



STRUCTURE MEMORANDUM

IIFM-BAFT MASTER UNFUNDED & FUNDED PARTICIPATION AGREEMENTS FOR TRADE FINANCE TRANSACTIONS

مذكرة هيكل
اتفاقية مشاركة رئيسة مُمولة و غير مُمولة لمعاملات التمويل التجاري

This Structure Memorandum is designed primarily to give an indication of some of the key concepts that are intended to apply in respect of the proposed Shari'ah compliant unfunded and funded trade finance transaction structures. It is not designed to describe all of the features of an unfunded or funded transaction or all aspects of the participation agreements.

This Structure Memorandum has been approved by IIFM Shari'ah Board on 25 October 2018.

بِسْمِ اللَّهِ الرَّحْمَنِ الرَّحِيمِ

In the name of Allah, the Most Gracious, the Most Merciful

الحمد لله ، و الصلاة والسلام على نبينا محمدٍ وعلى آله وصحبه أجمعين.

All perfect praises are due to Allah Almighty, the Lord of all that exist. We praise and thank Him for His help and guidance. May peace and blessings of Allah Almighty be upon the Prophet Muhammad the son of 'Abdullah, his family and his companions.

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1. GENERAL *SHARI'AH* RULINGS ON PARTICIPATION ARRANGEMENT

As per the principles and rules of *Shari'ah*, it is allowed for two or more parties to participate in any *Shari'ah* compliant obligation through a *Shari'ah* compliant mechanism. Therefore, it is permissible for an Islamic bank to share part of its risk exposure under an unfunded or funded risk participation arrangement with one or more Islamic or conventional banks.

A risk participation agreement is however different from an assignment or transfer by a party of its rights or obligations under an agreement.

Subject to compliance with the principles and rules of *Shari'ah* and in a remote possibility, a party may assign or transfer its rights or obligations under a risk participation agreement.

2. PURPOSE AND OBJECTIVE OF IIFM-BAFT MASTER PARTICIPATION AGREEMENTS

The International Islamic Financial Market ("**IIFM**") and the Bankers Association for Finance and Trade ("**BAFT**") have jointly developed the IIFM-BAFT master unfunded participation agreement for trade finance transactions (the "**IIFM-BAFT Master Unfunded Participation Agreement**") and the IIFM-BAFT master funded participation agreement for trade finance transactions (the "**IIFM-BAFT Master Funded Participation Agreement**") to facilitate *Shari'ah* compliant unfunded and funded participation transactions between financial institutions. IIFM and BAFT encourage the use of each of the IIFM-BAFT Master Unfunded Participation Agreement and the IIFM-BAFT Master Funded Participation Agreement by all industry stakeholders and interested parties and its use shall not be restricted to their members only.

Unless separately defined herein or the context requires otherwise, all capitalised terms used and not otherwise defined herein shall have the respective meanings given to them in the IIFM-BAFT Master Unfunded Participation Agreement or the IIFM-BAFT Master Funded Participation Agreement as the context may require.

3. OVERVIEW OF THE STRUCTURE MEMORANDUM - GENERAL DESCRIPTION

This structure memorandum details the two proposed structures for the development of a master agreement for a *Shari'ah* compliant trade financing transaction namely unfunded and funded participation transactions. The two structures that will be examined in further detail are as follows:

(a) IIFM-BAFT Master Unfunded Participation Agreement

The Grantor acts as an agent (*wakil*) of the Participant in accordance with the terms of the IIFM-BAFT Master Unfunded Participation Agreement as well as a guarantor (*kafil*) to the Obligor (on a *kafalah* basis).

(b) IIFM-BAFT Master Funded Participation Agreement

The Grantor acts as an agent (*wakil*) of the Participant in accordance with the terms of the IIFM-BAFT Master Funded Participation Agreement.

Each structure will be considered from a practical application perspective in accordance with the principles and rules of *Shari'ah* as well as the role of the parties involved and the documentation that will be required.

4. STRUCTURE I: IIFM-BAFT MASTER UNFUNDED PARTICIPATION AGREEMENT

4.1 Parties

Grantor & Participant:

The parties may wish, from time to time, to enter into trade participation transactions on an unfunded basis in accordance with agency (*Wakalah*) arrangement. The agency agreement must be signed before issuance of any letter of credit ("LC") or letter of guarantee ("LG") or alike to allow risk participation in a *Shari'ah* compliant manner. This will also facilitate sharing the participation fee (if any), which the Obligor will pay to the Grantor, in a *Shari'ah* compliant manner between the Grantor and the Participant.

If one party offers to the other party a participation on an unfunded basis in accordance with clause 3.1 (*Offer*) of the IIFM-BAFT Master Unfunded Participation Agreement and the other party accepts such offer in accordance with clause 3.2 (*Acceptance*) of the IIFM-BAFT Master Unfunded Participation Agreement, the provisions of the IIFM-BAFT Master Unfunded Participation Agreement shall apply to such participation (an "**Unfunded Participation**").

The party offering the Unfunded Participation will be called the "Grantor" and the Party taking such Unfunded Participation will be called the "Participant". By accepting to participate in an Unfunded Participation, the Participant will play the role of a third party guarantor (*kafil*) to the Obligor as well.

The Agent:

In relation to an Unfunded Participation under the IIFM-BAFT Master Unfunded Participation Agreement, the Grantor will be appointed as an agent by the Participant.

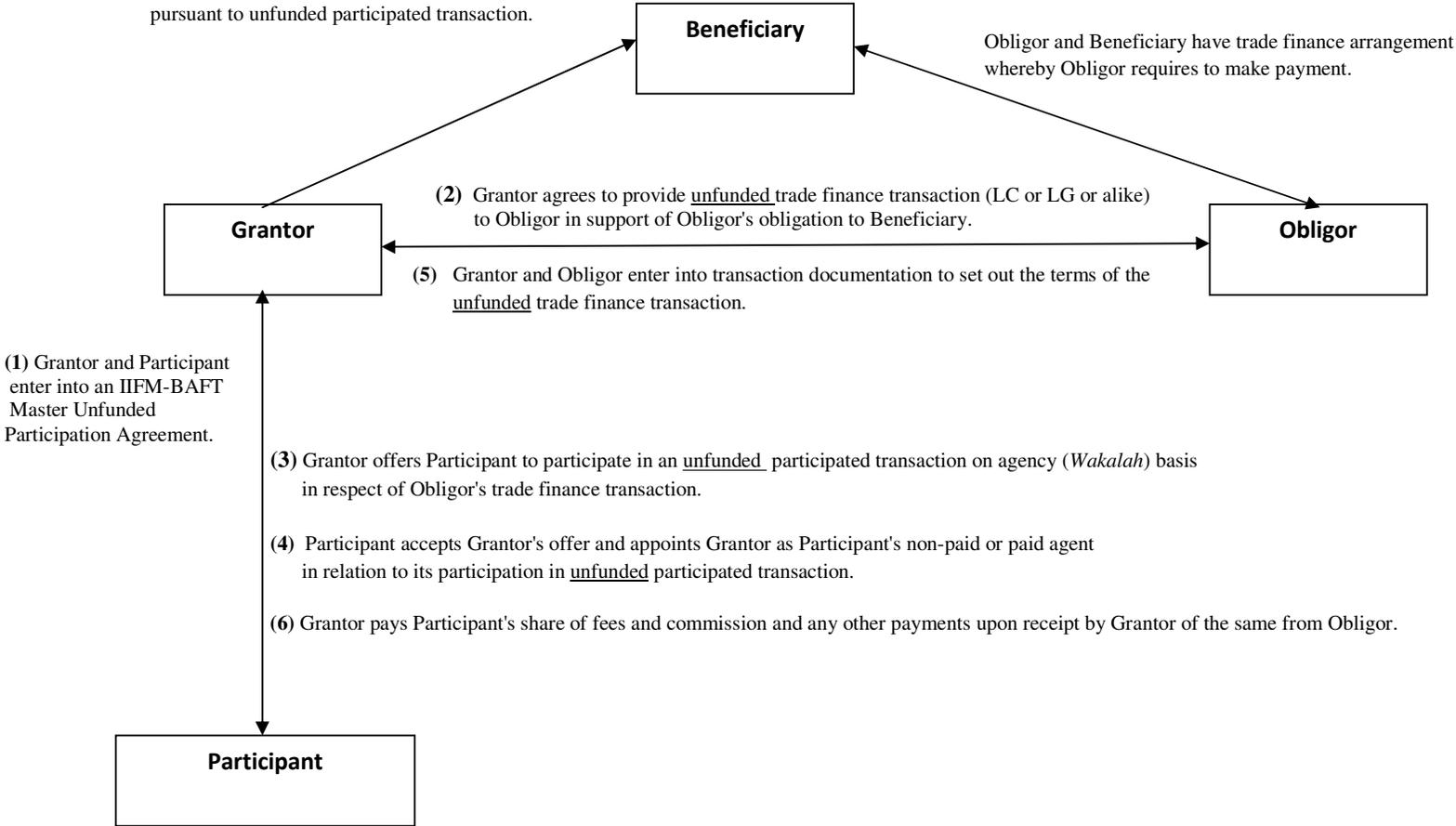
Since LC or LG or alike is to be issued only in the name of the Grantor, the Grantor shall sign an agency agreement with the Participant (and any other participating bank(s), if any) whereby the Participant (and the other participating bank(s)) will also appoint the Grantor as its (or their collective) agent to issue LC or LG or alike in the name of the Grantor. In this case, LC or LG or alike shall be issued by the Grantor on its own behalf for its own share in LC or LG or alike and on behalf of the Participant (and any other participating bank(s), if any) as an agent for its (or their respective) share in LC or LG or alike.

A form of agency agreement is appended as an Appendix to the IIFM-BAFT Master Unfunded

Participation Agreement (for *Shari'ah* reasoning, the form of agency agreement is not part of the IIFM-BAFT Master Unfunded Participation Agreement but only for the information/reference purpose). Before entering into an agency agreement, the parties (i.e., the Grantor and the Participant) should consider whether the underlying principal-agent relationship between the Grantor (as agent) and the Participant (as principal) would raise any issues related to the applicable local laws and/or the compliance with their respective risks, operational or administrative requirements.

4.2 **Unfunded Participation Structural Diagram**

Note: **In case of Obligor's default:**
Payment is due to Beneficiary on due date pursuant to unfunded participated transaction.



4.3 **Unfunded Participation Structural Diagram Explanation**

- (a) The Grantor and the Participant enter into the IIFM-BAFT Master Unfunded Participation Agreement.
- (b) The Grantor agrees to provide certain unfunded trade finance transactions by issuing LC or LG or alike to the Obligor in support of the Obligor's obligation to the Beneficiary.
- (c) The Grantor sends an offer in a designated form provided under the IIFM-BAFT Master Unfunded Participation Agreement to the Participant inviting to participate in an unfunded participated transaction in respect of the Obligor's trade finance transactions.
- (d) The Participant accepts the Grantor's offer and sends its acceptance in a designated form provided under the IIFM-BAFT Master Unfunded Participation Agreement to the Grantor and the Participant appoints the Grantor as its non-paid or paid agent in relation to its participation in the unfunded participated transaction.
- (e) Accordingly, subsequent to the signing of a risk participation agreement between the Grantor and the Participant, the Grantor and the Obligor will enter into transaction documentation to set out the terms of the agreed unfunded trade finance transactions by issuing LC or LG or alike.

4.4 **Note on *Shari'ah* Compliant Unfunded Participation Transaction**

- (a) In the event of the Obligor's default
 - (i) ***Kafalah* basis:** In the case that the Obligor fails to pay the due amount to the Beneficiary on the due date pursuant to the Obligor's trade finance transactions with the Grantor, which are the subject matter of an unfunded participated transaction between the Grantor and the Participant, upon the Grantor's demand for payment from the Participant, the Participant as guarantor (*kafil*) to the Obligor shall pay its participation proportion of the unfunded participated transaction.

In other words, if the Grantor issues a guarantee to the Beneficiary at the request of the Obligor either in the form of a LC or a LG, and if such guarantee is called by the Beneficiary in accordance with the terms set out therein, then it shall be mandatory on the Grantor to pay the guarantee amount covered by the guarantee to the Beneficiary.

- (ii) Generally, guarantees issued by the Grantor at the request of the Obligor provide the Grantor with the ability to have a right of recourse against the Obligor in the event of such guarantee being called by the Beneficiary. Such a right of recourse creates a debt relationship between the Grantor and the Obligor, whereby the Obligor is considered to be under a debt obligation for the guarantee amount to the Grantor.
- (iii) From a *Shari'ah* perspective, it is not allowed for the Grantor to charge the Obligor any extra amount for allowing additional time to pay the guarantee amount. Such prohibition is because the extra amount is in the nature of interest, which is strictly prohibited in *Shari'ah*.
- (iv) As per the principles and rules of *Shari'ah*, the Grantor cannot convert an unfunded facility such as a guarantee into a funded facility, since the same is

tantamount to extending an interest-bearing loan. It is however possible to structure a *Shari'ah* compliant solution between the Grantor (who is also acting on behalf of the Participant) and the Obligor whereby the Grantor can provide the Obligor with a separate *Shari'ah* compliant contingent financing facility such as *Murabahah*, *Salam* etc., with which the Obligor will be able to generate cash proceeds and will be able to settle its liability under guarantee. The liability created on the Obligor under such a facility shall be standalone and shall be paid by the Obligor as per an agreed payment plan.

- (v) It is not permissible in *Shari'ah* to combine agency and personal guarantees in one contract at the same time (i.e. the same party acting in the capacity of an agent on one hand and acting as a guarantor on the other hand), because such a combination conflicts with the nature of these contracts. But if a guarantee is not stipulated in the agency contract and the agent voluntarily provides a guarantee to its clients independently of the agency contract, the agent becomes a guarantor in a different capacity from that of agent. In this case, such an agent will remain liable as guarantor even if it is discharged from acting as agent.
- (vi) Personal guarantees are divided into two types. One type is a guarantee where the guarantor has a right of recourse to the debtor, and this guarantee is offered at the request or with the consent of the debtor. The other type is a non-recourse guarantee, which is offered voluntarily by a third party without the debtor's request or consent (voluntary guarantee).
- (vii) An institution is not entitled to guarantee financial commitments without a right of recourse to the debtor, i.e. to be a non-recourse guarantor, unless the institution is already authorized by its shareholders and investors to make donations or to perform acts of benevolence.
- (viii) It is permissible to subscribe to an Islamic insurance coverage as security for debt obligations but it is not permissible that debts are insured on a conventional insurance basis.

(b) **Fees and commissions**

- (i) Following the Participant's acceptance of the Grantor's offer, the Participant receives its pro rata share of fees, commissions and principal amount (if the Obligor defaulted and the Participant paid its pro rata share of the participated transaction upon the Grantor's demand for payment) on the relevant due date in relation to the unfunded participated transaction.
- (ii) It is also permissible for the institution to charge a fee for providing the required services, whether such a fee is in the form of a lump sum or a certain percentage of the transaction amount, provided that the duration of the transaction is not considered in determining such fees. This rule applies to services rendered for both import and export credit, except where the amendment involves a rescheduling for the institution to charge only the actual expenses incurred, in which case it will be a definite sum and not a percentage.
- (iii) The fees payable to the Participant shall be solely for the direct or indirect services provided by the Participant including, but not limited to, an assessment of the transaction, assessment of the counterparties, verification of documentation and preparation or issuance of any documents, reports or feasibility studies by the Participant related to or in connection with the

Obligors and/or the participated transaction and the parties involved in the participated transaction. All fees must commensurate with real operative market rates and any fees not deemed to be *Shari'ah* compliant (as determined by the Shari'ah board/adviser of the Participant) will not be payable to the Participant.

- (iv) All commissions and fees payable by the Grantor to the Participant will be generated from the participated transaction.

4.5 Documentation:

- (a) The IIFM-BAFT Master Unfunded Participation Agreement will be entered into between the Grantor and the Participant. The IIFM-BAFT Master Unfunded Participation Agreement is a master agreement which provides a framework for entering into an unfunded participation transaction between the Grantor and the Participant and includes clauses dealing with covenants, representations and warranties, events of default, governing law, jurisdiction and other boilerplate clauses which the Grantor and the Participant need to mutually agree between them. IIFM recommends that clauses dealing with "no violation of *Shari'ah*" and "waiver of payment of interest" in the IIFM-BAFT Master Unfunded Participation Agreement should not be altered.
- (b) Since an unfunded participation transaction between the Grantor and the Participant will be in accordance with *Wakalah* (agency) arrangement, the Grantor and the Participant will be required to enter into an agency agreement substantially in the form provided as an Appendix (*Form of Agency Agreement*) to the IIFM-BAFT Master Unfunded Participation Agreement. (For *Shari'ah* reasoning, the form of agency agreement is not part of the IIFM-BAFT Master Unfunded Participation Agreement but only for the information/reference purpose).

5. STRUCTURE II: IIFM-BAFT MASTER FUNDED PARTICIPATION AGREEMENT

5.1 Parties

Grantor & Participant:

The Parties may wish, from time to time, to enter into trade participation transactions on a funded basis in accordance with agency (*Wakalah*) arrangement.

In order to make a risk participation transaction *Shari'ah* compliant, an agency agreement must be signed between the Grantor and the Participant before the Grantor's entry into the underlying transaction with the Obligor. This will also facilitate sharing any up-front fee which the Obligor may pay to the Grantor in a *Shari'ah* compliant manner between the Grantor and the Participant.

It is not allowed for an Islamic bank to sell its obligation under this arrangement to any bank, Islamic or conventional, after such obligation has been established. This means that risk participation agreement must be signed between the Grantor and the Participant prior to a

participation arrangement. This includes the Participant entering into a sub-participation arrangement with a third party.

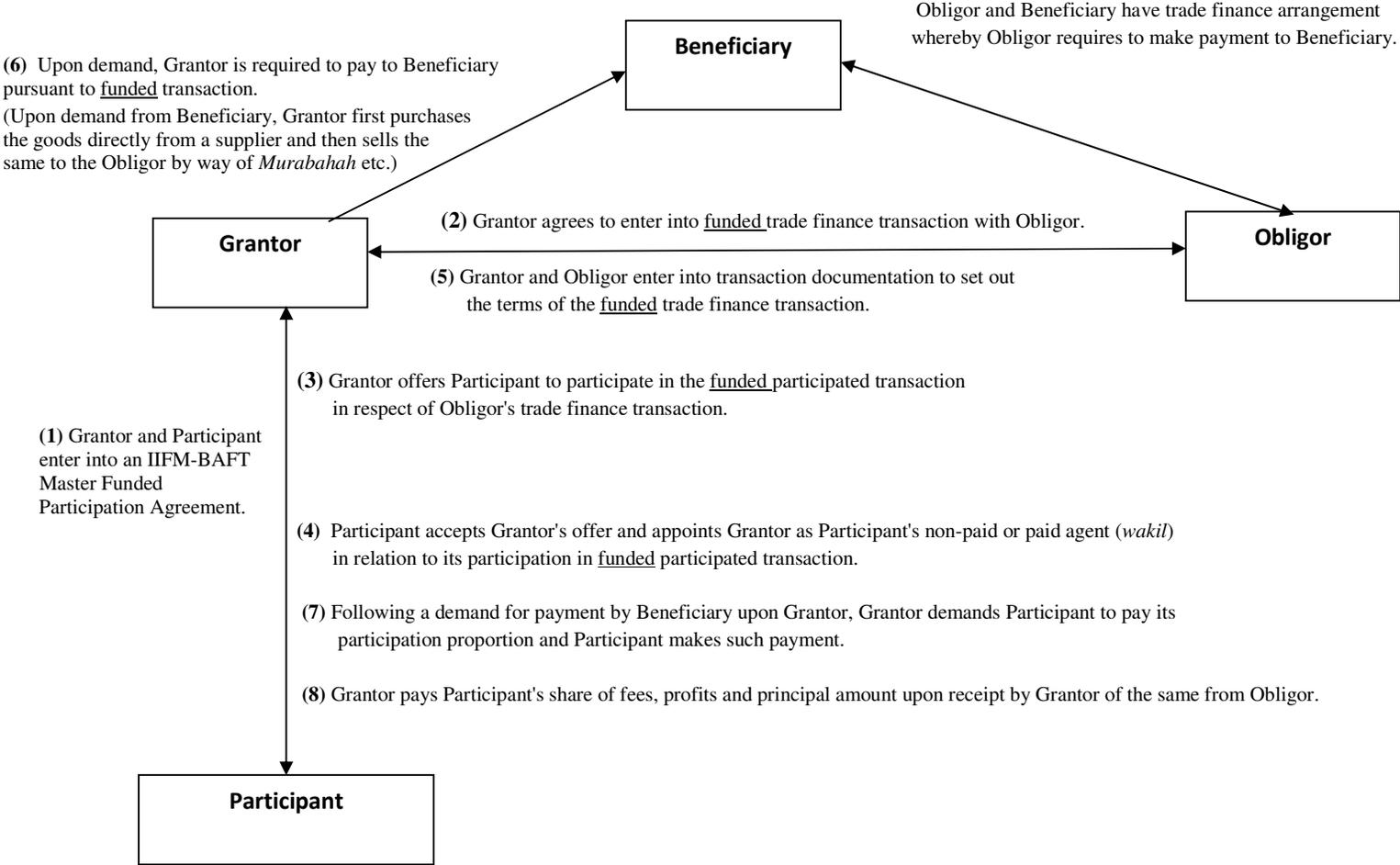
If one party offers to the other party a participation on a funded basis in accordance with clause 4.1 (Offer) of the IIFM-BAFT Master Funded Participation Agreement and the other party accepts such offer in accordance with clause 4.2 (Acceptance) of the IIFM-BAFT Master Funded Participation Agreement, the provisions of the IIFM-BAFT Master Funded Participation Agreement will apply to such participation (a "Funded Participation").

The party offering a Funded Participation will be called the "Grantor" and the party taking the Funded Participation will be called the "Participant".

The Agent:

In relation to a IIFM-BAFT Master Funded Participation Agreement, the Grantor will be appointed as agent (*wakil*) by the Participant. A form of agency agreement is appended as an Appendix to the IIFM-BAFT Master Funded Participation Agreement (For *Shari'ah* reasoning, the form of agency agreement is not part of the IIFM-BAFT Master Funded Participation Agreement but only for the information/reference purpose). Before entering into an agency agreement, the parties (i.e., the Grantor and the Participant) should consider whether the underlying principal-agent relationship between the Grantor (as agent) and the Participant (as principal) would raise any issues related to the applicable local laws and/or the compliance with their respective risks, operational or administrative requirements.

5.2 Funded Participation Structural Diagram



5.3 Funded Participation Structural Diagram Explanation

- (a) The Grantor and the Participant enter into an IIFM-BAFT Master Funded Participation Agreement.
- (b) The Grantor agrees to enter into certain funded trade finance transactions with the Obligor. Accordingly, the Grantor and the Obligor enter into transaction documentation to set out the terms of the agreed funded trade finance transactions.
- (c) Prior to signing the transaction documentation between the Grantor and the Obligor, the Grantor will send an offer in a designated form to the Participant inviting it to participate in funded participation in relation to certain trade finance transactions which are to be entered into between the Grantor and the Obligor in compliance with the principles of *Shari'ah* including on the basis of any one or more of the following modes of Islamic financing: *Murabahah*, *Musharakah*, *Mudarabah*, *Salam*, *Ijarah*, etc.
- (d) The Participant may accept the Grantor's offer and sends its acceptance in a designated form to the Grantor and appoints the Grantor as its non-paid or paid agent (*wakil*) in relation to its participation in the funded participated transactions.
- (e) The Grantor (on its own behalf and on behalf of the Participant) and the Obligor will enter into transaction documentation to set out the terms of the agreed funded trade finance transactions.
- (f) Upon demand for payment by the Beneficiary, the Grantor is required to pay to the Beneficiary pursuant to the funded participated transactions.
- (g) Following demand for payment by the Beneficiary, the Grantor demands that the Participant pays its participation proportion of the participated transaction to the Grantor and the Participant makes such payment.
- (h) The Obligor pays the Grantor under the terms of the transaction documentation and the Grantor passes the Participant its share of such monies received on a pro rata basis.

5.4 Note on *Shari'ah* Compliant Funded Participation Transaction

- (a) Import trade is generally financed through a *Murabahah* structure whereby the Islamic bank, based on a facility request and promise to purchase from the customer, purchases the goods from the supplier and subsequently sells the same to the customer with a sale price which comprises of procurement cost plus pre-agreed profit.
- (b) In other words, the standard *Shari'ah* practice for financing the goods through *Murabahah* is that the bank first purchases the goods directly from a supplier, which is evidenced by commercial invoice issued by the supplier in the name of the bank (or its agent), and then sells the same to the customer by way of *Murabahah*.
- (c) The fees payable to the Participant shall be solely for services rendered by the Participant to the Grantor including conducting any feasibility study, preparing any reports and examining any relevant documents related to the participated transaction.
- (d) All commissions and fees payable by the Grantor to the Participant will be generated from the participated transaction.

- (e) Profits (if any) due to the Participant will arise from the participated transaction.

5.5 Documentation:

- (a) The IIFM-BAFT Master Funded Participation Agreement will be entered into between the Grantor and the Participant. The IIFM-BAFT Master Funded Participation Agreement is a master agreement which provides a framework for entering into a funded participation transaction between the Grantor and the Participant and includes clauses dealing with covenants, representations and warranties, events of default, governing law, jurisdiction and other boilerplate clauses which the Grantor and the Participant need to mutually agree between them. IIFM recommends that clauses dealing with "no violation of *Shari'ah*" and "waiver of payment of interest" in the IIFM-BAFT Master Funded Participation Agreement should not be altered.
- (b) Since a funded participation transaction between the Grantor and the Participant will be in accordance with *Wakalah* (agency) arrangement, the Grantor and the Participant will be required to enter into an agency agreement substantially in the form provided as an Appendix (*Form of Agency Agreement*) to the IIFM-BAFT Master Funded Participation Agreement. (For *Shari'ah* reasoning, the form of agency agreement is not part of the IIFM-BAFT Master Funded Participation Agreement but only for the information/reference purpose).