IIFM Reference Paper

on

I'aadat Al Shira'a (Repo Alternative)

and

Collateralization

(Structuring Possibilities)

Acknowledgement

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1. Introduction to the Reference Paper

The reference paper aims to provide general information on the concept, operational mechanism and uses of conventional repurchase agreements (known as Repo or Sale and Repurchase Agreements), and it also attempts to explore the possibilities for the *I'aadat Al Shira'a* (Repo Alternative) as an alternative to the conventional repo. The reason why conventional repo is described in this paper is to explain and understand how conventional repo is structured and what kind of procedures and documentation is required, so as to assist in the attempt to find the right solution for the *I'aadat Al Shira'a*. The aim is to provide for the Islamic Institutions another tool to effectively manage its liquidity as well as to help it finance its inventory of Asset, *Sukuk* and equities, and not simply a replication of what exists in the conventional world.

2. Concept of Repo in Conventional Market

2.1 Definition of Repo

In a repo agreement, the borrower sells securities outright to the lender and at the same time agrees to buy equivalent securities from the lender at a specified price at some later date.

2.2 Significance/Importance of Repo

Conventional repo is primarily a money market instrument, which allows the seller to use financial securities as collateral for a cash loan at a fixed rate of interest.

For the buyer, a repo is an opportunity to invest cash for a customized period of time. It is short-term and safer because it is a collateralized investment. Market liquidity for repos is good, and rates are competitive for investors. Moreover, repos increase the volumes in the debt market as they serve as a tool for funding the purchase of securities. Repos enable dealers to deal in higher volumes. Thus, repos provide an inexpensive and efficient way of improving liquidity in the secondary markets for underlying instruments.

2.3 Types of repo

There are two basic types of short term money market repos available in the international market. In this reference paper, these two types are mentioned because of their relevance to the subject in hand. They comprise the following:

2.3.1 Classic Repo

Classic repo is an initial beneficial sale of securities with a simultaneous agreement to repurchase equivalent securities at a later date. The repurchase price is calculated by taking the price of the securities used for the initial sale and adding an amount to cover “interest" for the term of the transaction. In classic repo, the securities are sold outright by the seller to the buyer. They are effectively being used as collateral for a loan of cash, which is repaid through the repurchase of equivalent securities. As a result, the economic risks and rewards of owning the securities remain with the seller, and that is why, in classic repo the buyer is required to pay to the seller the value of the coupon income arising on the securities. This obligation to "pass on" the coupon is contained in the repo agreement, such as the GMRA.

2.3.2 Buy/Sell Back Transaction

Under a buy/sell back, as in a classic repo, the securities are sold outright at the outset and the seller simultaneously agrees to buy equivalent securities back on a later settlement date. In a buy/sell back, there is normally no pass through of any coupon interest due on the securities. Buy/sell back transactions are similar to classic repo transactions except that, if not documented, there is no margin maintenance during the life of the transaction i.e. there is an initial sale and transfer of securities and then a sale and transfer of equivalent securities at maturity. If GMRA type documentation is used, then marking to market can be applied and as a result margin maintenance can be included. Both classic repo and buy/sell back transactions involve:

(a) a transfer of the ownership of the securities, the subject of the repo or buy /sell back, by seller to buyer;[1]

(b) Similarly, usually, a transfer of the ownership of any additional securities transferred as part of margin maintenance;

(c) a transfer by buyer to seller of the ownership of the equivalent securities at maturity.

Classic repos, and increasingly buy/sell back transactions, are documented on the basis of a master agreement. The master agreement will contain customary provisions such as representations and warranties and events of default. In addition, it will contain provisions for marking to market and margin maintenance as well as close-out and netting provisions in the case of an event of default.

[1] For accounting purposes the transferred securities are likely to remain on the balance sheet of the seller - this is not because the transfer of legal ownership is being questioned: it is because the economic risk in the securities, that is the risk that the securities may lose their value (or indeed gain in value) remains with the seller, and since accounts reflect the economic position, the accounting perspective is that the economic position is better represented by leaving the transferred securities on the balance sheet of the transferor.

2.3.3 Tri-Party Repo

The distinguishing feature of a tri-party repo is that a custodian bank or international clearing organization, the tri-party agent, acts as an agent of the two parties to the repo. The tri-party agent is responsible for the administration of the transaction including collateral allocation, marking to market, and substitution of collateral.

As part of a tri-party agreement, the three parties to the agreement, the tri-party agent, the repo buyer and the repo seller agree to a collateral management service agreement which includes an "eligible collateral profile". It is this "eligible collateral profile" that enables the repo buyer to define its risk appetite in respect of the collateral that it is prepared to hold against its cash loan. For example a more risk averse repo buyer may wish to hold only non-financial, primary market, government bonds as collateral. In the event of a liquidation of the repo seller, the collateral is highly liquid thus enabling the repo buyer to sell the collateral quickly. A less risk averse repo buyer may be prepared to take non investment grade bonds as collateral, even though these may be less liquid and may suffer a higher price volatility in the event of a repo seller default, making it more difficult for the repo buyer to sell the collateral and recover their cash.

The tri-party agents are able to offer sophisticated collateral eligibility filters, which allow the repo seller to systematically generate collateral pools which reflect the repo buyer's "eligible collateral profile" and thus the buyer's risk appetite. Collateral eligibility criteria could include asset type, issuer, currency, domicile, credit rating, maturity, index, issue size, average daily traded volume, etc. Both the lender (repo buyer) and borrower (repo seller) of cash enter into tri-party transactions to reduce the administrative burden which they themselves would otherwise have to undertake in respect of transactions. In addition, because the collateral is being held by the agent, there is a greater likelihood of the collateral being readily available when the repo seller performs. A tri-party repo may be seen as the outgrowth of the due bill repo, in which the collateral is held by a neutral third party.

2.4 Repo Period

There are three types of repo maturities. They are as follows:

(a) Overnight Repo

Refers to a one-day maturity transaction. It lasts only one day.

(b) Open Repo

Refers to a repo with no specified end date[2]. In an open repo there is no fixed maturity period and the interest rate would change from day to day depending on the money market conditions. In such cases the lender agrees to provide money for an indefinite period and the agreement can be terminated on any day.

(c) Term Repo

Refers to a repo with a specified end date. Although there is no restriction on the maximum period for which repos can be undertaken, generally term repos are for an average period of one week but can be for much longer periods.

2.5 Repo Risks

While repos are generally credit-risk mitigated instruments, there are residual credit risks. Though a repo is essentially a collateralized transaction, the seller may fail to repurchase the securities sold at the maturity date. In other words, the repo seller defaults on his obligation. Consequently, the buyer may keep the securities, and liquidate the securities in order to recover the cash lent. The securities, however, may have lost value since the outset of the transaction as the securities are subject to market movements. To mitigate this risk, repos are often over-collateralized as well as being subject to daily mark-to-market margin calls. Credit risks associated with a repo are

[2] Although repos are typically short-term, it is not unusual to see repos with a maturity as long as two years.

subject to many factors such as the term of the repo, the liquidity of the securities, the strength of the counterparties involved, etc.

2.6 Uses of Repo

There are a variety of advantages repos can provide to the financial market in general, and the debt market, in particular. Some advantages are as follows:

(a) An active repo market can lead to increase in turnover in the underlying bond, thereby improving liquidity and the depth of the market
(b) For institutions and corporate entities, repos provide a source of inexpensive finance and offer investment opportunities to lend money at market rates thus earning a good return. It is a cash management tool allowing the seller to maximize funding of its bonds inventory
(c) Tri-party repos offer opportunities for suitable financial institutions or clearing houses to act as an agent between the lender and the borrower
(d) To cover short fall by borrowing the bonds on repo

The foregoing discussion of the concept and mechanism of conventional repos provides some insight into the operational technicalities and intricacies involved in repo transactions. The conclusions reached in the discussion can be summarized as follows:

(1) Repos are money market instruments and they are usually used to raise short-term capital.

(2) A repo transaction in conventional repos is effectively a lending as the terms of the transaction are structured to compensate for the funds lent through the payment of the repo rate. Thus, the inflow of cash from the transaction can be used to meet temporary liquidity requirements.

(3) Repo in the conventional market is economically similar to a secured loan with the buyer (i.e. the lender or investor) receiving securities as collateral to protect against default of the seller (i.e. the borrower). Although the underlying

commercial nature of the transaction is that of a loan, the terminology differs from that used when talking of loans because the structure is that of a sale and purchase of the legal ownership of the securities. So, although the actual effect of the whole transaction is identical to a cash loan, in using the "sale and purchase" terminology recognizes the movement of the legal ownership of the collateral securities by the respective parties.

3. Certain Jurisdictional Initiatives

The IIFM Working Team carried out extensive research on what is currently available in the market as well as jurisdictional repo initiatives. The following two repo initiatives were found to be more relevant to our concepts, which are briefly mentioned below:

3.1 Bahrain

This initiative of the Central Bank of Bahrain (CBB) is similar to the Concept # 3 (three party structure) covered later in this paper. However, for this structure to serve for international or cross border 'IS' certain issues would need to be addressed namely:

(a) Lack of margin maintenance

(b) The lack of an obligation on CBB to sell at maturity to party A

(c) Effectiveness in an insolvency of Party A

(d) CBB *Sukuk* specific

(e) Risk appetite outside the jurisdiction for this structure

(f) Fixing of Rate of Return

This structure is workable at country level, where the central bank is the liquidity provider especially considering issue (e) above which is required from *Shari'ah* perspective.

3.2 Malaysia

The Malaysian market has a Sell and Buy Back Agreement (SBBA) under which:

(a) Seller sells securities spot for cash to Buyer;

(b) Seller and Buyer enter into a second agreement under which Buyer promises to sell the securities to Seller at a later date

This structure is workable at country level, but for cross border transactions a number of issues need to be addressed in order for it to be universally acceptable.

NOTE: The above is for reference purpose only. Further details may be obtained directly from websites of respective regulators.

4. IIFM *I'aadat Al Shira'a* (Repo Alternative) Project

4.1 Background

The lack of liquidity management tools, particularly repo-like product is a challenge that has been faced by the Islamic Financial Services Industry (IFSI) for some time now. In 2007, IIFM initiated a process with the aim of trying to find a solution or identify the key factors which may eventually lead to the development of a product which Islamic Financial Institutions (IFI's) can use for their short term liquidity management requirements.

The start of the process was the signing of a MoU with the International Capital Markets Association (ICMA). ICMA is a European capital markets body whose members have contributed to developing the standard conventional Global Master Repo Agreement (GMRA), which is widely used by the industry. Since IIFM and ICMA share the objective to provide a liquidity management repurchase product along with standard documentation to their respective Islamic member institutions, the bringing together of their collective expertise on one platform was found to be prudent approach. A working team consisting of a few international and regional financial institutions and a couple of law firms was formed to start the process. Since IIFM represents the Islamic finance industry and has access to the expertise and support of *Shari'ah* scholars, IIFM has led the project, with the first step being to carry out an industry dialogue and research in finding a possible solution for *I'aadat Al Shira'a* (repo alternative) product under the guidance of the scholars on IIFM's *Shari'ah* Advisory Panel.

The biggest challenge to overcome has been to find a workable and internationally acceptable *I'aadat Al Shira'a* structure which could both be accepted by *Shari'ah* and be practical from a market perspective. The working team decided that without first identifying a *Shari'ah* compliant structure, developing standard documentation will not serve any purpose. The structures documentation considered are briefly described in Appendix A.

As a part of the research and consultation process, consultation have extensively been undertaken with presentations to the OIC Member States Stock Exchanges Forum (courtesy of Istanbul Stock Exchange), Euroclear, Thomson Reuters, financial institutions and other stakeholders, as they will play an important role once an internationally acceptable structure is adopted.

After over two years of extensive deliberation, the working team has reached a stage where it is sharing its finding and conclusion with a view to further development work being carried out by the industry, based on the findings and structuring possibilities mentioned in this reference paper.

4.2 Potential

The reality is that contemporary Islamic financial products are frequently developed through one of two different approaches as follows:

(a) To identify existing conventional products which are in general acceptable under *Shari'ah* principles and to remove from them any prohibited elements such as interest etc. so that they are able to comply with *Shari'ah* rules

(b) To apply various *Shari'ah* principles in order to facilitate the origination and innovation of new products

The conventional money market instruments may fall under the first category. However, the Islamic money market is primarily set up to help Muslim individuals and organizations to finance their businesses. It has in general, the same purpose as conventional money market practices except that it operates in accordance with the rules of *Shari'ah*. It does not allow the paying and receiving of interest and promotes profit/loss sharing in the conduct of finance and banking businesses. Although the application of repo in Islamic banking is not exactly the same as with a conventional repo, the conceptual framework remains the same. Repo in conventional banking, as explained earlier, is an agreement under which a seller of securities undertakes to repurchase equivalent securities from the buyer at an agreed price on a specified future date. This concept of the conventional repo is not accepted by *Shari'ah*. Nevertheless, conventional banks normally use these instruments as tools for liquidity management, something that is urgently needed by Islamic banks in their operations. For these reasons IIFM believes that an alternative must be found, explored and developed.

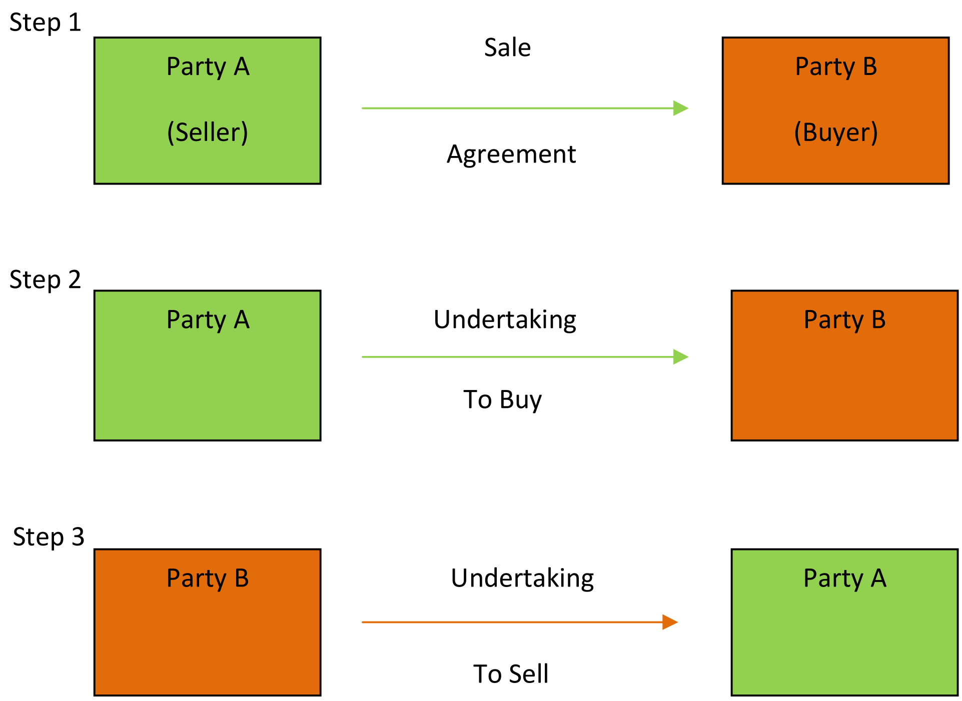
5. IIFM *I'aadat Al Shira'a* (IS) Findings & Structuring Possibilities

Concept 1: Bilateral Structure 'IS'

(i) Definition

Bilateral – Sale for spot value and purchase for an agreed forward date and price

(ii) Overview of Structure



(iii) Description

Step 1: Party A sells *Shari'ah* compliant securities ("Purchased Securities") to Party B on a spot basis. Title to the Purchased Securities passes to Party B against payment of an agreed price (the "Purchase Price").

Step 2: Pursuant to a Purchase Undertaking granted by Party A in favour of Party B, Party A undertakes to buy from Party B, certain *Shari'ah* compliant securities ("Equivalent Securities" as defined below) at the earlier of an agreed date ("Repurchase Date") or following the service of a notice of an Event of Default on Party A by Party B if certain agreed events occur, for a price equal to the Repurchase Price, being a price calculated by reference to a formula ("Purchase Undertaking A").

For the purposes of the above, Equivalent Securities are defined as securities which are:

(a) Issued by the same issuer of the Purchased Securities;

(b) Part of the same issue as the Purchased Securities;

(c) of an identical type, nominal value, description and (except where otherwise stated) amount as the Purchased Securities

Step 3 : Pursuant to a Sale Undertaking granted by Party B in favour of Party A, Party B undertakes to sell Equivalent Securities at Party A's request but only if the Purchase Undertaking is not exercised within an agreed period from maturity or following the service of a notice of an Event of Default on Party B by Party A.

(iv) Key Issues on Bilateral Structure

Even though the repurchased securities are equivalent securities and not the exact same securities or certificates, from a *Shari'ah* perspective they will be considered as the same securities with the result that it not be possible to transact such transactions between the two parties without avoiding *Bai Al 'Inah*[3].

The fact that the repurchase price is fixed at the outset, i.e. it is a fixed price irrespective of the market price at the time of repurchase raises possible *Riba* issues.

(v) *Shari'ah* Scholars' Suggestions

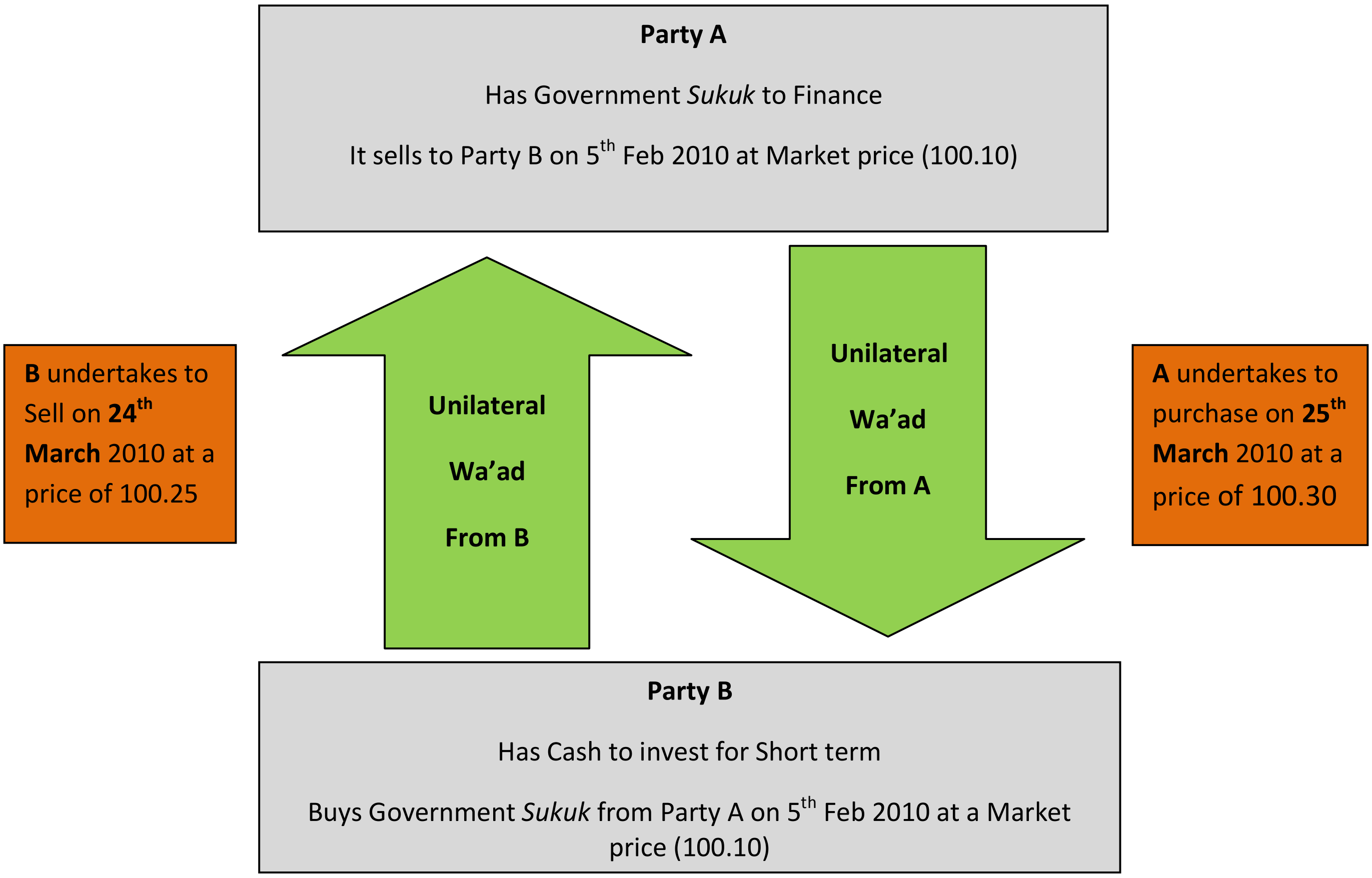
The Bilateral 'IS' is, *Shari'ah* wise, possible if effected using non-binding *Wa'ads* and the repurchase price is set at the market price at the time of the repurchase.

However, after extensive deliberations and explanation by calculation, it was concluded that, from a market risk perspective, this option will not be workable for market participants. Scholars also advise that corresponding risk has to be taken by transacting parties.

[3] A sale in which a purchaser buys merchandise from a seller for a stipulated price on a deferred payment basis and then sells the same merchandise back to the original seller for a price agreed than the original purchase price.

Concept 2: Bilateral Structure with Different Undertakings

The working team also explored the possibility of using the Bilateral 'IS' if structured based on two different *Wa'ads* as follows:



Spot Transaction

Party A sells the Sukuk to **Party B for delivery on 5th Feb 2010** against payment of the market price. The market price being 100.10

Forward Transaction0

Party A provides a unilateral undertaking to **BUY** the *Sukuk* from **Party B** (i) on **25th March 2010 at 100.30** or (ii) following service of a notice of default on Party A if certain agreed events occur.

Party B provides a unilateral undertaking to **SELL** the *Sukuk* to **Party A** (i) **on 24th March 2010 at 100.25** or (ii) following service of a notice of default on Party B if certain agreed events occur, for a pre-agreed Repurchase Price.

It is to be noted therefore that the events leading to and/or time periods enabling the exercise of the respective undertakings will be different so that it is not possible for both undertakings to be exercised simultaneously at any given time.

Based on discussions with scholars this *Wa'ad* based structure may not be acceptable to *Shari'ah* as it raises many *Shari'ah* issues which will be difficult to overcome.

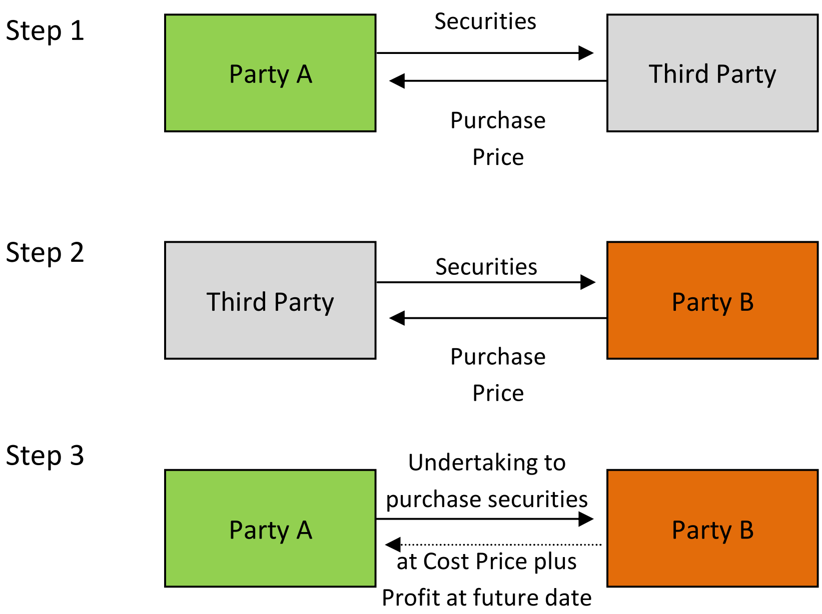
(i) Conclusion

Based on the above, it is difficult to bridge the gap between *Shari'ah* and market requirements for Bilateral structures (Concept 1 & 2) in the present form which is based on market research. The working team is of the view that other possibilities should be explored, which will continue to help deliberation on these concepts.

[Concept 3: Three Party Structure 'IS' (Not Tri-Party)]

(i) Overview of Structure

The major difference between a conventional Tri-Party repo and the Three Party 'IS' under consideration is that, in the case of a conventional repo, the role of the third party is that of an Agent while for the Three Party 'IS' the third party will act as a principal even though It is acting in an intermediary capacity between the other two parties. Therefore, the working team has named this structure Three Party 'IS', as the seller, the buyer and the third party are all required to assume risk.



Step 1: Party A sells securities to a third party (who may be a broker, a clearing agent, a custodian or another third party) against the payment of cash (ideally the aim should be to find an independent third party such as the clearing house of a Stock Exchange or a custodian bank)

Step 2: The third party immediately sells the securities to Party B against the payment of cash

Step 3: Party A undertakes to Party B to buy equivalent securities at maturity at a specified agreed price.

(ii) Issues for Consideration

1. **Underlying securities:**

   (a) The securities involved need to be *Shari'ah* compliant. *Sukuk* would in principle be satisfactory, as would other *Shari'ah* compliant securities such as *Shari'ah* compliant equities

   (b) The parties will need a basis for agreeing what securities are acceptable to them both for these purposes

2. **Margin**

   Consideration needs to be given to the following:

   A. How to replicate margin maintenance? A *Shari'ah* compliant basis for valuing the collateral and delivering more collateral or returning some collateral needs to be determined in cash or Sukuk form

   B. Re-pricing of transactions in terms of pricing Data, Hair Cut, Margin Variances and the actual mechanic of booking and transferring the cash or the securities

   C. How to deal with margin which is cash? Under conventional repo documentation cash margin represents an interest bearing debt obligation – this could be replicated with Murabaha and Reverse Murabaha. An alternative may be either to generate cash through a Murabaha transaction or to use an instrument like an L/C as an alternative to cash

   D. How to effect collateralization? In conventional repo documentation, the collateralization technique used is usually netting i.e. the ability to close out and set off in an insolvency where the value of the collateral securities can be determined and applied in set off against the repurchase price. The lack of recognition of set off in many GCC countries means that the applicability and efficacy of this technique would be limited for the present

   E. Complicating steps of going through 3 parties every time there is a margin call

3. **Accounting Treatment**

Confirmation of the accounting treatment that would be applied to a repo structured in this way.

4. **Third Party Credit Risk**

The parties will be taking settlement credit risk on the third party in respect of its obligations. Any third party involved would also be taking risk on the parties and would need to be comfortable with this.

5. **Income Treatment**

Consideration as to whether there should be a mechanism for passing to Party A the income on coupon or dividend securities received prior to Party A's Undertaking being exercised or whether the income should simply be reflected in the "Repurchase Price"

6. **Master Terms**

Shari'ah acceptance of the Master terms and conditions have certain obligations which may be regarded by *Shari'ah* as adversely affecting the unilateral nature of the *Wa'ad*.

7. **Party B Undertaking**

Consideration needs to be given to whether an Undertaking from Party B is required to ensure on-sale by Party B of the equivalent securities should their value exceed the "Repurchase Price". From a *Shari'ah* perspective, it may not be permissible to make such an Undertaking binding on Party B.

8. **Netting Issues**

As indicated above, the applicability and efficacy of netting is a practical issue with this structure. There is a need to develop law provisions allowing effective netting.

(iii) *Shari'ah* issues to be tackled

I'aadat Al Shira'a if affected on a three party basis is possible and the recommended approach by some scholars, although resolution is still required on the following:

1. Type of arrangement between A & B and what form of undertaking
2. Whether the undertaking may be a unilateral undertaking or simple undertaking
3. Whether B has the right to exercise: If yes then, this may raise *Shari'ah* issues
4. Contingent contracts and entering the contract now for future (has to be non-contingent contracts)
5. Undertaking by B to A; has to be developed based on different scenarios
6. Linking of undertaking and transactions, keeping in view the *Shari'ah* rulings

(iv) Conclusion

The working team is of the view that this concept should be further developed based on the above findings and the third party who is willing to step in as principal. Moreover, as mentioned in the background, the 'third party' will be required to assume risk similar to the CBB structure. It is also recommended that Islamic Development Bank (multilateral institution) or clearing company of a major OIC Stock Exchange (could be Istanbul Stock Exchange) or clearing/custodian institution may assume the role of principal in Three Party Concept.

Once the 'third party' is decided then the remaining issues identified in the concept can be finalized by working team together with the market participants. Moreover, IIFM can also play role in the standardization of documentation as mentioned in Appendix "A".

Concept 4: Collateralized 'IS'

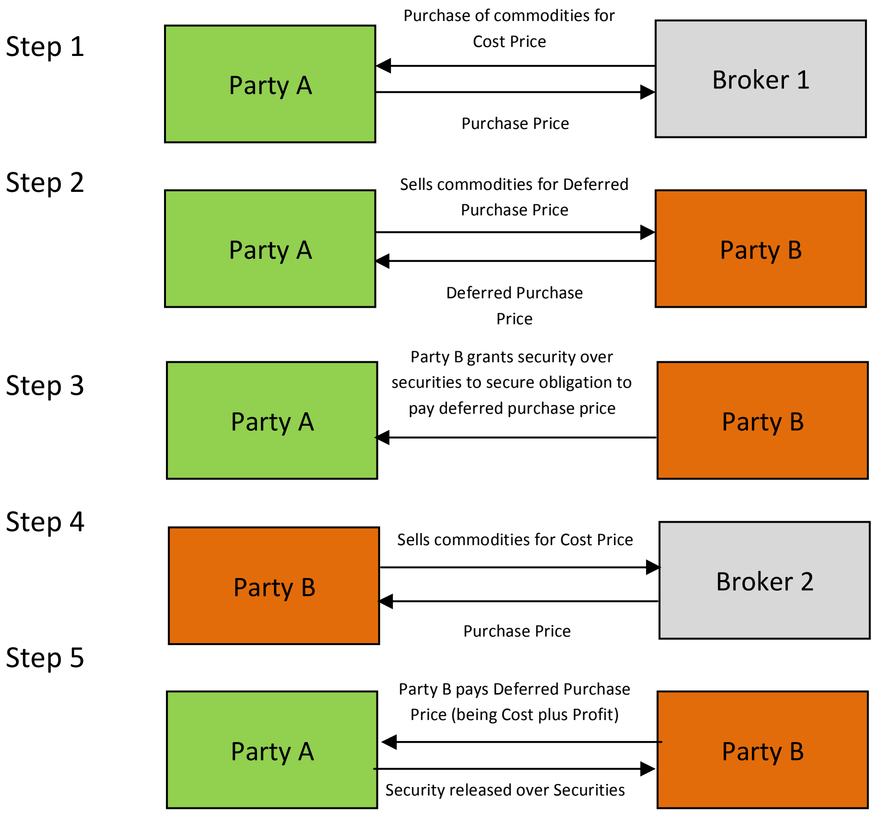
In order to make use of parties *Sukuk* portfolios and to initiate the process while further research and deliberation on finding an ideal 'IS' structure may continue, the working team is of the view that a collateralized structure is one of the options which perhaps can be initiated now given the industry's urgent requirement for a workable liquidity management tool.

The proposal is to make use of Sukuk, which are currently not utilized in a bank's portfolio, through either a *Murabaha* or *Wakala* arrangement. Since *Murabaha* is more developed and widely used, the working team is of the view that the following proposed structure may be initiated in various jurisdictions so that not only do funds remain within the Islamic system but the required legal procedures can be managed at the jurisdiction level (the suggestion is to seek required legal changes in OIC countries to facilitate the process).

Sukuk collateralization through a *Wakala* arrangement is another option which, if required, can be further developed by the IIFM working team if requested by the industry.

To show how the structure will work the following commodity *Murabaha* based structure is proposed for illustrative purposes only:

(i) Overview of Structure



Step 1: Party A buys commodities ("Commodities") from a broker 1 against payment of the cash purchase price.

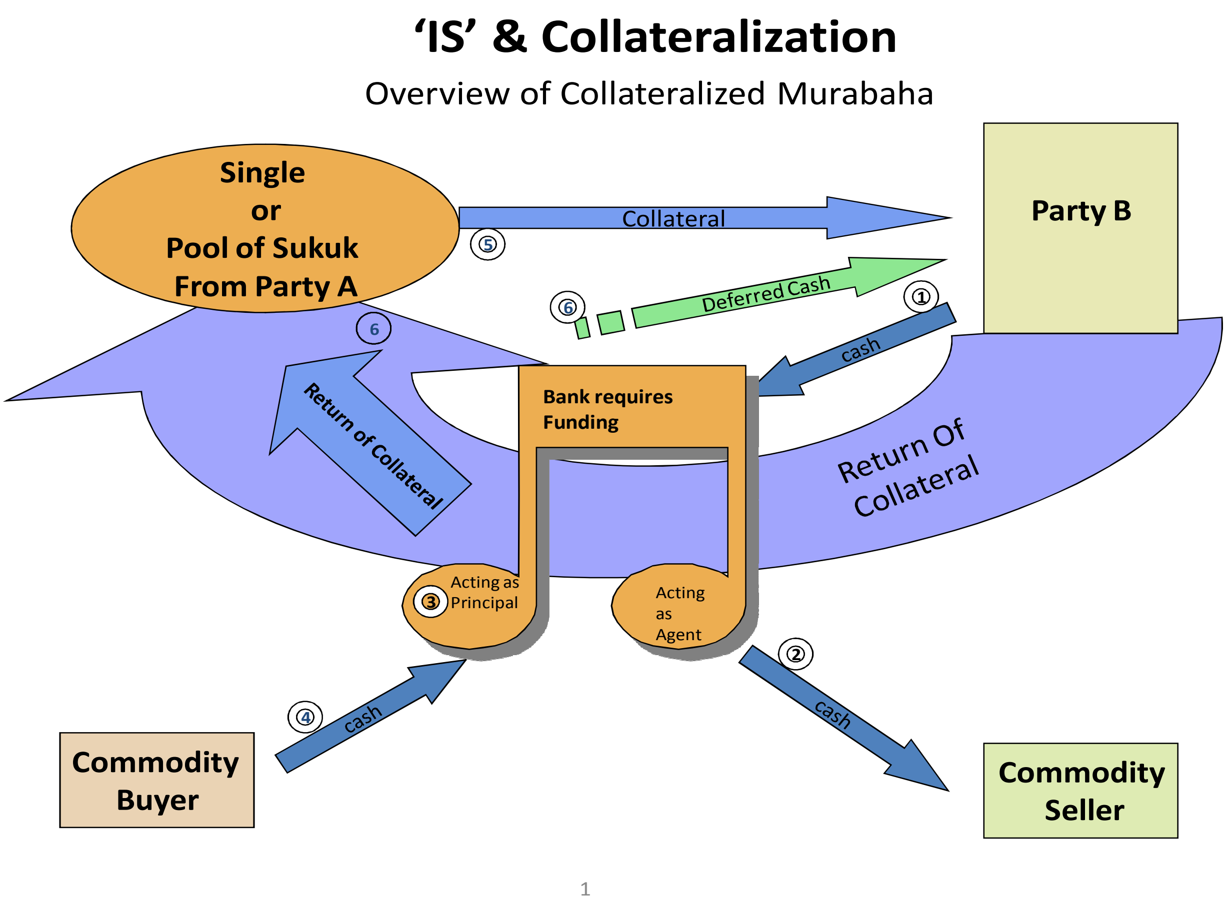
Step 2: Party A sells the Commodities to Party B against payment of a deferred purchase price (being cost plus profit) (the "Deferred Purchase Price").

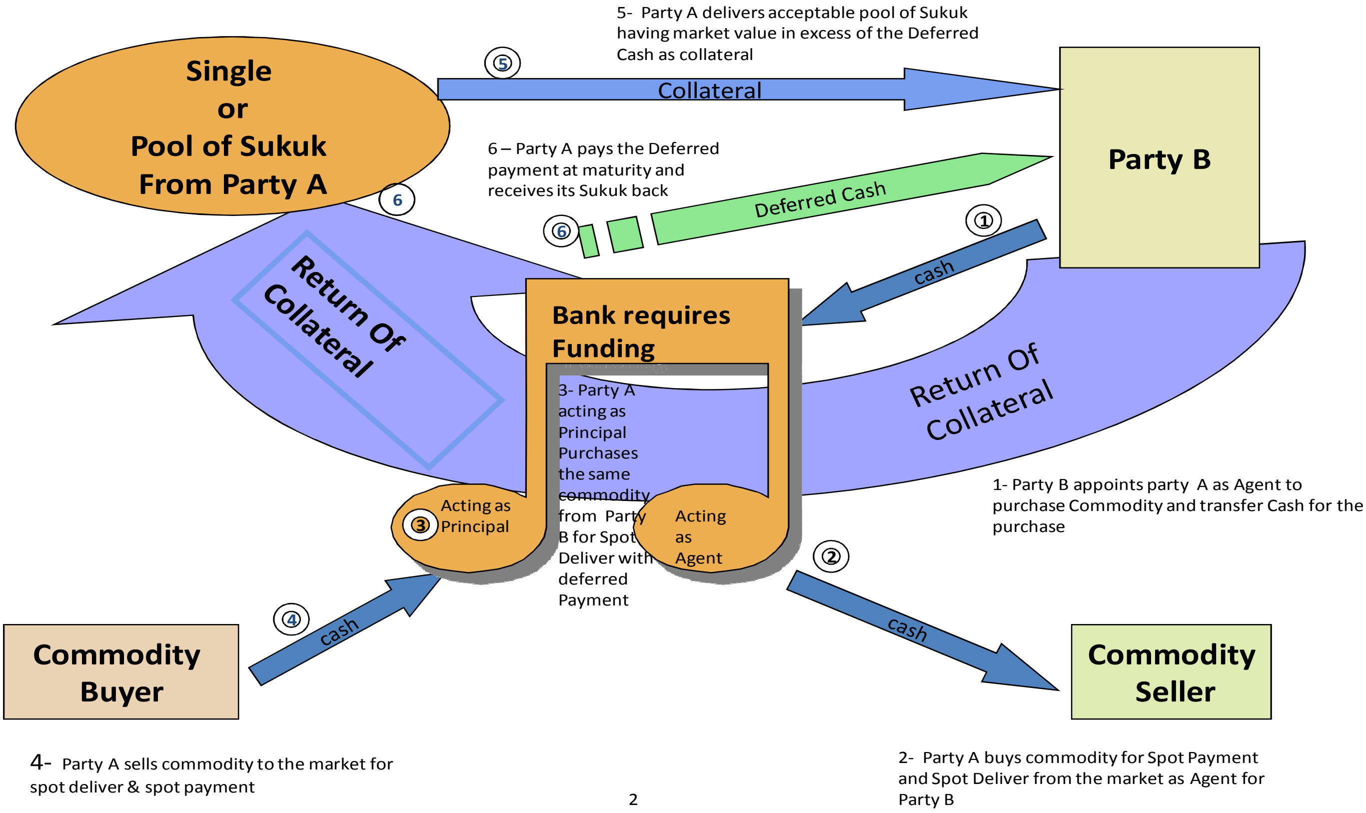
Step 3: As security for payment of the Deferred Purchase Price, Party B grants security over securities held by it in favour of Party A.

Step 4: Party B sells the Commodities to a broker against payment of the cash purchase price.

Step 5: At "maturity", Party B pays the Deferred Purchase Price to Party A and the security granted in favour of Party A is released.

(ii) Working of Collateralization





a) *Transactional Steps*

- Step One – Both parties agrees on Term of the transaction, the mark up, type of *Sukuk*, and Margin call parameters (Haircut, Threshold & Base Currency)
- Step Two – Party B invest $100 million Cash for say1 Month via a *Murabaha* transaction with a local bank
- Step Three – Party B receives acceptable *Sukuk* as agreed by both parties to a value of $ 110 million to collateralize the exposure and allow 5% variance on both side. Reason to provide 10 million extra coverage is to allow for price fluctuation and to reduce the movement of Collateral back and forth
- Step Four –Assuming Collateral fluctuation remains within the band then on the deferred maturity date the Party B receives its $ 100 million + the profit and the Party B returns all of the *Sukuk* Collateral to the Islamic bank

b) ***Assuming the Collateral Value Decreases Below the Threshold Variance***

- Bank to provide more (same or other) acceptable *Sukuk*
- Provide other acceptable Collateral as previously agreed
- Or Provide acceptable Letter of Credit
- Or Provide Reverse *Murabaha*
- To bring the collateral level back to 110%
- If none of the above agreed instrument is delivered then the Party A will be in Default
- The Party B will Return part of the *Sukuk* in order to bring it down to 110% of the *Murabaha* Amount
- Or the Party A may consider not to request this extra amount from the Party B if it wishes to leave extra buffer and save of operational cost

c) ***Commitment of Both Parties***

- At all times during the 1 Month *Murabaha* a 100% to 110 % collateral cover will be maintained against its Deferred payment exposure
- Any Increase above the 115%, Party A has the right to call collateral back
- Any Decrease below 105%, Party B has the right to ask for Top up

d) ***Notes & Considerations***

- The counter parties could be Bank and Central Bank, or Banks and any Financial Institution
- *Sukuk* could be clearing house based as well as domestic *Sukuk*
- Rating benefit is taken as implied
- Other securities which could be used as collateral are not considered at this time
- Use of collateral i.e. *Sukuk* by CB and FI – probably FI is likely to use *Sukuk* as compared to CB
- Governing Law – seems English law needs to be used
- Clearing system based *Sukuk* and its treatment?
- Accounting treatment for collateral assuming leaving pledge or security interest

(iii) Issues for Consideration

1. **Taking security:**

   For this structure to be practical, it would need to be possible to take security over the securities quickly, effectively and robustly. In addition it needs to be possible for Party A to re-hypothecate the securities over which Party B has granted security.

2. **Securities used as security for the obligation to pay Deferred Purchase Price:**

   It is presumed that the securities used as security will be limited to *Shari'ah* compliant securities.

3. **Margin Maintenance**

   The margin maintenance methodology also needs to be resolved and again needs to be quick, effective and robust. Easiest form would be to add or return *Sukuk* depending on collateral level agreement

4. **Broker Credit Risk**

   The parties will be taking a credit risk on the commodity broker in respect of its obligations. However, this is similar to standard commodity *Murabaha* documentation.

5. **Re-hypothecation**

   In conventional repo, the buyer has an ability to make use of the repo'd securities in its own business, which adds to the economic value of the repo to the buyer. How to replicate this in *Shari'ah* complaint way needs to be determined. Potentially Title Transfer Agreement may achieve the desired result.

6. **Accounting Treatment**

   The applicable accounting treatment would need to be clarified.

(iv) Definition of *Al-Rahn*

Al-Rahn means a pledge or a security related to loan. It means under *Shari'ah* by definition, possessing a guarantee. *Al-Imam Ibn Qudamah* in his famous book *Al-Mughny* has defined *rahn* as: “An object made as trust for the payment of debts, by which debts are met if the debtor could not pay to the creditor”[4]

(v) Conclusion

The working team is of the view that, through collateralization, the banks would be able to use their securities portfolios (such as *Sukuk* portfolios) to manage their liquidity requirements and, to a great extent to produce similar results to Repo.

Alternative Solution under Deliberation

In addition to the above mentioned concepts, the IIFM working team is currently also deliberating on another structuring possibility/concept. Once that deliberation has been completed and guidance from *Shariah* is received, it is expected that IIFM may also include this as Concept 5.

[4] Ibn Qudamah, Al-Mughny (Maktabah Al-Riadh Al-Hadithat), pp.361

6. Recommendations on “IS” Concepts

The working team is of the view that Concept 3 and Concept 4 can be used at international level and its recommendations are as follows:

Concept 3 – Three Party Structure ‘IS’

The three party structure should be explored further by involving an active Repo Stock Exchange such as clearing company of Istanbul Stock Exchange or bringing other financial institution such as a clearing house or custodian bank who will be willing to assume the risks of acting as a third party and not the agent role as is the case with conventional tri-party repo.

Concept 4 – Collateralized “IS”

The working team is of the view that institutions may initiate this concept which will give similar results as those achieved by a repo. Moreover, this concept will allow IFI’s to raise cash to fund the inventory while providing the cash investor a return which is further comforted in form of collateral.

It is envisaged that some of the concept developed in Tahawwut Master Agreement specifically netting could also be used under this concept.

Appendix “A”

Proposed Structures Documentation (once the structure is agreed)

Concepts 1 and 2: Bilateral Structure ‘IS’ – Proposed Documentation

(a) Securities Sale Agreement

(b) Unilateral Undertaking from Party A to buy Equivalent Securities (the Purchase Undertaking)

(c) Unilateral Undertaking from Party B to sell Equivalent Securities (the Sale Undertaking)

(d) Master terms and conditions (setting out representations, events of default, warranties, governing law provisions and so on)

Concept 3: Three Party Structure ‘IS’ – Proposed documentation

(a) Party A – Third Party Sale Agreement

(b) Party B – Third Party Sale Agreement

(c) Undertaking from Party A in favour of Party B ("Party A Undertaking")

(d) Undertaking from Party B in favour of Party A ("Party B Undertaking")

(e) Master terms and conditions between Party A and Party B

Concept 4: Collateralized ‘IS’ – Proposed Documentation

(a) Party A – Broker Commodity Sale Agreement

(b) Party B – Broker Commodity Sale Agreement

(c) Party A – Party B Commodity Sale Agreement (to include any other terms between the parties such as events of default etc.)

(d) Collateral Document

(e) [Potential Title Transfer Agreement]