What is International Islamic Financial Market (IIFM) ?

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IIFM is the international Islamic financial market's organization focused on the Islamic Capital & Money Market segment of the Islamic finance industry. Its primary focus lies in the standardization of Islamic financial products, documentation and related processes at the global level.

IIFM was founded with the collective efforts of the Central Bank of Bahrain, Bank Indonesia, Central Bank of Sudan, Labuan Financial Services Authority (Malaysia), Autoriti Monetari Brunei Darussalam and the Islamic Development Bank (a multilateral institution based in Saudi Arabia).

Besides the founding members, IIFM is supported by its permanent member State Bank of Pakistan and further supported by a number of regional and international financial institutions as well as other market participants as its members.

The main strength of IIFM is pooling of expertise from banks, legal and other market participants who work together under the guidance of *Shari'ah* scholars

What IIFM provides to the Industry?

- Addressing the standardization needs of the industry & creating awareness
- Universal platform to market participants through 'Global Working Groups' for the development of Islamic Capital and Money Market
- *Shari'ah* harmonization in documentation, products and processes

What's Wakalah (Agency) Contract ?

- Wakalah as defined by AAOIFI:

  Is the act of one party delegating the other to act on its behalf in what can be subject matter of delegation.

- Types of Wakalah (Agency) Contracts

  There are two types of Wakalah contracts namely:

  I. Restricted
  II. Unrestricted

In this presentation I will focus only on inter-bank Unrestricted Walakah Arrangements as IIFM is working on a documentation standard on this

Issues in Inter-Bank Unrestricted *Wakalah*

A. Legal Challenges

- When restructuring the classical *Wakalah* arrangement, the challenge is therefore to transform the risk of *Wakalah* to rank *pari passu* with a normal senior unsecured obligation of the deposit-taking institution while retaining the key *Shari'ah* feature of no explicit capital guarantee. This could be achieved in my view as follows:

I. *Undertakings by the deposit-taking institution relating to the basis on which funds are received and will be dealt with, including early termination if at any time the deposit-taking institution believes that the expected maturity proceeds may be lower than that indicated to the client, i.e. the Wakalah becomes immediately repayable (placement amount plus accrued profit) if the there is reduction in the credit quality of one or more assets in Wakalah portfolio or if returns are too low to meet the target profit rate*

II. *Compensation to the client for any loss he may suffer due to the deposit-taking institution's failure to comply with the terms of the agreement, including circumstance where it negligently fails to adhere to (i) above.*

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B1. Operations/Risk Management Framework

- It is essential that a comprehensive operational risk process is put in place for on-balance sheet unrestricted *Wakalah* for Islamic inter-bank market

- The deposit taking institution should implement robust front and middle office systems to monitor compliance with the legal structure and to achieve internal objectives of not having to repay the deposit early thereby adverse impact on liquidity

- Longer term assets in general produce a higher absolute return than short term assets. At the outset it is imperative that the deposit taking institution formally confirm and record amongst others the following policy decisions through its relevant sanctioning authorities:

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Issues in Inter-Bank Unrestricted *Wakalah*

B2. Operations/Risk Management Framework (continued)

- Mandate and delegate authorities to a designated individuals and committees, e.g. the Treasurer and Asset & Liability Management Committee (ALCO) to monitor the portfolio daily (Treasurer) and weekly (ALCO) and consider the constituent components (assets and liabilities) of the *Wakalah* portfolio

- Include new assets entered into, for example day's Commodity *Murabahah* and *Wakalah* money market transactions

- Exclude any transactions (assets) where repayment is doubtful or likely to become doubtful. Advisable to agree mark to market thresholds on assets as indicators/guidelines

Issues in Inter-Bank Unrestricted *Wakalah*

B3. Operations/Risk Management Framework (continued)

- Constant monitoring to the portfolio for any material deterioration in asset quality is essential and required in this process. These deterioration assets may be excluded from the portfolio before losses are sustained; however, this is subject to further deliberation
- In my view these are the key issues/elements of the Unrestricted Walakah which need to be elaborated by the market participants as well as Shariah Scholars

Issues in Inter-Bank Unrestricted *Wakalah*

C. Indicative Rate of Return & Guarantee on Return

"If the *Wakil* (Agent) makes a profit by the maturity date, the profits belong to the *Muwakkil* (Investor), and the *Wakil* is entitled for *Wakalah* fee in <u>pre-agreed amount or pre-agreed percentage of asset under management</u>. Conversely, if a loss is made this loss <u>is borne</u> by the *Muwakkil* in the absence of gross negligence, fraud or willful default by the *Wakil*"

In a normal market, feasibility reports may be relied on by the *Muwakkil* in order to decide whether to invest with the *Wakil* or not, however where the market is volatile relying on such reports may be a problem. Where the economy is witnessing a downturn, <u>it becomes difficult to rely on predicted rate of return; hence, a methodology based on operational process mentioned earlier could be incorporated to overcome this issue.</u>

Issues in Inter-Bank Unrestricted *Wakalah*

D. Other related Issues

A. **Capacity Risk**

The issue of guaranteeing a minimum return on the *Muwakkil*'s investment raises further questions in relation to the capacity of the *Wakil* to give such guarantees and whether or not the *Wakil* can renounce his obligations under the *Wakalah* agreement on the basis of lack of capacity

As per our research most of the institutions are now including the capacity risk clause as a standard clause in their master agreement

B. **Mixing of Funds Versus Insolvency**

Based on general market practice, when a *Muwakkil* invests money with the *Wakil* under a *Wakalah*, such money is usually mixed with the *Wakil*'s own pool of funds. In the event that the *Wakil* becomes insolvent, the *Muwakkil*'s money will be mixed with the *Wakil*'s other money and may well be treated by the liquidator in certain jurisdiction’s law governed insolvency as part of the *Wakil*'s liquidation assets. For this reason, in some jurisdictions, where there is an absent insolvency remote trust laws, investors are advised to consider this risk when investing their funds under a *Wakalah* agreement. Due to this reason it is recommended that a reference pool of assets is created and should be managed as per the proposed *Wakalah* operational process.

Issues in Inter-Bank Unrestricted *Wakalah*

Other related Issues (continued)

C. **Honoring Indicative Versus Low Portfolio Return**

A policy of honoring an indicated profit rate, in the event the portfolio return is lower than the indicated profit rate or certain assets from the reference pool need to be taken out due to not meeting the criteria under the operational process, may have *Shari'ah*, legal, accounting treatment and shareholders implications and these need to be addressed.

On the other hand the requirement of taking *Shari'ah* approval on each instance will become cumbersome and if in principle an Islamic bank's *Shari'ah* board allows then it does not need to approve individual transactions.

All the above issues need to be tackled by the stakeholders

Issues in Inter-Bank Unrestricted *Wakalah*

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Important things to be studied & considered

a) Issues related to central bank regulations, accounting treatment, capital allocation need to be studied extensively

b) Transfer of risk from fund placing institution back to fund taking institution and its impact to shareholders equity is a critical factor to be addressed in light of *Shari'ah* and also its legal implications

c) The possibility of funds taking entity to be able to disclose the asset pool, if required, to the *Muwakkil* in order to address the issue of transparency in most of the *Wakalah* arrangement

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Shukaran

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