

**THE 2010 TAHAWWUT MASTER AGREEMENT:
PAVING THE WAY FOR *SHARI`AH*-COMPLIANT HEDGING PRODUCTS**

Michael J.T. McMillen
mjtmcmillen@gmail.com
Fulbright & Jaworski L.L.P. (Partner; Global Head of Islamic Finance)
University of Pennsylvania Law School (Lecturer)

Richard Fagerer
Fulbright & Jaworski L.L.P.

Michael E. Pikiel, Jr.
Fulbright & Jaworski L.L.P.

Working Paper
This Version: August 21, 2010
Original Version: May 30, 2010

Copyright 2010 by Michael J.T. McMillen; all intellectual property rights reserved

Abstract

Modern Islamic finance remains in its infancy, having emerged only in the mid-1990s. Despite exceptional growth rates, Islamic finance is essentially devoid of derivatives products, in part due to doctrinal constraints and due in part to the infancy of the industry. In March of 2010, after years of effort, the International Swaps and Derivatives Association (ISDA) and International Islamic Financial Market (IIFM) released The 2010 Tahawwut Master Agreement for the standardized effectuation of certain swaps and derivative transactions that are compliant with the principles of Islamic *Shari`ah*. This paper analyzes certain provisions of The 2010 Tahawwut Master Agreement and compares those provisions with ISDA's 2002 Master Agreement.

Keywords: *tahawwut*, derivatives, swaps, foreign exchange, ISDA, *murabaha*, *musawama*, Islamic finance, Islamic banking, and *Shari`ah*.

JEL Codes: F31, F34, K12, K29.

Citations Note: Much of the audience for this paper is not familiar with A Uniform System of Citation (the "Bluebook"). Therefore, citations are currently provided in full rather than in accordance with the Bluebook.

INTRODUCTION

As the global financial markets strive to emerge from an economic period marked by volatility and contraction, one segment has defied expectations and exhibited astonishing growth. In a recent report, Standard & Poor's Ratings Services observed that, despite the generally turbulent and depressed financial climate surrounding most financial institutions in recent years, "Islamic finance growth has stayed strong and will likely be brisk during [2010]."¹ The same report noted the significant growth exhibited by Islamic financial institutions this past year, where "[a]ssets of the top 500 Islamic banks expanded 28.6% to total \$822 billion in 2009, compared with \$639 billion in 2008."² Even many financial institutions based in the United States and Europe have recognized the opportunities available in the field of Islamic finance, with organizations such as HSBC, Deloitte Touche Tohmatsu, Palisades Park Capital and Thomson Reuters recently making substantial efforts to grow their Islamic finance capabilities and to serve customers seeking to engage in *Shari'ah* compliant financial transactions.³

Recognizing that the rapid growth of Islamic finance will be accompanied by a corresponding need for *Shari'ah*-compliant risk mitigation tools, the International Islamic Financial Market ("IIFM") teamed up with the International Swaps and Derivatives Association, Inc. ("ISDA") to develop a standardized framework that could be used to document privately negotiated Islamic hedging products.⁴ On March 1, 2010, the IIFM and ISDA released the ISDA/IIFM *Tahawwut* (Hedging) Master Agreement (the "*Tahawwut Master Agreement*"), which is based on ISDA's 2002 Master Agreement (the "*2002 Master Agreement*") but modified for compliance with *Shari'ah* rules and principles.⁵ The *Tahawwut* Master Agreement was developed under the guidance and approval of the IIFM *Shari'ah* Advisory Panel, and was designed for use in all jurisdictions where Islamic finance is practiced.⁶ An Explanatory

¹ *Islamic Finance Is Likely To Advance In 2010 On Firm Growth And Widening Geographic Reach*, Standard & Poor's Ratings Services, February 4, 2010, available at <http://www.standardandpoors.com/ratings/articles/en/us/?assetID=1245205629399> ("S&P").

² S&P, *supra* note 1.

³ See the various reports at <http://www.islamic-finance-blog.com/?cat=4>, reporting that (i) in 2009 HSBC Amanah grew its operations in Saudi Arabia, through SABB, UAE, and Malaysia and expanded in Indonesia, Qatar and Bahrain; (ii) on January 19, 2010, Thomson Reuters launched an Islamic banking-tailored risk management system; (iii) Palisades Park Capital launched a hedged fund that they described as *Shari'ah*-compliant; and (iv) Deloitte Touche Tohmatsu hired Daud Viacary Abdullah as global leader of Deloitte's Islamic Finance Industry.

⁴ News Release by ISDA at www.isda.org/media/press/2010/press030110.html (March 1, 2010) ("*ISDA News Release*").

⁵ ISDA News Release, *supra* note 4.

⁶ ISDA News Release, *supra* note 4.

Memorandum was issued by ISDA along with the *Tahawwut* Master Agreement to provide a general overview and explanation of how the document operates.⁷

Consistent with the framework of the 2002 Master Agreement and its 1992 predecessor, the *Tahawwut* Master Agreement merely provides a standard framework that parties may agree to adopt without change or modify at their discretion.⁸ Nevertheless, the *Tahawwut* Master Agreement represents the combined effort and input of numerous *Shari`ah* scholars, lawyers and finance industry experts, an effort reflected in the record 24 drafts developed before reaching the released version, and any modification to the standard framework of the *Tahawwut* Master Agreement should not be made without a thorough understanding of how the original language functioned and the language's underlying rationale.⁹

This article will first summarize some basic background information on the *Shari`ah* and provide a general introduction to Islamic finance and some of the principles and structures of relevance in considering hedging arrangements. This article will then review the most significant modifications to the 2002 Master Agreement reflected in the *Tahawwut* Master Agreement and analyze the reasoning behind these modifications. We hope this article will serve as an enticing introduction to the world of Islamic finance and as a useful guide to the *Tahawwut* Master Agreement.

BASIC BACKGROUND ON SHARI`AH

General Background on *Shari`ah*

The term *Shari`ah* refers to “the way” or “the path” by which a Muslim should live his or her life.¹⁰ The *Shari`ah* extends to all aspects of a Muslim's life, including not only religious, theological, spiritual and moral aspects, but also the social, political, cultural, legal, commercial and financial aspects of human existence.¹¹ The *Shari`ah* therefore represents the principles and

⁷ Explanatory Memorandum Relating to the ISDA/IIFM *Tahawwut* Mater Agreement, 1 March 2010, of ISDA and IIFM, available at <http://www.isda.org/publications/pdf/ISDA-IIFM-Explanatory-Memorandum.pdf> (the “*Explanatory Memorandum*”).

⁸ Compare generally the 2002 Master Agreement and the *Tahawwut* Master Agreement; see also Explanatory Memorandum, *supra* note 7.

⁹ See ISDA News Release, March 1, 2010, at www.isda.org/media/press/2010/press_030110.html.

¹⁰ See Michael J.T. McMillen, *Islamic Project Finance: An Introduction to Principles and Structures*, Global Infrastructure, Volume III, Fulbright & Jaworski L.L.P. (Spring 2009) (“*McMillen: Principles*”), at 7. Early derivations of the word “*shari`ah*” relate to the path by which camels were taken to water, to the source and essential sustenance element of life. The defined term “*Shari`ah*”, as used in this article, refers to the principles and precepts of Islamic *shari`ah* as applied to commerce and finance.

¹¹ See McMillen: Principles, *supra* note 10, at 7-8, and sources cited at footnotes 23 through 26, for discussions of the matters summarized in this paragraph.

precepts, including rules and “laws”, by which a Muslim should abide in each and every aspect of his or her life. This includes the observance of the *Shari`ah* in the conduct of business matters. Islamic finance, therefore, refers to the conduct of financial and commercial activities in accordance with *Shari`ah*.

In Islamic orthodoxy, the primary sources of the *Shari`ah* are (a) the *Qur`an* (the divine word of Allah), (b) the *sunna* (the practices, writings, pronouncements and examples of the Prophet Mohammad), (c) *ijma`* (consensus, particularly the consensus of the community of scholars or the “assembly of the learned”), and (d) *qiyas* (or analogical deductions and reasoning).¹² The application of the *Shari`ah* to commercial and financial activities, and thus the practical elucidation of the *Shari`ah*, is effected by Islamic scholars.¹³ In turn, Islamic scholars subscribe to different schools (*madhhahib*) of Islamic jurisprudence that in some cases apply varying interpretations to identical factual situations.¹⁴ Consequently, to a certain extent, Islamic law functions by a case-by-case methodology in which different schools of Islamic jurisprudence may arrive at somewhat different conclusions.¹⁵ As a result, *Shari`ah* scholars and the boards on which they sit play a highly influential role in Muslim life generally and in Islamic finance particularly. In Islamic finance transactions, transaction parties often seek certification by, or the advisory services of, Islamic scholars and boards in order to receive assurances that a financial transaction is *Shari`ah* compliant.¹⁶

Islamic Finance

Islamic finance is based on a somewhat different paradigm than that practiced in “western” finance.”¹⁷

¹² S.G. Vesey-Fitzgerald, *Nature and Sources of the Shari`a*, in LAW IN THE MIDDLE EAST, Majid Khadduri and Herbert J. Liebesny, eds. (1955) (“*Khadduri & Liebesny*”), at 85 *et seq.*, and McMillen: Principles, *supra* note 10, at 8-9. The *Qur`an* and the *sunna* are “revealed” sources of the *Shari`ah*. An interesting and informative discussion of the derivation of the term “*sunna*” is Zafar Ishaq Ansari, *Islamic Juristic Terminology Before Šāfī: A Semantic Analysis with Special Reference to the Kūfa*, in Wael B. Hallaq, THE FORMATION OF ISLAMIC LAW (2004), at 215-38. The nature of *hadith* as verified reports of the *sunna* of the Prophet Mohammed is discussed in Marshall G.S. Hodgson, THE VENTURE OF ISLAM: CONSCIENCE AND HISTORY IN A WORLD CIVILIZATION: VOLUME 1: THE CLASSICAL AGE OF ISLAM (1974), at 63-660.

¹³ McMillen: Principles, *supra* note 10, at 8-9.

¹⁴ See, e.g., Joseph Schacht, *The Schools of Law*, in Khadduri & Liebesny, *supra* note 12, at 57, and Noel J. Colson, AN INTRODUCTION TO ISLAMIC LAW (1964), at 37.

¹⁵ McMillen: Principles, *supra* note 10, at 8-9.

¹⁶ McMillen: Principles, *supra* note 10, at 9.

¹⁷ For purposes of this article, the generic terms “western” and the “west” are meant to refer to the conventional financial practices observed in the North and South America, Europe, Japan, Korea and similar non-Muslim jurisdictions which are predominantly based on an interest-bearing model.

First and foremost, western finance is predominantly concerned with economic behavior, and generally removed from any religious or ethical dimension. Second, western finance conceives of money as a commodity that can and should accumulate additional wealth. Money costs money, the idea that forms the basis of the concept of interest. Interest is often used as a tool (i) to compensate the creditor for temporary loss of access to its own funds, during which time these funds could presumably be put to an alternative use to accumulate additional wealth (*i.e.*, opportunity cost), (ii) to compensate the creditor for the risk that the debtor defaults on the loan (*i.e.*, default risk) and (iii) to discourage the debtor from engaging in undesirable behavior (*i.e.*, penalty). Third, the allocation of risks and benefits as among the parties (*e.g.*, the creditors and the debtors) need not be proportional. Risk allocations may place essentially all of the risk of a transaction on a single party, irrespective of the preferential allocation of benefits to another party. Fourth, speculative trading is an accepted, though not always encouraged, practice.

Islamic finance embodies distinct religious and ethical, as well as economic, elements. A relatively widely known religious and ethical element is the prohibition on involvement with activities relating to alcohol for human consumption. Less well known, but equally important, are “consumer protection” principles and rules embodied in the *Shari`ah*. An example is the principle that a lessor must provide a sound and fully functional and operational asset in any leasing transaction. The *Shari`ah* rules thus require the lessor to maintain structural maintenance obligations throughout the lease term (unless structural damage is caused by the lessee).

Islamic finance is founded on the principle of risk-sharing. All parties to a transaction must bear exposure to a risk of loss and the allocations of risks and rewards must be proportional. Rewards without commensurate risk, and preferential rewards are not permitted. Therefore, the *Shari`ah* forbids the payment or receipt of any predetermined, guaranteed rate of return (the prohibitions are embodied in numerous doctrines, including the *riba* doctrines). Islamic scholars are in general consensus that the *riba* doctrines prohibit the payment and receipt of interest since interest accrues regardless of the success or failure of a business venture. Since the creditor that charges interest accumulates wealth even if the borrower’s business venture fails, he is not subject to the same risk as the borrower-business operator. Under the *Shari`ah*, both the borrower and the creditor must share in the risk of the business operations; wealth may only be accumulated if the underlying business is successful.

Moreover, in further contrast to “western” finance, money may not be used as a commodity that accumulates additional wealth; it may be no more than a medium of exchange and measure of stored value. Instead, every financial transaction must involve a tangible asset (aside from certain limited exceptions, such as intellectual property) that is permissible under the *Shari`ah*.

Other variations of financial practices used in those jurisdictions are ignored for these purposes. See McMillen: Principles, *supra* note 12, at 10.

As a summary of a few illustrative *Shari`ah* principles of relevance to the current discussion, *Shari`ah*-compliant finance transactions must abide by the following principles:

- they may not involve *riba*, which is generally described in current practice as a prohibition on the payment or receipt of interest;
- no guarantees or assurances of return of capital are permissible;
- a tangible asset that is permissible under Islamic Law (*halal*) must form the basis of the transaction;
- there must be compliant risk-sharing among the parties to the transaction; and
- transactions may only be entered into for the purpose of hedging actual risks, rather than for purposes of speculation.

In the following section, we explore how these basic *Shari`ah* principles were integrated into the *Tahawwut* Master Agreement.

REVIEW AND ANALYSIS OF *TAHAWWUT* MASTER AGREEMENT

As was the case with the 2002 Master Agreement, the *Tahawwut* Master Agreement provides a standard global framework that sets out many of the basic terms pursuant to which parties may enter into *Shari`ah*-compliant hedging transactions.¹⁸ Execution of the *Tahawwut* Master Agreement does not give rise to an actual transaction.¹⁹ The parties must enter into additional agreements (*i.e.*, a Schedule and a Confirmation) pursuant to which the parties make elections as to which sections of the *Tahawwut* Master Agreement apply and in which the specific terms of a particular transaction are set forth.²⁰ While a Confirmation applies to a specific transaction, an executed *Tahawwut* Master Agreement and the accompanying Schedule serve as an umbrella agreement that may govern a series of transactions.

The following analysis presumes some familiarity with the 2002 Master Agreement. For the sake of brevity, this article focuses solely on the most significant differences between the *Tahawwut* Master Agreement and the 2002 Master Agreement and the *Shari`ah* principles underlying these differences. Before proceeding to that analysis, however, it is useful to have some familiarity with contemporary *murabaha* and *musawama* transactions, which are the *Shari`ah*-compliant transactions presently contemplated for use in effecting the *Tahawwut* Master Agreement.

¹⁸ Compare the 2002 Master Agreement against the *Tahawwut* Master Agreement.

¹⁹ Explanatory Memorandum, *supra* note 7, §1, at 1, and §3.1, at 2.

²⁰ Explanatory Memorandum, *supra* note 7, §3.1, at 2.

Currently Contemplated *Shari`ah* Transactions

By way of background, it is important to note that the review and approval of the IIFM *Shari`ah* Advisory Panel extends only to the *Tahawwut* Master Agreement, and not to any specific Transaction, DFT Terms Agreement, Designated Future Transaction (each as hereinafter defined) or amendment or modification of the *Tahawwut* Master Agreement.²¹ Thus, each of the parties to a Transaction, a DFT Terms Agreement or a Designated Future Transaction must satisfy itself as to compliance with the *Shari`ah* of that Transaction and any DFT Terms Agreement or Designated Future Transaction, and provide appropriate representations and warranties as to such compliance.²² Two new representations have been added to the *Tahawwut* Master Agreement as §§ 3(h) and 3(i). These representations clarify that each party is responsible for investigating and obtaining all necessary assurances that the *Tahawwut* Master Agreement and any specific Transaction or Designated Future Transaction is *Shari`ah* compliant. Parties may not rely on any declaration, pronouncement, opinion or other attestation or document prepared or obtained by the other party, including any dealer.

At present, two types of *Shari`ah*-compliant transactions are contemplated by the *Tahawwut* Master Agreement: the *murabaha* and the *musawama*. Only the *murabaha* is listed in Part 5 of the form of the Schedule to the *Tahawwut* Master Agreement. One or more of these transactions will be effected each time one party owes the other party any amount pursuant to the framework established in the *Tahawwut* Master Agreement, as hereinafter discussed. Each of these transactions is a commodity or asset sale agreement that is subject to a wide range of requirements under the *Shari`ah*. The *Shari`ah* requirements applicable to a *murabaha* and a *musawama* are essentially identical, with one important exception.²³ In a *murabaha* transaction, the cost of the commodity or asset being sold and purchased must be disclosed and known to both the seller and the purchaser. In a *musawama* transaction, the cost of the commodity or asset being sold and purchased need not be disclosed and known to both the seller and the purchaser. It is anticipated that risk mitigation transactions other than the *murabaha* and the *musawama* will be approved for use under the *Tahawwut* Master Agreement in the future, after such other transactions are reviewed and approved for *Shari`ah* compliance.²⁴ Use of such other risk

²¹ Explanatory Memorandum, *supra* note 7, §2, at 2.

²² Explanatory Memorandum, *supra* note 7, Disclaimer, at 1.

²³ The *Shari`ah* requirements applicable to the *murabaha* (and the *musawama*) as currently used in Islamic finance, and the structures currently used in Islamic finance, are described in Michael J.T. McMillen, *Islamic Project and Infrastructure Finance in the Middle East: Re-Emergence of the Murabaha* (“McMillen: *Murabaha*”), in *INVESTING IN THE GCC MARKETS: NEW OPPORTUNITIES IN A CHANGING LANDSCAPE*, 2ND EDITION, Sohail Jaffer and Kamar Jaffer, eds. (2009), at 133 *et seq.*, and Michael J.T. McMillen, *Islamic Project and Infrastructure Finance: Re-Emergence of the Murabaha*, *THE IN-HOUSE LAWYER* (December 2009/January 2010), 2.

²⁴ Explanatory Memorandum, *supra* note 7, §4, at 8.

mitigation transactions is left, explicitly, to the individual *Shari`ah* supervisory boards of transactional participants.²⁵

Each of the *murabaha* and the *musawama*, in any context, is a sale, and must conform to the *Shari`ah* requirements pertaining to sales.²⁶ A summary of some of the major sales principles applicable to each of these transactional types is helpful to understanding the use of the *murabaha* and the *musawama* in connection with Transactions under the *Tahawwut* Master Agreement.

The object of the sale must be in existence at the time of the sale. Agreements relating to objects not yet in existence (an unborn calf, a future harvest, an unmanufactured good) are not valid *murabaha* transactions.²⁷ The sale object must be known and clearly specified to the parties in a manner that allows its precise identification. Of course, the object may not be a *haram* object (alcohol, pork, impermissible financial instruments, and the like). The object must have determinable value at the time of sale.

The sale object must be owned by the seller at the time of the sale. A sale of a jar that is owned by a third party is not valid, however likely it is that the third party will sell the jar to the initial buyer so as to allow the sale to the second buyer. The object must be in the actual or constructive possession of the seller (initial buyer) at the time of the sale. Constructive possession here means that the seller has assumed all liabilities and obligations of ownership and possession, including in respect of destruction or “perishing”, even though the seller has not

²⁵ Explanatory Memorandum, *supra* note 7, §4, at 8. The importance of this point cannot be overstated, particularly in light of (a) the disagreements among adherents of different schools of Islamic jurisprudence (*madhhahib*) that arose (and were accommodated) in the negotiation of the *Tahawwut* Master Agreement and that will undoubtedly arise in the transactional implementation of the *Tahawwut* Master Agreement, and (b) the infancy of Islamic finance and the relative dearth of *Shari`ah*-compliant products and structures.

²⁶ McMillen: *Murabaha*, *supra* note 23, discusses the elements of the *murabaha* and some of the variations in documentary provisions and transactional structures that are encountered in contemporary Islamic finance (for example, the variations in addressing late payments and defaults in payment and the widespread use of metals *murabaha* transactions). See, also, Taqi Usmani, *Murabaha*, available at <http://www.darululoomkhi.edu.pk/fiqh/islamicfinance/murabaha.html> (“*Usmani*”), and Wahbah Al-Zuhayli (Mahmoud El-Gamal, translator, and Muhammad S. Eisaa, revisor), *AL-FIQH AL-ISLAMI WA-ADILLATUH (ISLAMIC JURISPRUDENCE AND ITS PRO.OFS), WAHBAH AL-ZUHAYLI, FINANCIAL TRANSACTIONS IN ISLAMIC JURISPRUDENCE*, which is a translation of Volume 5 of *AL-FIQH AL-ISLAMI WA ‘ADILLATUH, FOURTH EDITION (1997)* and appears in two volumes (“*al-Zuhayli*”), at 353 *et seq.*

²⁷ The *Shari`ah* Advisory Panel of the IIFM emphasized the necessities of avoidance of speculation and having a tangible asset as the subject of the *murabaha* or *musawama* Transaction under the *Tahawwut* Master Agreement: Explanatory Memorandum, *supra* note 7, at §2, clause (ii).

taken physical delivery of the object. Delivery of the object must be certain and not contingent or dependent upon conditions, events or circumstances.

The sale must be immediate and not contingent on future conditions, events or circumstances.²⁸ If not immediate, or if contingent, it is void as a present sale and will have to be renewed and reaffirmed at the specified future date or upon the occurrence of the contingency.

The validity of a *murabaha* or a *musawama*, like that of any sale, is dependent upon certainty of price. In a *murabaha*, the price is a function of two fully-disclosed and mutually agreed elements: the initial cost and the profit. In a *musawama*, the cost need not be disclosed, and the price may thus be agreed as a composite figure that does not differentiate between cost and profit. In each transactional type, the price must be determinable and fixed with certainty. The price, once fixed, may not be increased or decreased, even if payment is made earlier or later than the agreed payment date, including in default and early payment scenarios.

Transactions and Designated Future Transactions

The most significant difference between the 2002 Master Agreement and the *Tahawwut* Master Agreement is the addition of the “Designated Future Transaction” concept.²⁹ To accommodate the *Shari`ah* requirements pertaining to sales, the *Tahawwut* Master Agreement contemplates two different types of situations: (i) live transactions documented to occur immediately (“*Transactions*”); and (ii) undertakings or agreements to enter into Transactions in the future upon the satisfaction of certain conditions (“*Designated Future Transactions*”).³⁰ A Transaction is documented through a Confirmation and a Designated Future Transaction is documented through a “*DFT Terms Agreement*”.³¹ Once a Designated Future Transaction is finally concluded, it becomes a Transaction.³²

Shari`ah requirements pertaining to sales, including those requiring delivery of the asset that is the subject of the sales transaction at the time of the sale, give rise to the differentiation between consummated Transactions and DFT Terms Agreements leading to Designated Future Transactions.³³ Parties seeking to enter into a *Shari`ah*-compliant ISDA transaction have two

²⁸ The *wa`ad* arrangement embodied in the *Tahawwut* Master Agreement is designed to address this requirement and its ramifications in a contemporary hedging transaction.

²⁹ See *Tahawwut* Master Agreement.

³⁰ See *Tahawwut* Master Agreement, §2(d)(B)(4).

³¹ Explanatory Memorandum, *supra* note 7, at 1.

³² *Tahawwut* Master Agreement, footnote 2.

³³ See the previous section of this article and McMillen: *Murabaha*, *supra* note 23. The *Shari`ah* permits of only a limited number of “futures” or “forward sale” contracts in which a binding sale and purchase agreement provides for future delivery of an asset against future delivery of the

options. If the parties wish to immediately enter into a binding “Transaction,” the parties must agree to the immediate delivery of at least a portion of the agreed-upon asset(s). For example, the *Tahawwut* Master Agreement specifically contemplates parties entering into valid *murabaha* transactions.³⁴ These may well be metals *murabaha* transactions in which the metal (say, platinum) is a vector for implementation of the desired sale and purchase and creation of the payment obligation.³⁵

In the event the parties prefer to defer the delivery of the asset(s) to a date subsequent to consummation of the agreement, or must defer the asset purchase and sale transaction to an uncertain future date relating to early termination of the hedging arrangements, they will do so by virtue of the Designated Future Transaction mechanism. Given the uncertainties as to the amount and timing of future obligations (say, upon early termination, if it should occur), and thus the uncertainties regarding the amount, timing and pricing of future sales and purchases of assets, the parties will not be able to enter into valid sale and purchase agreements as to those future sale and purchase transactions. However, each of the parties will be able to enter into a separate “*wa’ad*” to enter into a Designated Future Transaction. A *wa’ad* is a promise or undertaking to enter into a transaction in the future at the election of the other party upon the occurrence of a given set of circumstances (such as early termination, including as a result of default). A *wa’ad* is not a binding agreement and may be canceled or at any time prior to becoming a binding agreement. Use of the *wa’ad* arrangement avoids violation of the relevant *Shari`ah* sale and purchase requirements.

Using these two transaction types of arrangements, Transactions and Designated Future Transactions, parties may structure arrangements that mimic many of conventional derivative hedging products that are available under the 2002 Master Agreement without violating the *Shari`ah*.

Section 2(e): *Wa’ad* to enter into a *Musawama*

purchase price. Two examples of permissible forward sale transactions are (a) the *salam* contract in which the purchase price is paid in full at the time of entering into the sale and purchase agreement and the asset is delivered at a specified future date, and (b) the *arboon* contract in which a down payment in respect of the purchase price is paid at the time of entering into the sale and purchase agreement and the purchaser has the option, at a specified future date, of completing the sale and purchase and taking delivery of the asset or forfeiting the down payment. In connection with future and options, see *A Review of Forward, Futures and Options from the Shariah Perspective: From Complexity to Simplicity*, Nuradli Ridzwan Shah Mohd Dali & Dr Sanep Ahmad, SEKI 2005 Conference, 1, 31 (August 30, 2005)

³⁴ See footnote 2 to *Tahawwut* Master Agreement and Part 5 of the Schedule.

³⁵ See McMillen: *Murabaha*, *supra* note 23, which discusses, and critiques, modern metals *murabaha* transactions in which the metal asset is not of substantive import to the parties other than as a vector to allow generation of a debt obligation pursuant to a transaction that is *Shari`ah* compliant in form.

The *Tahawwut* Master Agreement provides for two separate and distinct types of *wa'ad* arrangements. In addition to the *wa'ad* to enter into a Designated Future Transaction as previously discussed, the *Tahawwut* Master Agreement also includes *wa'ad* arrangements with respect to *musawama* sale and purchase transactions in the event of an Early Termination.³⁶

Prior to maturing into a “Transaction,” the Designated Future Transaction is non-binding.³⁷ However, §2(e) of the *Tahawwut* Master Agreement does provide recourse in the event an early termination (including by way of default) occurs prior to the Designated Future Transaction becoming a binding Transaction. The mechanism established by §2(e), together with §6(f)(v) of the *Tahawwut* Master Agreement, provides that the party who would be owed an early termination payment has a right to sell to the other party a pre-agreed quantity of the designated assets for a price equal to the sum of: (i) the market value of the assets; (ii) an early termination payment (referred to as the value of the “Relevant Index” in the *Tahawwut* Master Agreement); and (iii) certain taxes and other costs of such asset transfer; subject to the set-off provisions. Calculation of the early termination amount payable in respect of these assets is discussed below.

Even in the absence of a binding Transaction (*i.e.*, a *murabaha*), §§2(e) and 6(f)(v) ensure that a tangible asset will be exchanged upon early termination of a Designated Future Transaction in compliance with *Shari`ah* rules and that the party owed an early termination amount has redress even in the absence of a binding Transaction.

Early Termination

Section 5 of the *Tahawwut* Master Agreement remains largely unchanged from the 2002 Master Agreement aside from the incorporation of the Designated Future Transactions concept and the addition of the “Failure to enter into a Designated Future Transaction” as an Event of Default. As is the case with the 2002 Master Agreement, the *Tahawwut* Master Agreement provides that, in the case of an Event of Default, the non-defaulting party may choose to terminate all the Transactions and DFT Terms Agreements. In the event of a Termination Event, the relevant party may elect to terminate all affected Transactions and affected DFT Terms Agreements.

³⁶ The *Tahawwut* Master Agreement provides for two distinct *wa'ad* undertakings with respect to *musawama* transactions, with each of the two parties to the *Tahawwut* Master Agreement being an asset seller in one such transaction and an asset purchaser in the second such transaction. In other words, in the event of an Early Termination, if Party A owes money to Party B based upon the calculation of the Relevant Index (discussed below), then Party A agrees to purchase X amount of Asset A from Party B at Asset A’s cost. And Party B separately agrees to purchase Y amount of Asset B at Asset B’s cost in the event of an Early Termination where Party B would owe money after calculation of the Relevant Index.

³⁷ See §2(e) of *Tahawwut* Master Agreement.

On the other hand, the mechanism to determine the payment due upon Early Termination underwent significant changes to account for the various transaction types available under the *Tahawwut* Master Agreement and to effect net risk management.³⁸ The *Tahawwut* Master Agreement provides for two different early termination payment calculations, one calculation applicable to Transactions under which all deliveries (*i.e.*, of tangible assets) have been made and the other calculation applicable to DFT Terms Agreements and Transactions under which at least one delivery (*i.e.*, of tangible assets) remains to be made.

Fully Delivered Transaction

With respect to Transactions under which all deliveries have been made (“*Fully Delivered Transactions*”), an Early Termination Amount equal to the sum of (i) the Close-Out Amount and (ii) all other unpaid amounts related to the *Tahawwut* Master Agreement, is calculated and paid.³⁹ All payments due under all terminated Fully Delivered Transactions are accelerated, aggregated and set-off against one another to arrive at the “Close-out Amount”. Thus, determination of the Early Termination Amount in respect of the Fully Delivered Transactions is rather straightforward. The Early Termination Amount is then netted against the value of the “Relevant Index”, calculated as described in the next section.

DFT Terms Agreements and Non-Fully Delivered Terminated Transactions

With respect to DFT Terms Agreements and Transactions in which deliveries remain to be made (“*Non-Fully Delivered Transactions*”), an early termination payment based upon the value of the “Relevant Index” is made.⁴⁰ 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.”⁴¹ This net replacement cost, the Relevant Index value, is determined by calculating a “Relevant Index Amount” for each terminated DFT Terms Agreement and each terminated Non-Fully Delivered Transaction, and aggregating these amounts together.

The Relevant Index Amount for a terminated DFT Terms Agreements or terminated Non-Fully Delivered Transactions is determined through the Market Quotation method, and in the event a Market Quotation cannot be determined or would not lead to a commercially reasonable

³⁸ *Tahawwut* Master Agreement, footnote 6.

³⁹ See *Tahawwut* Master Agreement, at 15, and Explanatory Memorandum, *supra* note 7, §3.6(i), at 4-5.

⁴⁰ See *Tahawwut* Master Agreement, at 16, and Explanatory Memorandum, *supra* note 7, §3.6(ii), at 5-7.

⁴¹ Explanatory Memorandum, *supra* note 7, §3.6(ii), at 5-7.

result, through the Loss method.⁴² The Relevant Index Amounts are then aggregated and set-off against one another to arrive at the “Relevant Index” value.

If the Relevant Index is positive, that means the calculating party would have to make a net payment to one or more third parties to replace the terminated Non-Fully Delivered Transactions and DFT Terms Agreements. This would be the case where the calculating party, in the aggregate, is owed cash flows under the terminated Non-Fully Delivered Transactions and DFT Terms Agreements. For example, if the Relevant Index Amounts of three terminated Non-Fully Delivered Transactions and DFT Terms Agreements are \$100, -\$20 and \$30, then the Relevant Index value is \$110, and the calculating party would need to pay \$110 to replace the terminated transactions with identical agreements and thus be restored to his or her position prior to the early termination. In this event, the non-calculating party owes a payment to the calculating party to compensate the calculating party for this net replacement cost.

On the other hand, if the Relevant Index is negative, that means the calculating party would actually receive a net payment to replace the early terminated Non-fully Delivered Transacts and DFT Terms Agreements. This would be the case where the net cash flows that would be payable in the future on these terminated transactions (if it were not for early termination) would be from the non-calculating party to the calculating party. Thus, a third party would make a net positive payment to step into the shoes of the calculating party to receive these remaining net positive cash flows. Under the *Tahawwut* Master Agreement, the calculating party is not permitted to retain this gain—the non-calculating party is entitled to receive this amount.

The early termination mechanism is designed to ensure that the calculating party (generally, but not always, the non-defaulting/affected party) neither suffers a loss nor benefits from a gain as a result of an early termination of Non-Fully Delivered Transactions or DFT Terms Agreements. Conversely, the non-calculating party (generally, but not always, the defaulting/affected party) is required to compensate the other party for any loss the other party would otherwise suffer due to the early terminations and is paid any gain that would result from the early terminations.

Payments in respect of these early terminated Non-Fully Delivered Transactions and DFT Terms Agreements are effected pursuant to §2(e) of the *Tahawwut* Master Agreement, the *wa'ad* each party makes to enter into a *musawama*. At the outset of the transaction, the parties agree upon an asset type and the quantity of such asset, which they set forth in the Schedule to the *Tahawwut* Master Agreement. Pursuant to such §2(e), each party agrees to purchase the specified quantity of the specified asset from the other party at a price equal to the cost of the asset plus the absolute value of the Relevant Index value (plus taxes and other transfer costs).

⁴² *Tahawwut* Master Agreement, at 29.

Thus, if the Relevant Index value is positive, the calculating party has the right to sell the specified asset in the specified quantity to the non-calculating party at a price equal to the cost of the asset plus the positive Relevant Index amount. Conversely, if the Relevant Index value is negative, then the non-calculating party (often the defaulting or affected party) has the right to sell the specified asset in the specified quantity to the calculating party at a price equal to cost plus the absolute value of the Relevant Index.

Now, the foregoing presumes that the party owing payment will comply with its obligation to enter into a *musawama* under §2(e) of the *Tahawwut* Master Agreement. In the event a party refuses to comply with its §2(e) *wa'ad*, then the party seeking to exercise its “put” is entitled to liquidated damages equal to the value of the Relevant Index and is discharged from its obligation to deliver the designated assets.⁴³

It is not clear, however, how §6(f)(v)(2), which specifies the penalty for failing to abide by the §2(e) *wa'ad*, could be enforced. Given that the obligation set forth in §2(e) is merely a non-binding *wa'ad* rather than an enforceable agreement, it may be difficult to enforce the liquidated damages right each party has for the other’s refusal to comply with its §2(e) *wa'ad*.

No Interest Payable

As previously noted, the payment of interest is prohibited by the *Shari`ah*. Consequently, the concept has been completely removed from the *Tahawwut* Master Agreement. Thus, delay of payment due to Illegality or Force Majeure Event (§6(e)(iv) of the 2002 Master Agreement), default of any payment or delivery obligation (§9(h)(i) and delay of payment of any Unpaid Amount or Early Termination Amount (§9(h)(ii)) will not entitle the other party to any payment of interest. These provisions and sections therefore were not included in the *Tahawwut* Master Agreement.⁴⁴

⁴³ See *Tahawwut* Master Agreement, §6(f)(v)(2).

⁴⁴ Under the *Shari`ah*, the non-defaulting party is permitted to recover actual damages resulting from the default, including all fees, costs and expenses (other than interest and consequential damages) incurred as a result of such default. Frequently, cost recovery provisions (often capped at a amount determined on the basis of a default rate) are included in the documentation. That was not the approach taken in the *Tahawwut* Master Agreement. In *Shari`ah*-compliant *murabaha* and *musawama* transactions, obligations to pay interest are sometimes permitted in the documentation as an inducement to timely performance (although the non-defaulting party must donate the interest to charity, rather than retaining any interest amount). That also was not the approach taken in the *Tahawwut* Master Agreement. See McMillen: *Murabaha*, *supra* note 23, and Usmani, *supra* note 26.

Miscellaneous Changes

Agency Contemplated

Section 3(g) of the 2002 Master Agreement expressly prevented parties from entering into the Transaction as an agent for another party, unless this representation was overridden in the related Schedule or Confirmation. New language in the same section of the *Tahawwut* Master Agreement appears to acknowledge that parties sometimes do elect to enter into agreements through an agent, clarifying that the obligations arising under the *Tahawwut* Master Agreement, and any Transactions and DFT Terms Agreements thereunder, are nonetheless obligations of the principal.

In conventional hedging transactions, the use of agents in ISDA transactions is commonplace and is effected through an override of §3(g) of the Master Agreement in the Schedule or Confirmation. The use of agents in *murabaha* transactions is widespread. The use of agencies is virtually universal in metals *murabaha* transactions, which are likely to constitute the bulk of the *murabaha* transactions under the *Tahawwut* Master Agreement.⁴⁵

Redesignation versus Transfer

In the case of a Tax Event, the 2002 Master Agreement allows the party “affected” by the Tax Event to transfer the transactions “affected” by the Tax Event to another one of its offices to avoid the tax effect. The *Tahawwut* Master Agreement instead allows the affected party to “redesignate” these affected transactions. Nonetheless, the effect of the language is the same as it was under the 2002 Master Agreement.

Transfer

In a footnote to §7 of the *Tahawwut* Master Agreement, ISDA reminds parties desiring to effect a permitted transfer of the *Tahawwut* Master Agreement or any obligation thereunder to establish that the transfer price is also *Shari`ah* compliant (*e.g.*, whether the transfer is required to be at par).⁴⁶ Parties are entitled to transfer their rights to any Early Termination Amount, purchase price or liquidation damages due to it by the other party by virtue of the early termination calculations, subject to the set-off provisions.

Arbitration

In contrast to the 2002 Master Agreement, the *Tahawwut* Master Agreement includes an arbitration provision that the parties may elect to apply in the Schedule. Nonetheless, in a footnote to §13(c), ISDA provides that the IIFM *Shari`ah* Advisory Panel had not considered

⁴⁵ See McMillen: Murabaha, *supra* note 23.

⁴⁶ See *Tahawwut* Master Agreement, §7.

whether the default arbitration rules, the Rules of Arbitration of the International Chamber of Commerce, are themselves compliant with the *Shari`ah*.⁴⁷

CONCLUSION

The use of derivatives products in Islamic finance is still in its infancy.⁴⁸ The disparate standards of Islamic derivatives advocated by various *madhhahib* have led to the employment of a wide variety of structures and documentation.⁴⁹ This lack of uniformity has hampered the frequent use of Islamic derivatives instruments, despite the industry's appetite for *Shari`ah*-compliant risk hedging tools. The lack of harmonization and coordination has also inhibited Islamic financial institutions from operating outside their domestic markets, where *Shari`ah* standards may be unfamiliar or inconsistent with that of their own markets.

The *Tahawwut* Master Agreement, which has been approved by some of the industry's most prominent and widely respected *Shari`ah* scholars, provides much needed standardization and opens the door to largely untapped markets and opportunities. Though it may take some time until Islamic banks are able to integrate ISDA's new framework into their own agreements and structures, the long-term advantages of standardization will provide banks with plenty of incentive to make the transition.⁵⁰

⁴⁷ See *Tahawwut* Master Agreement, §13(c).

⁴⁸ *Derivatives: "In need of robust architecture"*, Robin Wigglesworth, *Financial Times*, May 12, 2010 ("Wigglesworth").

⁴⁹ Wigglesworth, *supra* note 48.

⁵⁰ Wigglesworth, *supra* note 48, at 2.