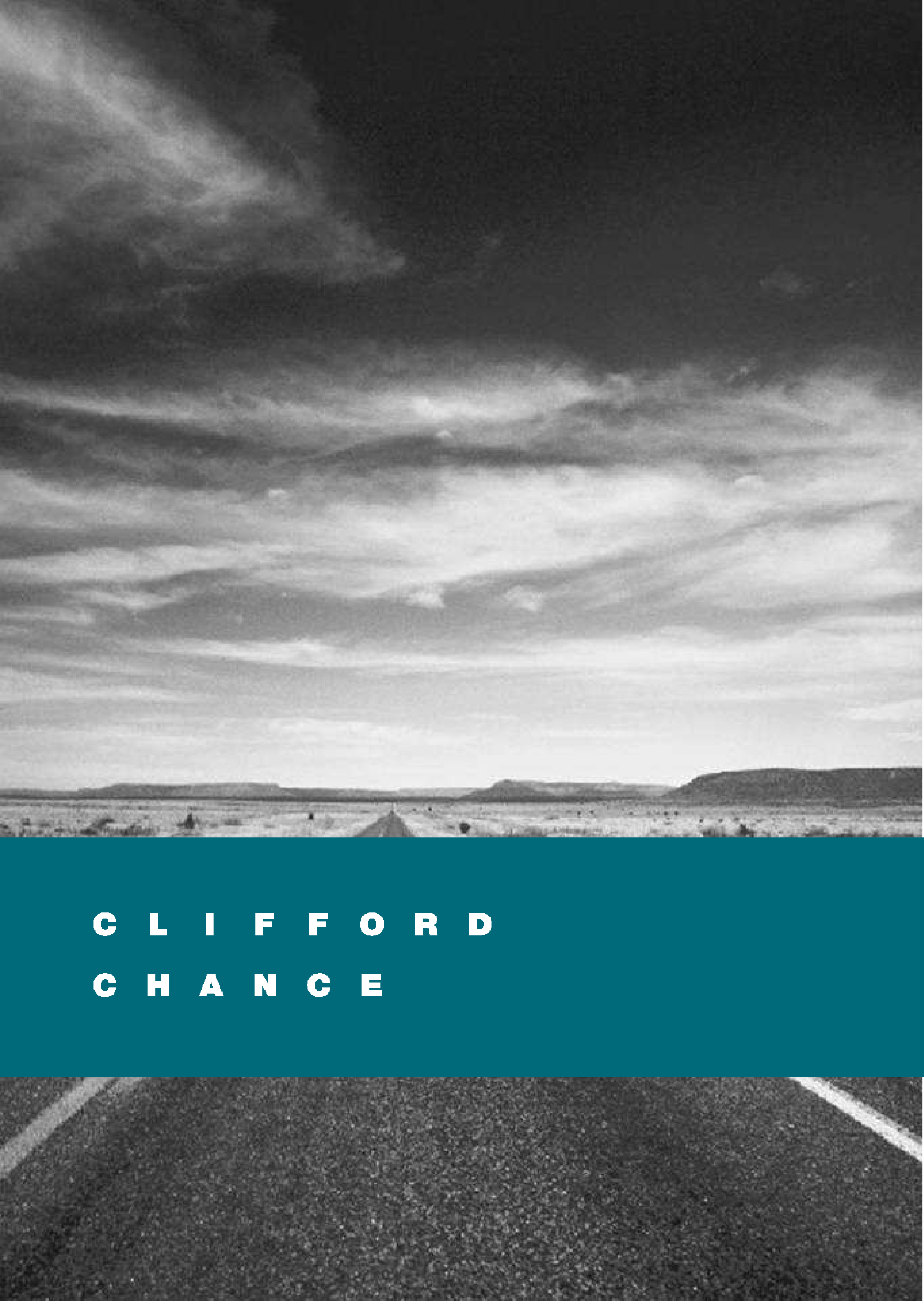

Islamic Banking and Finance Conference

Institute for Law and Finance
Goethe University, Frankfurt

Islamic Derivatives and ISDA

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24 April 2012

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Background

- Early Stages of Islamic derivatives market
  - 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
- 2006/2007 ISDA receives requests for involvement, leading to MoU between ISDA and IIFM to develop standard documentation
- For some time considerable discussion as to whether derivatives are acceptable from the Shari'a perspective but many Shari'a scholars now accept the use of hedging as a tool of prudence and risk management
- Recent market events have increased awareness of the need for hedging
- March 2010 ISDA and IIFM publish Tahawwut Master Agreement (TMA)
- March 2012 ISDA and IIFM publish Template Confirmations for PRS transaction under the TMA

The Need for Standardisation

- Lack of standardisation means a proliferation of bespoke documentation
  - Cost of evaluating and negotiating documentation
  - Documentation not likely to be balanced
  - Basis risk
- Constrains the growth of the market
- Standardisation contributes to efficiency, liquidity and certainty
- Provides a benchmark in the market (as did the development of the original ISDA Master Agreement in the 1980s)
- Helps reduce price divergence between Islamic derivatives and their conventional counterparts

Features

- Comply with Shari’a requirements
- Provide the necessary hedge
- Structured so as to be enforceable
- Structured to optimise risk management and risk mitigation

Shari'a Compliance

- Entered into to hedge actual risks
- Not speculative
- Involve real transactions and actual transfer of ownership and risk
- Asset must be halal
- No interest

Providing the Necessary Hedge

- Market demand for
  - Profit Rate Swap
  - FX forward
  - Cross Currency Swap

Structured to be enforceable

- Agreement based: enforceability issues
- Wa’ad based: wa’ad is binding on undertaking provider

Structured to Optimise Risk Management and Risk Mitigation

- Where more than one transaction:
  - accumulation of risk
  - relative values of different transactions likely to contain off-setting protection
  - absent a mechanism to close-out and net, that protection remains unaccessed
  - master agreement required to provide that mechanism to enable close-out and netting
  - ultimately, accessibility requires enforceability in insolvency of counterparty
  - impacts regulatory capital, accounting position as well as risk management

- TMA – Tahawwut Master Agreement
- Master Agreement governing all transactions
- Confirmations sit under TMA Master Agreement
- Contractually allows close-out on default
- Contains netting mechanism
- But recognition in insolvency a matter of local insolvency laws

ISDA/IIFM Tahawwut Master Agreement Key Features

- Architecture - Multiproduct Agreement
- Framework agreement covering all trades between the parties
- Single Agreement – Section 1(c)
- Flawed Asset and Conditionality – Section 2(a)(iii)
- Close-Out and Netting – Section 6
- All designed to ensure that in the event of a default or termination the exposures of the parties under all outstanding transactions are aggregated and netted, in particular in order to stop an insolvency practitioner from cherry picking, that is enforcing profitable ("in the money") transactions entered into under the Agreement and leaving unprofitable (“out of the money”) transactions as claims in the insolvency

Governing Law and Dispute Resolution

- No reference to Shari'a in the governing law clause
- Parties may elect either English law or the laws of the State of New York as the governing law of the Agreement and each Transaction and Designated Future transaction made thereunder
- The parties at the outset have the flexibility to elect whether dispute resolution should take place through the courts or through arbitration

PRS Structures

- Use Murabaha to generate the fixed or floating profit rate cash flow
- A/B sells halal asset to B/A at cost plus profit amount which is the relevant fixed rate or floating rate and vice versa
- Wa'ad based
- Two sales structure
- Single sale structure
- Spot delivery with deferred payment
- Spot delivery with spot payment

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