

ISLAMIC UNFUNDED RISK PARTICIPATION

An insight to Unfunded Risk Participation complying the Sharia'h Principal

What is Risk Participation Arrangement in Trade Finance

Risk Participation arrangement in trade finance refers to a financial arrangement, where a financial institution shares the risk associated with a trade finance transaction with another party, typically another financial institution, bank or investor. It is a mechanism used to mitigate the potential risks involved in international trade transactions and enhance liquidity in the market.

There are various risks involved in trade finance transactions, such as credit risk, country risk, currency risk, political risk, etc. By participating in the risk, the financial institution mitigates its exposure to these risks and diversifies its portfolio. This allows them to take on larger trade finance transactions and support more businesses in their international trade activities.

Risk participation is common in international trade transactions, especially those involving significant amounts of money or higher-risk countries. It enables banks to leverage their expertise and collaborate to support global trade by spreading the risk and facilitating the movement of goods and services across borders.

Overall, risk participation in trade finance facilitates the sharing of risk between multiple parties, enabling financial institutions to manage their risk exposure and provide greater support to businesses engaged in international trade.

The risk participation can take different forms, depending on the agreement between the lead bank and the participating banks. The participating banks may acquire a portion of the trade finance facility, meaning they would share in the repayment obligations and **potential defaults**. Alternatively, they may enter into a risk-sharing agreement where they agree to undertake a percentage of the risk associated with the trade transaction without directly acquiring any part of the facility.

HERE'S HOW RISK PARTICIPATION WORKS:

1. **Primary Bank:** The primary bank is the institution that initially originates the trade finance transaction and carries the primary risk associated with it. This bank may not have the capacity or desire to hold the entire risk on its own **Risk Sharing:** To reduce its exposure, the primary bank may enter into a risk participation agreement with one or more other banks or investors. These participants agree to share a portion of the risk and potential losses associated with the trade finance transaction.
2. **Risk Sharing Agreement:** The risk sharing agreement (or the Master Risk Participation Agreement) outlines the terms and conditions of the participation, including the percentage of risk to be shared, the sharing of profits or losses, and any other relevant details. The agreement may also specify the obligations and responsibilities of each party involved.
3. **Risk Allocation:** Through risk participation, the primary bank transfers a portion of the risk to the participating banks or investors. The extent of risk sharing can vary depending on the agreement, with participants taking on a percentage of the total risk involved.
4. **Benefits:** Risk participation allows the primary bank to free up capital and manage its risk exposure more effectively. It helps to enhance liquidity in the market and supports larger trade finance transactions. Additionally, risk participation can provide an opportunity for participating banks or investors to diversify their portfolios and earn potential profits from the transaction.

Shariah compliant Risk Participation Arrangements:

Shari'ah, or Islamic law, provides guidance on various aspects of life, including financial matters and business transactions. When it comes to participation arrangements, which generally refer to joint ventures or partnerships, Shari'ah principles play a significant role in determining the permissibility and requirements of such arrangements.

Islamic Unfunded Risk Participation:

A Shari'ah compatible mechanism may be used by two or more parties to participate in any Shari'ah compliant obligation, according to the principles and laws of Shari'ah. As a result, it is acceptable for an Islamic bank to collaborate with one or more conventional or Islamic banks under an unfunded (or funded risk participation arrangement) to share a portion of its risk exposure, provided that such risk

participation, be it funded or non-funded, is based on Sharia compliant structure and under Sharia compliant agreements.

PARTIES IN ISLAMIC UNFUNDED RISK PARTICIPATION:

The Party offering the Participation shall be called the "**Grantor**"

The Party taking the Participation shall be called the "**Participant**".

"Beneficiary" means the person entitled to payment from the Grantor under a Participated Transaction;

"Recourse Party/Primary Party or Obligor" means the persons to whom the Grantor has recourse in respect of a Participated Transaction, as specified in the relevant Offer.

"Default" means:

Any non-receipt of monies due to the Grantor by the Recourse Parties on the Due Date under a Participated Transaction.

"Defaulted Amount" means:

A sum, due to the Grantor by the Recourse Parties under a Participated Transaction which has not been received by the Grantor.

TYPES OF TRANSACTIONS:

Each Party may from time to time desire to offer and the other Party to this Agreement may desire to accept and adopt Unfunded Participations and/or Funded Participations in the following Transactions:

- a. Letters of credit issued or confirmed by the Grantor, drafts accepted and deferred payment or negotiation obligations incurred by the Grantor under letters of credit;
- b. Confirmations or guarantees of letters of credit given at the request of the Beneficiary (Silent Confirmation);
- c. Refinancing of sight payments under letters of credit made by the Grantor;
- d. Financing of drafts accepted and deferred payment or negotiation obligations under letters of credit or under banker's acceptances made by the Grantor;
- e. Bankers acceptances created by the Grantor;

- f. Bills of exchange and promissory notes purchased, avalised or accepted by the Grantor;
- g. Irrevocable reimbursement undertakings, letters of indemnity, guarantees or similar instruments issued by the Grantor;
- h. Letters of Guarantees issued by the Grantor;
- i. Any other Sharia Compliant transaction the Grantor and the Participant may agree upon.

Subject of Fatwa: Risk Participation under LGs and LCs

QUERY

An Islamic bank's customer has recently been awarded facilities in relation to a large developmental project the customer has won in a tender. The facilities include letters of credit (LCs) and letters of guarantee (LGs). In view of the large size of the bank's liability under the LCs and LGs, the bank's management is now considering to share up to 50% of the risk exposure under such LCs and LGs with other banks. As per initial input, several Islamic and conventional banks in the market would be willing to contribute for such risk participation. Can an Islamic bank share part of its risk under LCs and LGs with other Islamic banks as well as conventional banks? It is to be noted that the Islamic bank would like to issue the LCs and LGs in its own name.

PRONOUNCEMENT

It is allowed in Sharia for two or more parties to jointly guarantee any Sharia compliant obligation through a Sharia compliant mechanism. Therefore, it is permissible for an Islamic bank to share part of its risk exposure under an LC or LG with conventional or Islamic banks, taking into consideration the following:

- a) It is not allowed for an Islamic bank to sell its obligation under an LC or LG to any bank, Islamic or conventional, after such obligation has been established pursuant to the issuance of an LC or LG. This means that risk participation agreement must be signed between the issuer of the LC or LG and the participating banks prior to issuance of the same.
- b) Since the LC is to be issued only in the name of Islamic bank, the Islamic bank shall sign an agency agreement with other participating banks whereby the other banks will appoint the Islamic bank as their collective agent to issue the LC or LG in its name under the facility. In this case, the LC or LG shall be issued by the Islamic bank on its own behalf for its own share in the LC or LG and on behalf of the other participating banks as an agent for their respective share in the LC or LG.
- c) The aforementioned agency agreement must be signed before issuance of any LC or LG to allow risk participation in a Sharia compliant manner. This will also facilitate sharing the administrative fee the customer shall pay to the Islamic bank in a Sharia compliant manner.

d) Risk participation agreement must not create any Sharia repugnant obligation on any party, such as entitlement of penalty interest in case of delay by the customer in funding any claim under LG or LC.

e) Each bank in such participation arrangement must adhere to the rulings that govern the handling of guarantee in Sharia.

It is also to be noted that the above guidance only applies to the risk participation of an Islamic transaction where conventional banks can have risk participation. It is not allowed for an Islamic bank to share the risk under an LC or LG to be issued by a conventional bank since these may not comply with Sharia terms and conditions. (**Dar Al Sharia weekly Fatwa No. 55**)

DOCUMENTATION:

Master Unfunded Participation Agreement

The Master Unfunded Participation Agreement will be entered into between the Grantor and the Participant. The 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 clauses which the Grantor and the Participant need to mutually agree between them.

Wakala Agency Agreement

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.

Offer

If the Grantor wishes to offer the Participant, a participation in a Transaction, it shall send to the Participant an Offer.

If the Participant so requests, the Grantor shall use reasonable endeavours to promptly provide to the Participant a copy of the Transaction Documents prior to the expiry date set out in the Offer.

Acceptance

Participation Agreement shall be concluded upon the Grantor receiving the Participant's Acceptance to the Offer

Upon conclusion of a Participation Agreement, the terms of the Offer (together with such amendments as may have been agreed in writing by each Party) shall, together with the terms of the Agreement, constitute the Participation Agreement.

If the Participant has not accepted an Offer before the expiry date set out in the Offer, the Offer shall lapse and no purported Acceptance by the Participant of such Offer after such date shall be effective.

The Participant is under no obligation to accept any Offer.

The Participant shall not be obliged to enter into any Transaction where it determines (in its absolute discretion) that the subject matter of such Transaction does not comply with Shari'a as directed by the Shari'a Supervisory Board of the Participant.

The Parties agree that Transactions involving non-halal products like pork, alcoholic drinks, tobacco, or narcotics shall not be offered to the Participant:

DEFAULT UNDER THE PARTICIPATED TRANSACTION

Subject to the other provisions of the Agreement, the Grantor may take or refrain from taking any steps the Grantor sees fit (acting reasonably and relying on such professional opinions as the Grantor thinks appropriate) in recovering all sums due to the Grantor from the Recourse Parties under a Participated Transaction.

Following a Default and provided that the Participant is in compliance with its payment obligations under this Agreement, prior to taking or refraining from taking any steps contemplated by relevant Clause of the Agreement, the Grantor shall consult in good faith with the Participant for a reasonable period and shall use all reasonable endeavours to reach agreement with the Participant as to what steps (if any) to take or refrain from taking to obtain repayment or reimbursement of a Defaulted Amount from the Recourse Parties under the Participated Transaction. The obligation of the Grantor to consult with the Participant under this paragraph shall not apply if the Grantor, acting reasonably, determines that its interests or the interests of the Participant under the Participated Transaction would be prejudiced or adversely affected by the time taken to conduct such consultation.

Following a Default, the Participant irrevocably and unconditionally undertakes to pay to the Grantor, irrespective of any objections or exceptions, within **XXX** Business Days as described in the agreement, of the Grantor's first written demand, an amount equal to the relevant Participation Portion.

Each demand for payment to be delivered by the Grantor to the Participant substantially in the form specified in the Agreement, no earlier than XX calendar days from the date of the relevant Default but within YY calendar days of the relevant Default (such YY days period being the "**Default Notice Period**"). The Grantor's right to demand payment in respect of a specific Default shall lapse at the end of the relevant Default Notice Period.

The Grantor may not make any demand for payment after the Termination Date.

In the event that the Credit Amount under a Participated Transaction is reduced, the Participation Amount in respect of such Participated Transaction shall decrease by

the Participation Percentage of such reduction and the Grantor shall promptly inform the Participant of any such reduction.

DOCUMENTARY DISCREPANCIES

The examination of any documents submitted by the Beneficiary in respect of a Participated Transaction is the sole and full responsibility of the Grantor and shall not be affected by any delegation by the Grantor.

In respect of Participated Transactions the Grantor shall exercise such care and attention in relation to the presentation and form of documents with respect to a Participated Transaction as would a bank acting in accordance with UCP or URDG, ISP (if applicable) or otherwise as is in accordance with established market practice (without prejudice to Islamic Sharia Standards) in the relevant financial centre for Transactions of a similar nature.

If a dispute arises between a Recourse Party and the Grantor under a Participated Transaction as to whether documents examined by the Grantor complied with the documentary requirements of that Participated Transaction and the Grantor is of the reasonable opinion that the Recourse Party is unjustified in its refusal to repay to the Grantor any sums paid by the Grantor to the Beneficiary (a **"Relevant Dispute"**), the Grantor shall (without prejudice to its obligations under relevant Clause of the Agreement) use its reasonable endeavours to obtain a final non-appealable legally binding decision, whether obtained in a court of competent jurisdiction, through arbitration or DOCDEX decision (a **"Relevant Decision"**) as soon as is reasonably possible.

Should a Relevant Decision not be in favour of the Grantor, the Grantor shall reimburse to the Participant the relevant Participation Portion including an amount sufficient to indemnify the Participant against any actual cost or loss it may have suffered or incurred by reason of such delay (excluding any opportunity loss)

Where a Relevant Decision holds that the Recourse Party should reimburse the Grantor, the Participant shall promptly pay to the Grantor an amount equal to its Participation Percentage of the costs incurred by the Grantor in relation to obtaining the Relevant Decision (including without limitation all associated legal fees and costs) (**"Relevant Costs"**). The Grantor shall enclose with any such claim a certificate setting out in reasonable detail the calculation of amounts demanded thereunder. In all other cases, all Relevant Costs incurred by the Grantor shall be exclusively borne by the Grantor and the Participant shall have no liability in respect of the same.

The fees paid to the Participant shall only be for the direct or indirect services rendered by the Participant, including, but not limited to, an evaluation of the transaction, evaluation 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.