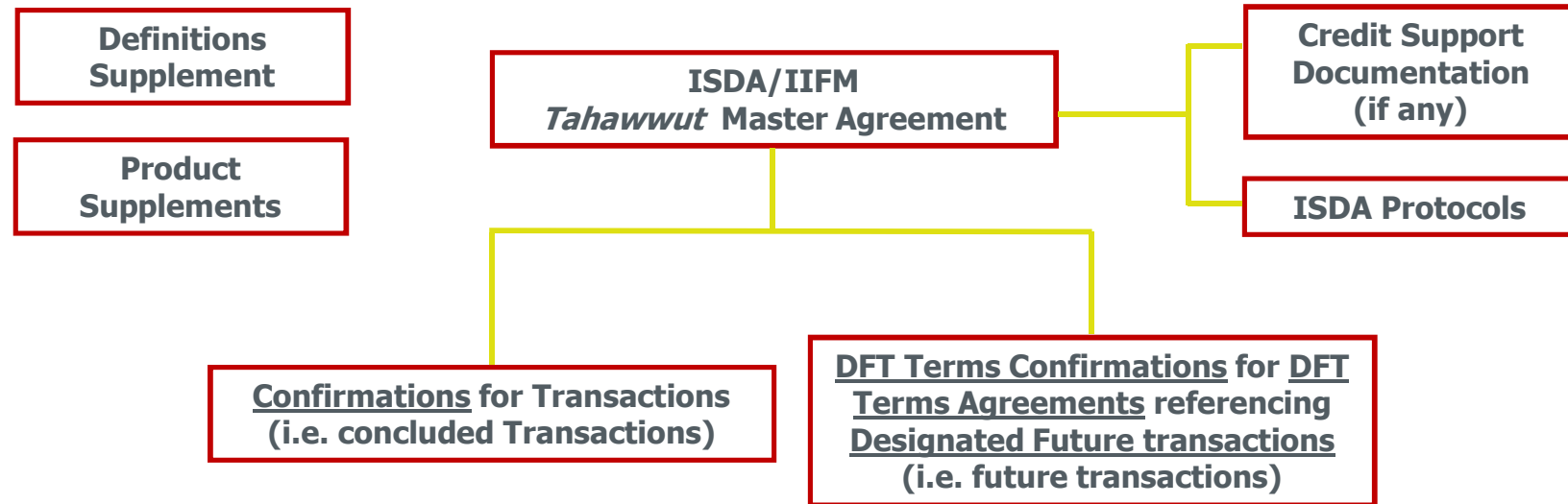
Background to the TMA

- **Concerns with conventional derivatives**
- **TMA to be used for the purposes of risk management arrangements (NB. *tahawwut*)**
- **Collaboration between the International Swaps and Derivatives Association, Inc. (ISDA) and the International Islamic Finance Market (IIFM)**
- **Publication on 1 March 2010**
- **Aims:-**
 - Standardising documentation
 - Reducing price divergence between Islamic derivatives and conventional derivatives
 - Benchmark for the industry
- **Published Documents:-**
 - TMA
 - Confirmation templates for wa'ad-based *Mubadalatul Arbaah* (Profit Rate Swap) – single sale and two sales
 - Explanatory Memorandum
 - Legal Opinion addressed to ISDA

***Shari'ah* Principles**

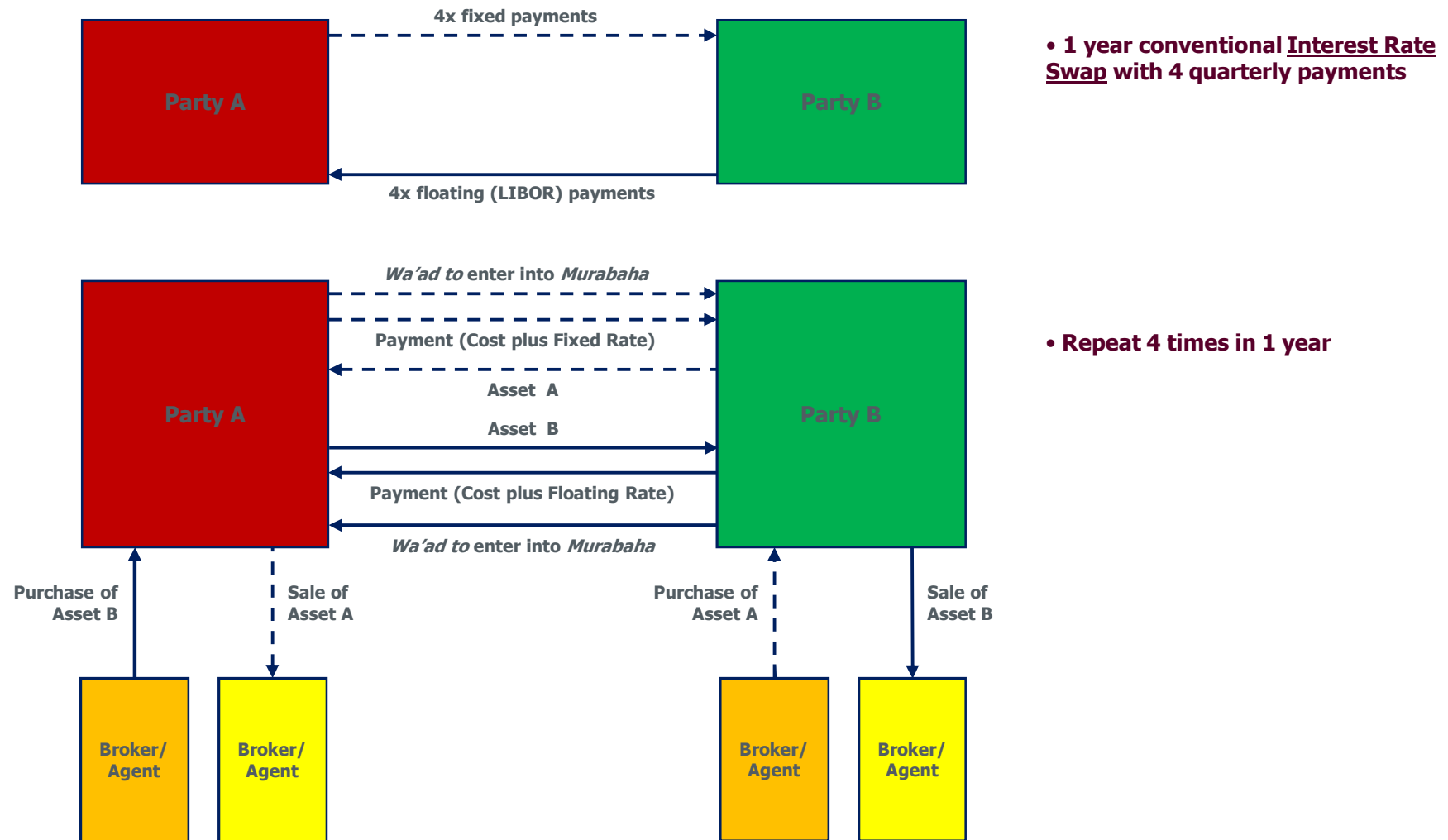
- Hedging of actual risks
 - No speculation (i.e. actual settlement of assets and payments must take place) – real transactions
 - Asset must be *halal*
 - No interest
-
- Asset based
 - *Wa'ad* (i.e. unilateral undertaking) leading to a *murabaha* – similar to an “agreement to agree”.

TMA Documentation Architecture



- **Transactions vs. Designated Future transactions**
- **English law/NY law**
 - Part 4(g) of ISDA Schedule
 - *Shari'ah* (Sections 1(d), 3(h), 3(i) and 4(c))
 - Arbitration (Section 13(c))
- **IIFM *Shari'ah* Advisory Panel has only approved the TMA**
- **To date, ISDA has not published a Credit Support Annex/Deed for the TMA**

Example *Mubadalatul Arbaah* (Profit Rate Swap)



Example *Mubadalatul Arbaah* (Profit Rate Swap) (contd.)

- **Two sets of Confirmations**

- *Wa'ad*-based and involving a Two Sales Structure
- *Wa'ad*-based and involving a Single Sale Structure

NB. For *Shari'ah* reasons, distinct transactions / *wa'ad* used for each leg.

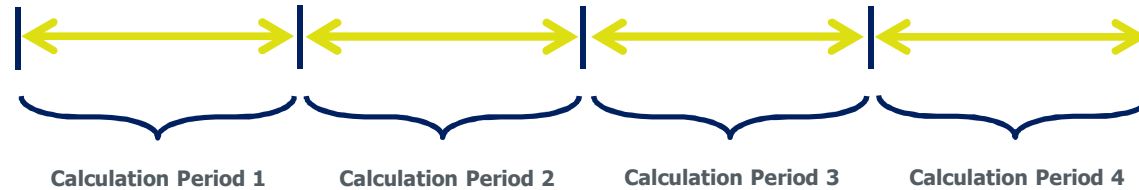
NB. Executed as deeds.

NB. "Seller" represents to "Buyer" that assets are free of cumberances but otherwise sold on an "as is where is" basis.

NB. Disapplication of the United Nations Convention of Contracts for the International Sale of Goods.

NB. Various sensitivities regarding brokers/agents.

Example *Mubadalatul Arbaah* (Profit Rate Swap) (contd.)



- **Implementation of PRS**

- *Wa'ad* to enter into 4 *Murabaha* ("DFT Terms Agreement")

– or –

- On first Payment Date/Exercise Date:
 - Entry into 1st *Murabaha* ("Transaction")
 - *Wa'ad* to enter into 3 subsequent *Murabaha* ("DFT Terms Agreement")

- **Timing**

- **At end of a Calculation Period, enter into a *Murabaha* ("Transaction")**
 - Spot delivery of commodity
 - Spot payment of purchase price
- **At beginning of a Calculation Period, enter into a *Murabaha* ("Transaction")**
 - Spot delivery of commodity
 - Deferred purchase price payable at end of Calculation Period

Example *Mubadalatul Arbaah* (Profit Rate Swap) (contd.)

- **Settlement Risks**

- Broker risk
- Commodity risk
- Counterparty risk

- **Other Issues**

- Tax
- Accounting
- Regulatory capital

Key Differences with 2002 ISDA Master Agreement

- **Aim to minimise changes with 2002 ISDA Master Agreement**
- **Preserving the 3 Pillars**
 - Single Agreement (Section 1(c))
 - Flawed Asset/Conditionality (Section 2(a)(iii))
 - Close-Out Netting (Section 6)
- ***Additional Shari'ah undertakings***
 - *Wa'ad* to enter into *Musawama* (Section 2(e))
- ***Additional Shari'ah representations***
 - Consents (Section 3(a)(iv))
 - Principal (Section 3(g))
 - Satisfaction as to *Shari'ah* compliance (Section 3(h))
 - Non-reliance (Section 3(i))
- **Tax**
 - Designated Future transactions (Section 2(d)(4)(B))

Key Differences with 2002 ISDA Master Agreement (contd.)

- **Events of Default**

- Failure to Pay or Deliver (Section 5(a)(i))
- Breach of Agreement; Repudiation of Agreement; Failure to enter into a Designated Future transaction (Section 5(a)(ii))
- Credit Support Default (Section 5(a)(iii))
- Misrepresentation (Section 5(a)(iv))
- Default Under Specified Transaction (Section 5(a)(v))
- Cross-Default (Section 5(a)(vi))
- Bankruptcy (Section 5(a)(vii))
- Merger Without Assumption (Section 5(a)(viii))

Key Differences with 2002 ISDA Master Agreement (contd.)

• Termination Events

- Illegality (Section 5(b)(i))
- *Force Majeure* Event (Section 5(b)(ii))
- Tax Event (Section 5(b)(iii))
- Tax Event Upon Merger (Section 5(b)(iv))
- Credit Event Upon Merger (Section 5(b)(v))
- Additional Termination Event (Section 5(b)(vi))

NB. Transfer to Avoid Termination Event (Section 6(b)(ii))

Early Termination and Close-Out upon Default

- **What terminates?**

- **Event of Default**

- All Transactions
 - All DFT Terms Agreements

- **Termination Event**

- All Transactions
 - All Affected DFT Terms Agreements

NB. In the case of Illegality or Force Majeure Event, can terminate less than all Transactions/Affected DFT Terms Agreements

Early Termination and Close-Out upon Default (contd.)

Example (*wa'ad*-based and involving a two sales structure)

Floating Rate *Wa'ad* – Party A grants *wa'ad* exercisable 4x for one year.

Fixed Rate *Wa'ad* – Party B grants *wa'ad* exercisable 4x for one year.

- Floating Rate *Wa'ad* 1 exercised on Effective Date. Floating Rate *Murabaha* 1 performed.
- Fixed Rate *Wa'ad* 1 exercised on Effective Date. Fixed Rate *Murabaha* 1 performed.
- Floating Rate *Wa'ad* 2 exercised on Exercise Date 2. Floating Rate *Murabaha* 2 entered into. Commodity delivered by Party B on Exercise Date 2. Floating rate purchase price deferred and payable by Party A on Payment Date 2.
- Fixed Rate *Wa'ad* 2 exercised on Exercise Date 2. Fixed Rate *Murabaha* 2 entered into. Commodity delivered by Party A on Exercise Date. Fixed rate purchase price deferred and payable by Party B on Payment Date 2.
- Early Termination Date designated on 10th day after Exercise Date 2 (i.e. intra-period).
 - Floating Rate *Murabaha* 1 = Fully Delivered Terminated Transaction
 - Fixed Rate *Murabaha* 1 = Fully Delivered Terminated Transaction
 - Floating Rate *Murabaha* 2 = Fully Delivered Terminated Transaction
 - Fixed Rate *Murabaha* 2 = Fully Delivered Terminated Transaction
 - Floating Rate *Wa'ad* exercisable on 2 dates = 2 DFT Terms Agreements
 - Fixed Rate *Wa'ad* exercisable on 2 dates = 2 DFT Terms Agreements

Early Termination and Close-Out (contd.)

Following designation of Early Termination Date due to Event of Default, Non-defaulting Party makes the following calculations:-

$$(i) \text{ Early Termination Amount } = \begin{array}{c} \text{Close-out Amount} \\ + \\ \text{Unpaid Amounts owing to} \\ \text{Non-defaulting Party} \end{array} + \begin{array}{c} \text{Unpaid Amounts owing to} \\ \text{Defaulting Party} \end{array}$$

$$(ii) \text{ Relevant Index Amount } = \text{Aggregate of the Market Quotation (or Loss) for Non-Fully Delivered Terminated Transactions and Terminated DFT Terms Agreements}$$

NB. Close-Out Amount reflects netted accelerated payments under Fully Delivered Terminated Transactions.

NB. Unpaid Amounts determined for Fully Delivered Terminated Transactions and Non-Fully Delivered Terminated Transactions.

NB. Relevant Index Amount represents the net replacement costs for all Non-Fully Delivered Terminated Transactions and Terminated DFT Terms Agreements.

NB. Each of Early Termination Amount and Relevant Index Amount may be positive or negative

NB. Need for a real transaction with real asset in respect of Relevant Index Amount (see next slide). However, note timing issues and fallback (i.e. liquidated damages).

$$(iii) \quad \begin{array}{l} \text{Early Termination Amount calculation} \\ \text{Positive Indexed Value/Negative Indexed Value} \end{array} \left. \vphantom{\begin{array}{l} \text{Early Termination Amount calculation} \\ \text{Positive Indexed Value/Negative Indexed Value} \end{array}} \right\} \text{Set-off for single amount}$$

Early Termination and Close-Out upon Default (contd.)

Musawama in respect of Relevant Index Amount:-

- If Relevant Index is positive (i.e. Non-defaulting Party is "in the money"), it can exercise *wa'ad* (Section 2(e)) requiring Defaulting Party to enter into *musawama* and purchase Designated Assets from Non-defaulting Party for the Positive Indexed Value.
- Positive Indexed Value = market value of Designated Assets + Relevant Index value + VAT, sales tax, etc.



- If Relevant Index is negative (i.e. Defaulting Party is "in the money"), Defaulting Party can exercise *wa'ad* (Section 2(e)) requiring Non-defaulting Party to enter into *musawama* and purchase Designated Assets from Defaulting Party for the Positive Indexed Value.
- Negative Indexed Value = market value of Designated Assets + absolute value of Relevant Index value + VAT, sales tax, etc.



Miscellaneous

- **No interest payable**
- **Transfer**
- **Arbitration**

Your Contact



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Introduction to the ISDA/IIFM *Tahawwut* ISDA Master Agreement

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This document provides a general summary only and is not intended to be comprehensive. Specific legal advice should always be sought in relation to the particular facts of a given situation.

BL BERWIN
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PAISNER

