

**Explanatory Memorandum
Relating to the ISDA/IIFM Tahawwut Master Agreement**

Disclaimer

Potential users of the ISDA/IIFM Tahawwut Master Agreement should note that, when entering into Transactions or DFT Terms Agreements under it or credit support arrangements in relation to it, or making any amendment or addition to it they must first take all action required to satisfy themselves as to the Shari'ah compliance of such Transactions, DFT Terms Agreements, credit support arrangements, amendments or additions and of the Shari'ah compliance of such Transactions, DFT Terms Agreements or credit support arrangements when taken together with the ISDA/IIFM Tahawwut Master Agreement and of the ISDA/IIFM Tahawwut Master Agreement incorporating such amendment or addition. No Shari'ah approval is given by the IIFM Shari'ah Advisory Panel with respect to any Transactions, DFT Terms Agreements or credit support arrangements or any amendment or addition to the ISDA/IIFM Tahawwut Master Agreement.

1. **Introduction**

The Agreement is a Master Agreement or framework agreement which sets out terms upon which the parties can subsequently enter risk management arrangements. Entering into the Master Agreement does not give rise to any transactions. After the parties have entered into the Master Agreement, they may subsequently enter into further arrangements which will be subject to and governed by the Master Agreement.

Those further arrangements will be either (a) actual transactions (e.g. a *murabaha* transaction) – these are referred to in the Master Agreement as Transactions and the document setting out the terms of such a Transaction is called a Confirmation – or (b) undertakings or agreements to enter into a transaction in the future (subject to satisfaction of any condition, such as exercise of the undertaking by the other party). For the purposes of the Master Agreement such an undertaking or agreement is a DFT Terms Agreement, the document setting out its terms is a DFT Terms confirmation

and the transaction that will arise in the future, if all conditions are satisfied, is a Designated Future transaction.¹

The governing law of the Master Agreement will be English or New York law. Each party will represent that, if Shari'ah compliance is relevant for its purpose, then it has satisfied itself as to the Shari'ah compliance of the Transactions and DFT Terms Agreements entered into by it under the Master Agreement.

2. **Scope of Shari'ah Review and Guidelines**

The IIFM Shari'ah Advisory Panel has been requested to consider only the Master Agreement itself, not any Transactions, DFT Terms Agreement or Designated Future transactions nor any amendments or additions to the Master Agreement. In order to assist market participants, the IIFM Shari'ah Advisory Panel has indicated the following guidelines regarding Shari'ah compliance:

- (i) Transactions should be entered into only for the purpose of hedging actual risks of the relevant party.
- (ii) Transactions should not be entered into for purposes of speculation, i.e. actual settlements of assets and payments must take place. Cash settlement should relate to actual transactions involving a deliverable asset.
- (iii) The asset must be halal.
- (iv) No interest (whether called interest or an alternative name but which represents interest) is to be chargeable under a Transaction.

3. **The Content of the Agreement**

3.1 *Section 1* of the Agreement contains some general provisions on how to interpret the Agreement.

The purpose of Section 1(c) (*Single Agreement*) is to clarify that, as the Master Agreement is a master or framework agreement, when individual risk management arrangements are subsequently entered into, e.g. through entry into a Transaction, the Master Agreement will apply to those arrangements. So although the confirmation for such a Transaction will be a separate document, the Transaction will be regarded as entered into upon the terms set out in the Master Agreement and covered by the framework created by the Master Agreement.

¹ The agreement or undertaking (the DFT Terms Agreement) is not a Transaction, but if and when the Designated Future transaction which it provides for is entered into, that will be a Transaction.

- 3.2 *Section 2* sets out certain obligations of the parties regarding payments and deliveries. It also contains conditions precedent, provisions allowing for set off of payments and an obligation to make payments free from withholding tax.

In addition, each party (X) undertakes (*wa'ad*) that, in specified circumstances, upon the exercise by the other party (Y) of X's undertaking or *wa'ad*, X will enter into a *musawama* sale and purchase agreement relating to a specified amount of a specified asset. The circumstances in which a party's *wa'ad* to enter into a *musawama* may be exercised are where there has been an early termination. The terms of the Agreement are such that at any time only one of the parties will be able to exercise the *wa'ad* of the other party.

It is worth noting that the *wa'ad* of Party A to enter into a *musawama* is separate and distinct from the *wa'ad* of Party B to enter into a *musawama*, and in each case the underlying asset, if the *wa'ad* is exercised, is different.

- 3.3 *Section 3* contains a basic set of representations.
- 3.4 *Section 4* contains a basic set of agreements of the parties, such as an agreement to provide information required for tax compliance. It also contains an agreement by each party to pay any stamp taxes applicable to it and to indemnify the other party for certain stamp taxes.
- 3.5 *Section 5* contains Events of Default and Termination Events. These are events the occurrence of which may lead to early termination of Transactions and DFT Terms Agreements.

In the case of an Event of Default in relation to one party, the other party may choose to terminate all the Transactions and DFT Terms Agreements.

The Events of Default include:

- (i) failure to pay or deliver
- (ii) breach or repudiation of the Agreement
- (iii) a default by a party or its credit support provider of any provision of such credit support arrangements
- (iv) misrepresentation
- (v) default by a party (or its credit support provider) under a Specified Transaction (a Specified Transaction is another transaction between the parties, which may be a Shari'ah compliant or a non-Shari'ah compliant

transaction (see the definition of Specified Transaction in the Master Agreement))²

- (vi) cross-default; this includes a default by a party under Shari'ah compliant or non-Shari'ah compliant funding transaction
- (vii) bankruptcy and insolvency; and
- (viii) merger of a party with or into another in circumstances where any of the obligations of the merging entity under the Agreement (or any Credit Support Provider with respect to such obligations) are not taken over by the transferee entity.

In the case of a Termination Event, the relevant party will be entitled to terminate all affected Transactions and all affected DFT Terms Agreements.

The Termination Events include:

- (i) illegality
- (ii) force majeure
- (iii) a tax event and
- (iv) a credit event upon merger (i.e. where a party merges with or into another entity and the resulting entity is a materially weaker credit risk).

3.6 *Section 6* provides how early termination is to be effected where it is applied following an Event of Default or Termination Event under Section 5.

Early termination operates separately in relation to Transactions and DFT Terms Agreements.

- (i) *Early termination of Fully Delivered Terminated Transactions:* In the case of early terminated Transactions, under which all deliveries to be made have been made (called Fully Delivered Terminated Transactions) the Transactions which are early terminated are effectively accelerated e.g. if a Transaction is a *murabaha* under which an asset has been delivered but the purchase price (of say USD

² The transaction types listed in the definition of Specified Transaction are included solely for the purposes of determining whether there is an event of default. The list does not indicate the types of transaction that may be entered into under the Master Agreement.

1million³) has not been paid, then the USD 1million purchase price becomes payable. All payments under such early terminated Transactions are aggregated to determine a Close-out Amount.

The calculation of the Close-out Amount also involves set-off because if, say, A owes B 100 under Transaction 1 and 70 under Transaction 2 and B owes A 90 under Transaction 3 and 90 under Transaction 4, the Close-out Amount is 10 owed by B to A. This net amount becomes payable by the relevant party to the other (subject as below).

Payment in respect of the early termination of such Transactions is therefore made through payment of the Close-out Amount and any unpaid amounts related to the Agreement.

- (ii) *Early termination of DFT Terms Agreements and Non-Fully Delivered Terminated Transactions:* If there are early terminated DFT Terms Agreements or early terminated Transactions under which not all deliveries have yet been made (called Non-Fully Delivered Terminated Transactions), an index is calculated. Broadly speaking, the relevant Index represents the replacement cost of all the early terminated DFT Terms Agreements and all the early terminated Non-Fully Delivered Terminated Transactions. Again there is set-off built into the calculation so that the result is the net replacement cost. So, if the net replacement cost of all the early terminated DFT Terms Agreements and all the early terminated Non-Fully Delivered Terminated Transactions would be a cost to the calculating party (i.e. the calculating party would have to make a net payment to the market in order to replace all the early terminated DFT Terms Agreements and all the early terminated Non-Fully Delivered Terminated Transactions), then the Relevant Index is positive. In such case, the amount of the index is the net replacement cost of the early terminated DFT Terms Agreement and the early terminated Non-Fully Delivered Terminated Transactions.⁴

³ The purchase price in the *murabaha* would ordinarily be a combination of the cost price plus a profit element.

⁴ In the context of early termination following an event of default, the non-defaulting party is usually the calculating party. So in that context, where the non defaulting party would incur a net replacement cost (i.e. the non-defaulting party will have to pay the market), that will give a positive index. If the non-defaulting party would make a gain, then the index would be negative and the *musawama* mechanism described later in the Explanatory Memorandum is intended to operate in such circumstances so as to enable the defaulting party to be paid the gain.

If the calculating party would in fact make a gain on a net basis i.e. the market would make a net payment to the calculating party to replace the early terminated DFT Terms Agreements and the early terminated Non-Fully Delivered Terminated Transactions, then the Relevant Index will be negative. In this case, the amount of the index will be the net amount which the market would pay the calculating party, expressed as a negative number (e.g. if the market would pay the calculating party a net 50, the index will be -50).

Payment in respect of the early termination of DFT Terms Agreements and the early termination of the Non-Fully Delivered Terminated Transactions is conditional upon entry into a *musawama* transaction between the parties. If the Relevant Index is positive (i.e. there would be a net replacement cost payable to the calculating party), the calculating party is entitled to exercise the other party's *wa'ad* and require the other party to enter into a *musawama*. This is the *wa'ad* contained in Section 2(e) of the Master Agreement. The *musawama* entered into will involve the sale by the calculating party to the other party of a specified quantity of a specified asset at a price which will equal the cost of the asset plus the positive Relevant Index amount. The type of asset and its quantity will be agreed at the outset between the parties and specified in the Schedule to their agreement. By specifying the asset and its quantity, the intention is to reduce the uncertainty that would otherwise occur if the asset and quantity were left to be selected at the time the *musawama* is entered into.

If the Relevant Index is negative, the party which is not the calculating party may exercise the calculating party's *wa'ad* to enter into the *musawama* and sell to the calculating party a specified quantity of a specified asset at cost plus the absolute value of the negative Relevant Index value.

Where there has been an Event of Default, the person calculating the Index will be the non-defaulting party. However, the net replacement cost may be a cost for the non-defaulting party or a gain for the non-defaulting party. Therefore, the person exercising the *wa'ad* may be the non-defaulting party or the defaulting party, depending on whether the index is positive or negative.

Where the party entitled to exercise the *wa'ad* is the defaulting party, it needs to be recognised that if the defaulting party has become subject to insolvency proceedings, then, as a practical matter, its insolvency officer may need some time before he is able to assess and understand

the position of the defaulting party and then authorise it to take any action such as exercising the *wa'ad* of the counterparty and entering into a *musawama*. In order to accommodate this, the Agreement allows each party up to a year in which to exercise the other party's *wa'ad*.

Where a Close-out Amount (i.e. the amount payable in respect of the early termination of Fully Delivered Terminated Transactions) is payable by a party but that party will be the payee (as seller) under the *musawama* if the *wa'ad* is exercised (i.e. in relation to the early terminated DFT Terms Agreements and the early terminated Non-Fully Delivered Terminated Transactions, it is the one that will receive payment), that party is allowed to wait up to a year (or earlier exercise of the *wa'ad*) before it pays the Close-out Amount, so that it can set-off its payment in respect of the Close-out Amount against what the other party will pay it under the *musawama*, to give an overall net payment.

- 3.7 *Section 7* contains a provision allowing a party to assign or transfer (to a third party) the benefit of obligations owed to it by the other party in certain circumstances. There is a footnote in the Agreement warning that, where relevant, parties should ensure that any such assignment or transfer meets Shari'ah requirements, including any requirement for the transfer to be at par.
- 3.8 *Section 8* provides for payments to be made in the currency provided by the Agreement and includes a currency indemnity in case of court judgment in another currency.
- 3.9 *Section 9* contains miscellaneous agreements of the parties, including a provision that no interest will be payable under the Agreement and that, if a court awards interest, that interest will be paid to charity.
- 3.10 *Section 10* provides that where a party enters into the Agreement through a branch, its obligations under the Agreement will be binding against its head office as well as the branch.
- 3.11 *Section 11* deals with expenses.
- 3.12 *Section 12* deals with notices.
- 3.13 *Section 13* contains the governing law and dispute resolution forum provisions. The governing law is to be English or New York law as elected by the parties. The forum for dispute resolution will be the courts of the jurisdiction of the governing law unless the parties choose arbitration.

3.14 *Section 14* contains further definitions. Attention is drawn in particular to the definitions of Loss (which is intended to capture actual losses and gains), Market Quotation (which is relevant to the determination of the Relevant Index Amount and determines the cost or gain of replacement transactions) and Specified Transactions.

4. **The Schedule**

The Master Agreement is a printed document. When parties enter into the Master Agreement, they should do so by completing the pro forma Schedule. In doing so they will be setting out details of the parties (e.g. name, address etc), and will also be making and agreeing the elections that are to apply to the agreement between them (e.g. will court or arbitration apply, what will be the governing law, will there be any Specified Entity in respect of either party in relation to which the representations and events of default will also apply, will there be any Credit Support Provider in relation to either party and so on).

Part 5 of the Schedule also contains an agreement between the parties as to the types of Shari'ah compliant transactions that may be entered into between them under the Master Agreement. At present *murabaha* and *musawama* transactions are contemplated (including where the *murabaha* or *musawama* results from the exercise of a *wa'ad*) e.g. for the purposes of effecting a profit rate swap or a currency swap. In due course, the expectation is that other types of risk mitigation transactions will be provided for, once the Shari'ah compliance aspects with respect to them have been reviewed and addressed. Market participants whose own Shari'ah board have reviewed and approved other risk mitigation transactions may choose to use the Master Agreement with such other types of transaction, but in doing so should take care to ensure they stay within any such Shari'ah approval which their Shari'ah board has given.

1 March, 2010