


ISDA steps up to the plate

THE RECENTLY PUBLISHED ISDA/TAHAWWUT MASTER AGREEMENT HAS BEEN HAILED AS 'A BREAKTHROUGH'. NEIL D MILLER, KARL ROGERS, AND DANIELA SCHLUCKEBIER OF NORTON ROSE ASSESS THE CLAIMS.

It took IIFM, ISDA and market participants involved in the documentation process several years to agree the terms of the TMA and its publication has been hailed as "a breakthrough in Islamic finance and risk management" by the ISDA. This article will explore how the TMA works, why it may be seen as a breakthrough and how far such breakthrough may be considered to reach. We focus on legal aspects of the TMA and do not include regulatory, tax or accountancy considerations in the context of the TMA.

WHAT IS THE ISDA/IIFM TAHAWWUT MASTER AGREEMENT? The TMA constitutes a Shariah compliant framework agreement for bilateral Shariah compliant derivatives trades. Similar to the conventional ISDA Master Agreement, the TMA sets out the legal terms of the general trading relationship between derivatives counterparties. It does not contain any trade specific details. Individual derivatives products intended to be traded under the framework of the TMA will need to be documented separately between the parties. A standardisation of the underlying Shariah compliant derivatives products and related credit support transactions is generally viewed as desirable by market participants. However, the process of creating the documentation and obtaining approval from the various participants involved (including the relevant Shariah approvals) is expected to take some time. As a result, the TMA currently refers to underlying derivatives trades, including commodity Murabaha contracts, Wa'ads and collateral support transactions, but ISDA/IIFM published template documentation does not exist for any of these. In theory, any type of derivative trade may be traded under the TMA provided the parties are satisfied it is a Shariah compliant instrument.

It is interesting to note that in the 'Explanatory Memorandum Relating to the ISDA/IIFM Tahawwut Master Agreement' published by ISDA and the IIFM, the IIFM Shariah Advisory Panel has indicated, as part of its guidelines regarding Shariah compliance, that transactions under the TMA should only be entered into for hedging purposes and not for speculative purposes.



Earlier this year the International Islamic Financial Market (IIFM) and the International Swaps and Derivatives Association Inc (ISDA) published the agreed form of Shariah compliant ISDA/IIFM Tahawwut Master Agreement (TMA).



WHY IS THE AGREEMENT

NECESSARY? The conventional ISDA Master Agreement is widely adopted in the market as the legal framework agreement under which conventional derivatives products are documented. Market participants who wish to enter into Shariah compliant hedging products may, however, not avail themselves of the conventional ISDA Master Agreement. This is due to the fact that the conventional ISDA

Master Agreement potentially conflicts with the following principles of Shariah: (a) Riba – the payment and receipt of interest, (b) Maisir – gambling or speculation and (c) Gharar – uncertainty of the price or subject matter of a contract. As a result and as a reflection of the increased use of Shariah compliant hedging products, ISDA and IIFM together with numerous market participants have developed the TMA.

HOW DOES THE AGREEMENT WORK? The documentation architecture of the TMA is similar to the conventional ISDA Master Agreement: the parties sign (a) the master agreement setting out the terms of the framework agreement and (b) a schedule to the master agreement facilitating certain elections to be made in respect of the master agreement and certain counterparty credit related issues.

The key terms addressed by the ISDA/IIFM Master Agreement are the following:

- **Obligations between the parties:** This section creates payment and/or delivery obligations, as the case may be, between the parties. As mentioned earlier, the TMA is a framework agreement and does not comprise individual trade details. The section is therefore worded by reference to the details of such payment and delivery obligations to be specified in the relevant trade documentation.
- **Representations:** In addition to market standard representations for a derivatives master agreement, this section also contains a representation that each party has independently satisfied itself as to the Shariah compliance of the TMA and each trade entered into under it. Therefore each user of the TMA will, if required, need to ensure that the TMA is regarded as Shariah compliant by the Shariah board or advisers of such user. The same applies in respect of Shariah compliance of the trades documented under the ISDA/IIFM Tahawwut Agreement.
- **Events of default and termination events:** Similar to the corresponding section in the conventional ISDA Master Agreement, this section defines a number of events of default and termination events. Events of default are typically fault based events (for example a failure to pay or the bankruptcy of a party). Termination events are typically non-fault based events (for example it becoming illegal after the date a derivative transaction is entered

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into for a party to perform its obligations under a derivatives transaction) the occurrence of which is considered so grave that the parties should be given the opportunity to terminate certain, or all, as the case may be, outstanding transactions between them before their scheduled termination date. The occurrence of any of these events therefore – provided all relevant conditions set out in the

ISDA/Tahawwut Master Agreement are satisfied – allows parties to terminate certain or all derivatives transactions existing between the parties as of such time. As such the right to terminate is designed to manage risk with respect to outstanding derivatives transactions.

- **Early termination:** The section setting out the consequences of an early termination is of key importance to achieve effective risk management under the ISDA/Tahawwut Master Agreement. The relevant section of the TMA in this regard is section 6 (Early Termination). This sets out in detail (a) the requirements for an early termination, (b) which party may designate an early termination date and (c) the result of early termination of transactions outstanding under the TMA i.e. how payments in respect of an early termination date are determined – both in respect of each transaction and in respect of the TMA as a whole. In respect of (a) above: section 6 provides that an event of default or a termination event, as such terms are defined under the TMA, needs to have occurred. Further, section 6 provides that a notice of early termination will need to be given by the relevant party. Timing requirements and specifications as to content of such notice are also set out in section 6. In respect of (b) above: generally, in terms of events of default, the non-defaulting party is entitled to designate an early termination date. In respect of termination events, the distinction is not as clear cut as termination events are non-fault based and the TMA therefore expressly states in respect of each individual termination event which party may designate an early termination date. In respect of (c) above: section 6 basically provides that each outstanding transaction under the TMA is terminated and replaced with an amount due from either party to the other party (there are exceptions where only certain transactions are affected and terminated but for the purposes of this article we will focus on the scenario in which all outstanding transactions are terminated). All amounts so determined, together with any other amounts due and unpaid under the TMA (eg amounts due before termination which were not paid) are converted into the base currency chosen by the parties under the TMA and are netted off against each other. As a result only one

single net sum will become due between the parties, thus allowing them to effectively reduce risk in an early termination scenario across multiple transactions into one single net figure. To create the obligation to pay in a Shariah compliant manner, the TMA provides that the parties enter into a Musawama transaction under which the party owing the termination payment buys commodities from the other party and pays the latter the sum of (a) the termination payment and (b) the cost price for the commodities sold. If the Musawama for whatever reason fails to be entered into, the party entitled to the termination payment may claim the relevant amount as part of a damage claim provided for under the TMA.

■ **Determination of payments due on early termination:**

One of the key issues for the conventional ISDA Master Agreement and likewise the TMA has been how to determine the amounts due in respect of each individual transaction following early termination. Due to Shariah concerns regarding the recovery of estimated losses, future value of transactions and interest, the methodology used under the conventional ISDA Master Agreement could not simply be imported into the TMA.

To understand the way the ISDA/Tahawwut Master Agreement determines payments due in respect of individual transactions following an early termination, one needs to understand the legal nature of the Shariah compliant derivatives products which are traded under the ISDA/Tahawwut Master Agreement. The types of Shariah compliant hedging products expected to be traded under the TMA are likely to be structured using commodity Murabahas and/or Wa'ads although other techniques such as Arbuns may also be found as products evolve. Legally, a commodity Murabaha consists of an agreement between two parties for the sale and purchase of certain commodities in consideration for an agreed purchase price to be paid at a future date. A Wa'ad in comparison to a commodity Murabaha transaction is not a contract but an undertaking given by one party to the other party. The party in whose favour the Wa'ad is granted may exercise the undertaking if the conditions specified in the terms of the Wa'ad are satisfied. Following exercise of the Wa'ad, a contract for the disposition of the relevant underlying subject matter will be formed between the parties. In the context of the TMA this means that termination of outstanding transactions before their scheduled termination date may relate either (a) to commodity Murabaha transactions in respect of which the underlying commodity has not been delivered yet and/or the purchase price is not yet due and payable or (b) to Wa'ads which have not yet been exercised.

In respect of (a) above: the TMA provides that if a commodity Murabaha transaction is terminated after delivery of the relevant commodity but ahead of its contractually scheduled deferred payment date, the purchase price will be accelerated. As a consequence the purchase price will become due immediately from the relevant buyer to the seller. It is worth noting that the full, non-discounted purchase price becomes due regardless of how much time has elapsed between the conclusion of the commodity Murabaha and the early termination e.g. the full purchase price is immediately due whether termination occurs the day after the commodity Murabaha is entered into or the day before the day the purchase price was originally due.

In respect of (b) above: because early termination may occur when a Wa'ad has been granted but has not been exercised or, in respect of a commodity Murabaha transactions, during the commodity settlement cycle ie when the commodity Murabaha has been entered into but the commodity has not been delivered, the TMA had to provide a solution of how to capture the mark-to-market in such cases. The solution offered by the TMA is borrowed from the conventional ISDA Master Agreement and relies on the methodology of 'Market Quotation' with 'Loss' as a fallback to the extent market quotations may not be obtained or do not provide a commercially reasonable result. A party determining the amount due on early termination in such circumstances will therefore need to obtain quotations from four leading market dealers to replace the counterparty based on the specific terms of each of the relevant terminated commodity Murabaha transactions and/or Wa'ads, as the case may be. If such quotations may not be obtained or would not provide a



commercially reasonable result, the relevant party may in good faith estimate its losses or gains in respect of the relevant terminated transactions.

WHAT IS THE PURPOSE OF THE AGREEMENT? The main purpose of both the conventional ISDA Master Agreement and the Shariah compliant TMA is twofold:

- (a) standardisation of legal documentation, and
- (b) management of risk and counterparty exposure.

Regarding point (a): standardisation of legal documentation will help to manage legal risk through the harmonisation of contractual terms and reduce closing times for transactions. In the case of the TMA the underlying derivatives products will need to be negotiated on a bilateral basis so that the harmonisation and time saving benefits are achieved to a significantly lesser extent than in the case of the market standard conventional derivatives products. Regarding point (b): management of risk and counterparty exposure is subject to a variety of caveats and counterparty jurisdictional considerations, primarily intended to be achieved through the netting and set-off mechanisms in the case of early termination, for example due to bankruptcy of a counterparty. The early termination mechanism is designed to allow parties to terminate existing transactions before their scheduled termination dates. This mechanism permits parties to manage their risk by exiting transactions prematurely. An integral part of the termination process is the mark-to-marking of each existing transaction and the determination of a termination payment in the form of a single net sum between the relevant parties. This is particularly important in the case of termination following bankruptcy of a counterparty. In such scenario applicable bankruptcy laws may override contractual agreements and give the relevant insolvency official the ability to 'cherry pick', ie to disclaim transactions which are not favourable to the bankrupt party (and which are therefore likely to be favourable to the non-bankrupt party) while at the same time forcing the non-bankrupt party to perform its obligations under transactions which are favourable to the bankrupt party (and which are likely to be unfavourable to the non-bankrupt party). The insolvency laws applicable to a party (which may be the laws of the country of incorporation of such party, laws determined by supra-national rules or other criteria as determined by the laws applicable to the relevant counterparty) will determine whether the set-off and netting mechanism deployed by the ISDA/Tahawwut Master Agreement may be relied on by the parties in the case of bankruptcy of one of the parties. In some cases the contractual provisions may simply be overridden by the applicable insolvency laws. If this is the case, then the risk management mechanism through the early termination provisions in the TMA is clearly limited in its scope and may fail in exactly the circumstances when the termination mechanism is needed most.

To manage risk in these scenarios, a party should satisfy itself before entering into multiple transactions with the same counterparty under the ISDA/Tahawwut Master Agreement, whether the insolvency laws applicable to such counterparty permit and recognise the netting and set-off mechanisms contained in the TMA. Typically this would be achieved through a satisfactory legal

THE PUBLICATION OF THE TMA IS, IN OUR VIEW, A FIRST IMPORTANT STEP TO A GREATER MARKET TRANSPARENCY AND STABILITY

opinion from counsel in the jurisdiction of the relevant counterparty. ISDA commissions such legal opinions for numerous jurisdictions in respect of the conventional ISDA Master Agreement. The jurisdictions from which counterparties to the TMA operate may, due to limited bankruptcy case history or otherwise, limit the ability of local counsel to issue a satisfactory legal

opinion and it may actually be necessary to implement changes within the legal regimes regulating enforceability and netting in some of the relevant jurisdictions. In the absence of satisfactory netting legislation and legal regimes and legal opinion, parties will have to take a commercial decision as to whether they enter into transactions with the relevant counterparty and, if so, how to price the additional legal risk into the transaction. An additional consideration in case local insolvency laws should not recognise the netting and set-off mechanism under the ISDA/Tahawwut Master Agreement is whether in the absence of a satisfactory legal opinion existing transactions should be accounted for on a gross or a net basis. This will ultimately need to be determined by the accountancy rules applicable to the parties but we would like to point out that this is another issue which should be considered before entering into multiple transactions with the same counterparty under the TMA. It is worth mentioning that this problem is no different to that faced by counterparties to the conventional ISDA Master Agreement. At the time of writing the only countries listed on the ISDA website as providing netting opinions in the Muslim/Muslim majority world (which is where we can expect to see the TMA deployed) are Malaysia, Turkey and Indonesia.

CONCLUSION/OUTLOOK The publication of the TMA is, in our view, a first important step to a greater market transparency and stability although it remains to be seen how widely the framework agreement will be adopted by market participants in practice. The fact that the underlying transaction documentation is not yet standardised means that it may, in the short term, create more work for participants to document the bilateral hedging products under the new framework agreement, as market participants have over time developed their own templates and would now need to revise them to fit them in with the terms of the TMA. In the absence of robust legal opinions regarding netting and set-off in counterparty insolvency scenarios uncertainties will also persist in this respect which limits the fundamental benefits of a master agreement approach. While we therefore consider the publication of the TMA a milestone for the legal documentation, the reality of trading would seem to remain a matter of adequate pricing of persisting counterparty risk.

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