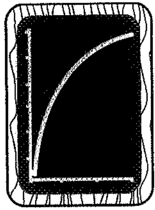

LEARNING CURVE®

Understanding The Shari'ah-Compliant Hedging Master Agreement – Part I

On March 1, 2010 after many months of work, he **International Swaps and Derivatives Association** and the **International Islamic Financial Market** jointly issued the first Shari'ah-compliant master agreement for over-the-counter derivatives. Named the "ISDA / IIFM Ta'Hawwut Master Agreement" it provides a framework for the expansion of derivatives activity in the Middle East, South Asia and many regions throughout the world where hedging is not standard practice.. Based on the 2002 ISDA Master Agreement, the Ta'Hawwut Agreement has been developed under the guidance and approval of the IIFM Shari'ah Advisory Panel. The Ta'Hawwut Agreement is therefore expected to be used as a reference for market participants where they or their customers need to hedge risks in line with Shari'ah principles.

In Part I of this learning curve, we focus on derivative transactions within Shari'ah-compliant finance principles, and in Part II, we look at some of the differences between the Ta'Hawwut Agreement and the 2002 Master Agreement.

Relevant Shari'ah Principles

In structuring the Ta'Hawwut Agreement, ISDA and IIFM have sought to provide a basis to hedge risks that are common in Shari'ah-compliant transactions in a Shari'ah-compliant way. There is a high correlation between Shari'ah-compliant investing and socially responsible investing. Shari'ah investment is constrained by restrictions on the way in which transactions can be carried out and the purposes for which they are entered into. In particular, Shari'ah-compliant financial transactions may not involve "riba" (the charging of interest), "gharar" (unavoidable uncertainty) or "maysir" (gambling or speculation). These restrictions have led to a number of amendments in the Ta'Hawwut Agreement compared to the 2002 Master Agreement.

Although these restrictions may make a Shari'ah-compliant derivative seem like a contradiction in terms, OTC derivative transactions are not necessarily repugnant to Islamic finance principles if carefully drafted and appropriately limited in purpose. Islamic finance, just like conventional finance, has a need for hedging against unexpected changes in exchange rates and commodity prices. Surprisingly, hedges are also needed in some transactions against changes in interest rates, despite the prohibition on interest in Islamic finance, because Shari'ah-compliant transactions often use published interest rates as a benchmark for pricing Islamic financial products. For example, although LIBOR rates would not be employed directly in an Islamic finance transaction, they may used as a guide for determining the premium payable on a finance lease arrangement ("Ijara") between a bank and Islamic end-user.

Consequences of Removing Interest Provisions

As expected, the Ta'Hawwut Agreement rigorously eliminates provisions for payment of interest. However, it is not clear how the time value of money is addressed in situations contemplated by the Ta'Hawwut Agreement where amounts may be deferred. Deferral of payments may occur in two circumstances. First, there is normal delay in obtaining payment of termination amounts and unpaid amounts as well as deferrals during the waiting period for force majeure. Second, delay occasioned by deferral of performance of future agreements is contemplated in, for example, the set-off provision. In the second case, the parties can structure the payment price or delivery amount, but it seems that in the first case the payee may lose the value of use of the money during the period it is tied up.

The absence of interest may also affect the behaviour of parties in a default situation. A defaulting party may potentially raise legal objections and elongate the process knowing that default interest is no disincentive. Equally, a non-defaulting party may prefer to continue with a transaction under a mechanism that has a premium attached rather than be left with a liquidated amount which carries no interest.

Applications For Shari'ah-Compliant Use

The Ta'Hawwut Agreement expressly contemplates that parties would enter into underlying Shari'ah-compliant transactions that may include murabaha transactions. Murabaha refers to a deferred payment arrangement used to provide trade or acquisition finance. In a "murabaha" transaction, the financier buys an asset from the supplier and sells it to the customer at a premium, typically payable in instalments. The premium is generally based on a benchmark

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rate, such as LIBOR, plus a margin, thus giving rise to the need to hedge fluctuations in such benchmark. The financier must acquire title to the asset in question, taking some commercial risk in relation to it. When one party undertakes to enter into a transaction in the future at the election of the other party, that undertaking is a wa'ad.

The Ta'Hawwut Agreement contemplates two distinct sets of wa'ad: the wa'ad to enter into designated future transactions between the parties to the Ta'Hawwut Agreement; this wa'ad will usually be contained in the DFT terms confirmation entered into at the time the parties agree the specific terms to apply to the specific DFT, and the wa'ad to enter into musawama under section 2(e) of the Ta'Hawwut Agreement in the event of an early termination date. A musawama is a sale contract in which a commodity is traded without the cost price of the object being known to the purchaser.

Is the Agreement Itself Compliant?

The Ta'Hawwut Agreement is intended to be Shari'ah-compliant. However, the standard representation by each party to the Ta'Hawwut Agreement at section 3(h) as to Shari'ah compliance is caveated by the words: "Insofar as [a party] wishes or is required for any reason to enter into transactions...which...are...Shari'ah-compliant...it has made its own investigation into and satisfied itself as to the Shari'ah compliance of this Agreement (including the obtaining of a declaration, pronouncement, opinion or other attestation of the Shari'ah adviser, board or panel relevant to it where required)." Therefore a party is only obliged to confirm that the transaction is Shari'ah-compliant as far as it wishes or is required to do so. This may lead to further discussions between the parties as to each other's stance on such issues. If a non-Islamic party is concerned, then it could attempt to exclude this representation. Due to the varied interpretations of Shari'ah law, users may also want to involve their Shari'ah advisers in approving the Ta'Hawwut Agreement.

There are disclaimers throughout the Ta'Hawwut Agreement that there is no guarantee of Shari'ah compliance for any amendments or additions to the Ta'Hawwut Agreement or related underlying transaction documents. Parties must obtain their own opinions from scholars if this is a concern. Areas where concerns could arise may include the transactions themselves that are being hedged as well as events of default under section 5(a)(v) (default under specified transaction) and 5(a)(vi) (cross-default), as those provisions, by their terms, may relate to transactions that are not Shari'ah-compliant.

It is important to note that, regardless of the Shari'ah compliance of the Ta'Hawwut Agreement or any transactions thereunder, the Ta'Hawwut Agreement provides for the election of New York law or the law of England and Wales as the governing secular law for the Ta'Hawwut Agreement, as is the case with the 2002 Master Agreement. Section 1(d) provides that any reference to "law" or "laws" in the Ta'Hawwut Agreement does not include reference to principles of the Shari'ah. It also provides that determinations of unlawfulness or illegality are made without reference to Shari'ah law. This means that termination events under section 5(b)(i) (illegality) or section 5(b)(iii)(2) (tax event - change of tax law) will be determined without regard to Shari'ah law principles.

The approach of relying on the law of a country as the governing law of a contract intended to be Shari'ah-compliant was confirmed by the English Court of Appeal in the case of *Beximco Pharmaceuticals Ltd and others v Shamil Bank of Bahrain E.C. 2004 EWCA Cir 19.* In that case, the clause provided "Subject to the principles of the Glorious Shari'ah, this Agreement shall be governed by and construed in accordance with the laws of England." The court found that the general reference to Islamic Shari'ah rules afforded no reference to, or identification of, those aspects of Shari'ah law that were intended to be incorporated into the contract. The reference was contrary to the choice of English law as the law of the contract and rendered the clause self-contradictory and therefore meaningless. The application of Shari'ah principles to finance contracts was a matter of controversy even amongst Shari'ah scholars. It was highly improbable that the parties intended an English court to determine any dispute as to the nature or application of such principles.

The approach suggested by the case is that, under English law, it is for each party to satisfy themselves that the substantive terms of the underlying contract comply with Shari'ah principles.

This English court approach prevents parties introducing Shari'ah principles to avoid the contract. However, it places even further importance on parties who require Shari'ah-compliance ensuring that the Ta'Hawwut Agreement and related transactions are blessed by Shari'ah advisers to their satisfaction. If there are aspects that need to be amended, then there will need to be changes to the template Ta'Hawwut Agreement before it is entered into.

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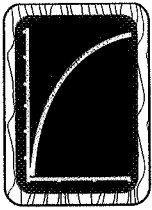
*This learning curve was written by **Jonathan Lawrence, Stephen H. Moller, Anthony R.G. Nolan and Paul de Cordova,** partners at **K&L Gates.** Part II will appear in next week's issue and address the differences between the new Ta'Hawwut Master Agreement and the old documentation.*



LEARNING CURVE®

Understanding The Shari'ah-Compliant Hedging Master Agreement – Part II

On March 1, 2010 after many months of work, the International Swaps and Derivatives Association and the International Islamic Financial Market jointly issued the first Shari'ah-compliant master agreement for over-the-counter derivatives. Named the "ISDA / IIFM Ta'Hawwut Master Agreement," it provides a framework for the expansion of derivatives activity in the Middle East, South Asia and many regions throughout the world where hedging is not standard practice.

Part I focused on derivative transactions within Shari'ah-compliant finance principles, and in Part II, we look at some of the differences between the Ta'Hawwut Agreement and the 2002 Master Agreement.

The Before And After

The Ta'Hawwut Agreement is heavily based on the 2002 Master Agreement and follows a similar layout and style. Important provisions such as the liability for indemnified taxes, events of default, termination events, governing law, cross-transaction payment netting and set-off are similar to those in the 2002 Master Agreement. However, there are some significant differences.

Transactions and Defined Future Transactions. The Ta'Hawwut Agreement includes not just completed transactions but also undertakings to enter into DFT. It appears that the separation of completed transactions and DFT agreements may be intended to create a mechanism to effectuate hedging, where it is helpful to separate the legs of underlying hedged transactions for purposes of Shari'ah compliance.

The inclusion of future transactions impacts many sections of the Ta'Hawwut Agreement. For example, the events of default and termination events have been modified to account for non-performance of future obligations (with a shorter grace period for failure to enter into a future transaction than for other non-payment events of default) and for illegality/force majeure affecting a party's ability to enter into future transactions; and the set-off provision is modified to provide for deferral of set-off where amounts are to be paid in future under future transactions. Another example is that the right to transfer payment entitlements under section 7 is expanded to include the right to receive the purchase price under a "musawama." It also may affect netting, as discussed below.

Close-out Mechanism. While in many respects the early termination provisions of the Ta'Hawwut Agreement are similar to those in section 6 of the 2002 Master Agreement, the close out settlement mechanics relating to the calculation of the settlement amount differ considerably between the two forms. The inclusion of future transactions also has significant consequences for the termination mechanism in sections 6(d) and 6(e), because, while the 2002 Master Agreement concept of a "close out amount" is included (in simplified form) for fully delivered transactions, the termination amount of non-fully delivered transactions or DFT is valued by determination of a Relevant Index, which essentially uses a methodology that is very similar to the market quotation methodology in the 1992 ISDA Master Agreement. Consequently, there is no single net sum payable under the Ta'Hawwut Agreement if it covers both fully delivered transactions and undertakings for future agreements or transactions under which delivery remains to be performed.

Additionally, the termination provisions require a market valuation of the Designated Assets under section 6(f)(v) as determined by the exercising party "acting in good faith and in a commercially reasonable manner." This adds a level of uncertainty to the termination mechanics.

In entering into the Ta'Hawwut Agreement, each party issues an undertaking to enter into a contract in the future for the sale of assets following the designation of an early termination date. The party to whom the Relevant Index Amount is due may exercise the "wa'ad" given in its favor and sell pre-agreed assets in exchange for the cost price of such assets and the Relevant Index Amount. If, in breach of the "wa'ad" it has issued, a party fails to purchase the assets under a "musawama", liquidated damages are determined and payable.

Shari'ah Compliance Provisions. The Ta'Hawwut Agreement includes many references that appear intended to ensure compliance with Shari'ah principles. These include references to Shari'ah law compliance, elimination of references to provisions for payment of interest (e.g., elimination of "interest and compensation" provisions of section 9(h) of the 2002 Master Agreement and replacement with "no interest payable" as well as elimination of related definitions such as "applicable close out rate" and "applicable deferral rate"); change of the term "specified indebtedness" to "specified obligation" albeit with no change to the substance; and references in various places to confirmation that provisions that may contemplate non-Islamic financing do not necessarily mean such are authorized (e.g., the footnote in

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the definition of "specified obligation," new language at the end of the definition of "specified transactions"). References to taking into account the credit-worthiness of a party in the context of obtaining quotations are also removed throughout.

Issues of Note

The Ta'Hawwut Agreement raises points of ambiguity on which advice will be required:

Netting of transactions and Relevant Index Amounts under DFT: Parties may elect to have cross-transaction payment netting apply. However, netting of future transactions is not covered (except in a footnote that contemplates that parties may provide for similar netting in those agreements). There is no provision in the Ta'Hawwut Agreement that purports to make it a cross-product master netting agreement. There may be enforceability issues in the bankruptcy of a party with respect to the netting of amounts under existing transactions versus amounts in respect of future transactions, particularly to the extent that future transactions may contemplate delivery of assets rather than payment of money. This will also be affected by whether and to what extent netting is enforceable as a matter of bankruptcy law in jurisdictions of parties to the Ta'Hawwut Agreement. It is important that parties consider netting in the relevant jurisdictions, particularly when netting a cash claim against an obligation to deliver an asset.

Redesignation to avoid termination event: The replacement of "transfer" with "redesignation" in section 6(b)(ii) may create ambiguity as to whether "redesignation of rights and obligations" implies the ability of the affected party to change substantive rights in connection with changing the obligor office.

Simplification of close-out amount: The Ta'Hawwut Agreement replaces the definition of close out amount that appears in the 2002 Master Agreement with a very brief definition, and with many elements of the definition that relate to good faith and commercial reasonableness inserted in the operative text relating to the close out amount and the determination of the Relevant Index. The change should be studied with care, because it appears to make this area very subjective. The relation of the close-out amount calculation to the automatic acceleration of specified payments in section 6(d)(i) of the Ta'Hawwut Agreement may also create ambiguity to the extent it may be read to imply that the specified payments are separate from the close-out amount.

Determination of close-out amount where there are two affected parties or burdened parties: Like the 2002 Master Agreement, section 6(e)(ii) of the Ta'Hawwut Agreement provides that, in certain cases, both parties calculate a close out amount and that the close out amount be calculated based on those calculations. Unlike in the 2002 Master Agreement, section 6(e)(ii) does not include a mechanism to split the difference between both calculations. This is probably an oversight, because a corresponding provision in section 6(f)(iii) for determination of the Relevant Index and Relevant Index Amount relating to future transaction agreements or non-fully delivered transactions does include that language.

Removal of credit-worthiness in determining quotations: The 2002 Master Agreement generally requires that mid-market quotes and some others may take into account the credit-worthiness of the requesting party. Not so in the Ta'Hawwut Agreement. This could distort the economics of a transaction on early termination or otherwise.

No Shari'ah advisory board approval for transactions: The introductory paragraph to the Ta'Hawwut Agreement states the limits of formal religious approval. Since section 5(a)(v) (default under specified transaction) and section 5(a)(vi) (cross-default) may relate to transactions that are not Shari'ah-compliant, it may be necessary to consider carefully any issues in obtaining this approval for particular transactions. Similar issues may arise with regard to hedging activities of dealer counterparties. Would parties have to wall off their transactions under the Ta'Hawwut Agreement from others? Would a party's own Shari'ah advisers require modification of those terms?

Basis risk concerns: It may remain to be seen how the Ta'Hawwut Agreement will coexist with other forms to the extent that counterparties may hedge exposure thereunder by entering into master agreements with differing terms. For example, the unique close out methodology may expose counterparties to risk of loss to the extent that hedging transactions would be closed out using a different methodology.

Conclusion

The Ta'Hawwut Agreement is a step forward in demystifying the Islamic finance and investment market by using an accepted market document as the basis for a new standard. It could be a pathfinder for further standardized documentation in the Islamic finance market. While it raises issues that market participants will consider carefully, ISDA and IIFM are working with sovereign players in the Islamic finance market - including the UAE and Malaysia - to amend domestic legal frameworks governing closing out and netting. In order for the efforts in development of standard documentation for transactions in Islamic derivatives to be optimized, legal and regulatory changes are needed across Islamic jurisdictions, in particular in relation to insolvency, collateral and conflict of law issues.

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