

Derivatives in the Kuwait Market

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March 2017

Financial derivatives also allow parties to take speculative positions in the market. There are many types of derivatives that parties may enter into, such as currency swaps, options, equity derivatives, credit derivatives, asset swaps, basis swaps and interest rate swaps. The term “derivative” is used to describe these classes of financial instruments due to their value being linked to an underlying bond, currency, stock, commodity, interest rate and even including weather data such as inches of rainfall. It is crucial to note that derivatives settle on a financial basis rather than a physical source. For instance, derivatives that are based on a particular commodity are generally settled by the payment by one party to the other and not by the physical delivery of the actual underlying commodity.

ISDA Documentation

The International Swaps and Derivatives Association (“ISDA”) provides the standard documentary formalities for swaps and derivatives. The use of the ISDA documentation in order to effectuate such derivative transactions is customary in Kuwait. ISDA documentation generally consists of the ISDA Master Agreement (the “Master Agreement”), the ISDA Schedule (the “Schedule”) and the ISDA Confirmation (the “Confirmation”). Credit support documentation may also be supplemented to these documents in the event that the counterparty is providing a collateral in order to mitigate the credit risk arising from the transaction. However, such credit support documents are not mandatory in order for an ISDA governed derivatives transaction to be completed.

The Master Agreement sets out the general terms of the transaction, essentially identifying and managing the obligations of the respective parties to the Master Agreement. The Agreement also lists in detail how the derivative transactions may be closed out upon the occurrence of certain events of default or otherwise labelled as the ‘termination events’. The Master Agreement does not contain any specific terms of the particular transaction; rather these terms are comprehensively scheduled in the confirmation document.

The Master Agreement is not commonly amended. Any amendments deemed necessary to ensure that the derivatives transactions governed by the particularised ISDA documentation meet the commercial and legal positions of the counterparties are made in the Schedule. The counterparties will decide what representations, threshold amounts, events of default and termination events, amongst any supplementary provisions, will apply and to which party. The Schedule is applicable to all of the transactions that take place under the Master Agreement. The negotiation of the Master Agreement provisions to be consolidated in the Schedule are largely determined in accordance with the relative strength of the concerned parties.

Kuwait Legal Issues

As mentioned above, many parties in Kuwait, including foreign and local financial institutions as well as corporates, enter into derivative transactions by utilizing the aforementioned ISDA documentation. Consequently, there are many Kuwait specific issues that such parties must bear in mind upon entering into ISDA documentation with a Kuwaiti counterparty.

a) Authority and Capacity

Generally, under Kuwait law, the capacity of corporate bodies to enter into a particular transaction is connected to its objects which are set out in the subject company's constitutional documents. The objects of a company determine the capacity of said company to enter into any particular transaction. Therefore, a counterparty cannot assume that a Kuwaiti counterparty's entry into an ISDA transaction is in the ordinary course of its business. Consequently, a counterparty to an ISDA transaction dealing with a Kuwaiti counterparty should ensure that the Kuwaiti counterparty has either; explicit authority subject to its constitutional documents to enter into the ISDA transaction or has obtained the appropriate corporate authorisations that are required pursuant to the constitutional documentation in order to enter into the ISDA transaction (i.e. a partners' resolution or shareholders' resolution).

Furthermore, with respect to the restrictions under the law, it is imperative to note that the Central Bank of Kuwait (the "CBK") has advised local financial institutions that banks, investment companies and investment funds may not enter into derivative transactions unless it is for 'hedging' purposes. Conversely, we are unacquainted of any instances in which the CBK has prohibited a financial institution from entering into an ISDA governed derivatives transaction due to it being deemed as entering into the derivative transaction for speculative purposes. In the event that a Kuwaiti financial institution does intend to enter into an ISDA governed derivatives transaction for speculative purposes, such Kuwaiti financial institution should obtain the prior consent of the CBK. In the event that the CBK discovers any such derivatives transactions that have in fact been entered into for speculative purposes by the Kuwaiti financial institution, sanctions may well be imposed against the said institution.

b) Documentation Requirements

Part 3(a) of the ISDA Schedule governs the documentation requirements for the counterparties to the Master Agreement. As aforementioned, parties negotiating an ISDA with a Kuwaiti counterparty should ensure that the Kuwaiti counterparty has either specific authority or capacity to enter into the ISDA transaction. Consequently, these documents should be requested from the Kuwaiti counterparty under Part 3(a) of the ISDA Schedule.

Moreover and depending on the legal form of the Kuwaiti counterparty, the respective parties are obliged to obtain the Kuwaiti counterparty's Articles of Association/Memorandum of Association, certificates issued by the Ministry of Commerce and Industry as well as the company's commercial license and commercial registration. In any case, Kuwait legal counsel should be retained for the purposes of providing a formal legal opinion on the Kuwaiti counterparty's requisite authority and capacity to sign, deliver and perform its obligations under the Master Agreement.

c) Netting & Set-Off

A significant feature of the ISDA Agreement is 'close out netting'. Close out netting occurs between a defaulting and a non-defaulting party. Under the close out netting, upon a default or termination event taking place, all derivatives transactions may be closed out and the values calculated and netted off against each other thus providing a single amount to be payable. This is important because in the event of insolvency of either party, the insolvency administrator will be unable to handpick ISDA transactions; insist on the payment of any profitable ISDA transactions and refuse to do so on non-profitable ISDA transactions. The reason the close out netting mechanism is possible across all derivatives transactions taking place under an ISDA Agreement is due to the presence of the specific provisions in the Agreement that provide that the Master Agreement, the Schedule and the Confirmations comprise one consolidated contract and that a counterparty may terminate all transactions (either automatically or, depending upon the provision selected in the ISDA schedule, on notice) upon the event of insolvency proceedings being instituted against a party.

Although the legal concept of set-off, which is akin to the concept of close out netting in the ISDA Master Agreement, is recognized under Kuwait law, it is not clear that the netting provisions of the ISDA Agreement will be enforceable against a bankrupt Kuwaiti counterparty. It is very possible that a Kuwaiti

bankruptcy court could set aside a termination and close out netting under an ISDA Agreement. As these issues have not been litigated in a Kuwaiti court and there are no clear laws regarding the same, it is difficult to predict how a Kuwaiti court will rule.

d) Central Bank of Kuwait Issues

Although there are no specific regulations or instructions regarding ISDA documentation, the CBK issued an instruction in 2006 whereby licensed Kuwaiti banks may enter into options, financial futures, interest rate futures and forward rate agreements both for hedging and trading purposes. However, as mentioned above, the CBK has advised local banks to not enter into derivative transactions for speculative purposes. Therefore, in the event that a party is negotiating an ISDA with a Kuwaiti financial institution, it may be advisable to include a representation and warranty by the financial institution that it is entering into the derivative transactions for hedging purposes and not for the purposes of speculation.