



**First International
Islamic Finance Conference
Labuan - Malaysia
(6-7 July 2004)**

A horizontal strip showing a satellite-style map of Southeast Asia, with a grid overlay, positioned between the conference details and the main title.

**Islamic Risk Management
Instruments**

**Corporate
and Investment
Banking**

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Section 1: The FX & Debt/Deposit issues



Islamic Institution and their risks

- **Contrary to common beliefs, Islamic Banks, as Conventional Banks, are fully exposed to Forex and Interest Rate risks**

>> The following example -based on the actual financials of an Islamic Institution financial- reinforce our opinion on this matter

Islamic Banks are exposed to FX fluctuations

- The FX issue:

>> As shown below, due to geographical diversification/mismatch of assets & liabilities, Islamic Banks are exposed to the effects of fluctuations in foreign currency exchange rates on both their financial positions and cash flows

2002	Saudi Arabia SR'000	Other GCC & Middle East SR'000	Europe SR'000	North America SR'000	Latin America SR'000	Southeast Asia SR'000	Other countries SR'000	Total SR'000
Assets								
Cash and balances with SAMA	6,831,287	-	-	-	-	-	-	6,831,287
Due from banks	2,458	24,210	90,808	185,243	-	132,575	71,400	506,694
Investments, net:								
Mutajara and mutajara by wakala	19,094,465	2,638,524	9,550,349	168,030	526,052	106,465	-	32,083,885
Installment sale	10,735,212	-	-	-	-	-	-	10,735,212
Islisnaa	4,303,778	-	-	-	-	-	-	4,303,778
Murabaha	560,110	27,267	-	-	-	-	-	587,377
Musharaka	-	-	-	-	-	-	-	-
Other	243,676	-	-	-	-	-	112,843	356,519
Total	41,770,986	2,690,001	9,641,157	185,273	526,052	239,040	184,243	53,404,752
Liabilities								
Due to banks	31,846	1,126	162,292	298,796	-	289,768	155,222	939,050
Customer credit								
Current accounts	43,296,828	-	-	-	-	-	-	43,296,828
Total	43,328,674	1,126	162,292	298,796	-	289,768	155,222	44,235,878
Contingent liabilities	16,715,200	785,059	7,573,972	3,568,237	41,239	727,629	634,549	30,045,885
Credit risk	1,578,843	307,949	444,659	150,827	41,239	727,629	634,549	3,885,695

⇒ Resulting in the Following FX exposures:

	SR'000
	(Dr) Cr Position
US Dollar	(11,438,215)
Euro	(230,984)
Lebanese Lira	(223,604)
Bangladeshi Taka	94,844
Pound Sterling	(77,575)
Emirates Dirham	(70,722)
Other	(85,886)

Mismatch

Islamic Banks are exposed to Interest Rate risk

- The Debt/Deposit issue:

>> Assets and Liabilities Mismatch is also a concern for Islamic Banks Indeed, such a mismatch, implies 2 other type of risks:

- Liquidity Risk and
- Interest Rate Risk

2002	Less than Three months SR'000	From Three months to one year SR'000	From One year to five years SR'000	Over five years SR'000	Without maturity date SR'000	Total SR'000
Assets:						
Cash and cash equivalents	4,218,204	-	-	-	-	4,218,204
Deposit with SAMA	-	-	-	-	3,119,777	3,119,777
Investments, net:						
Mutajara and mutajara by wakala	8,662,065	17,283,291	6,138,529	-	-	32,083,885
Installment sale	805,977	2,357,866	7,279,554	291,815	-	10,735,212
Istisnaa	106,684	639,135	2,352,004	1,205,955	-	4,303,778
Murabaha	150,402	301,488	135,487	-	-	587,377
Musharaka	-	-	-	-	-	-
Other	356,519	-	-	-	-	356,519
Customer debit current accounts, net	992,921	38,538	1,477	-	-	1,032,936
Leased assets, net	-	-	-	-	181,317	181,317
Fixed assets, net	-	-	-	-	908,664	908,664
Other assets, net	-	-	-	-	1,585,446	1,585,446
Total	15,292,772	20,620,318	15,907,051	1,497,770	5,795,204	59,113,115
Liabilities and shareholders' equity:						
Due to banks	-	-	-	-	-	939,050
Customer credit current accounts	43,296,828	-	-	-	-	43,296,828
Other customer accounts	2,198,732	-	-	-	-	2,198,732
Proposed gross dividends	-	-	-	-	1,295,639	1,295,639
Other liabilities	-	-	-	-	4,545,186	4,545,186
Shareholders' equity	-	-	-	-	6,837,680	6,837,680
Total	46,434,610	-	-	-	12,678,505	59,113,115

Maturity Mismatch

Islamic Financial Institutions' risks

- Summary:

Three different kind of risks can be clearly identified:

⇒ The Foreign Exchange risk

⇒ The Interest Rate risk

⇒ The Liquidity risk

⇒ Islamic Financial Institutions need appropriate Sharia-Compliant hedging instruments

Section 2: Conventional vs. Islamic instruments



Conventional Hedging instruments...

- Hedging tools used and proposed by conventional banks are the following:

⇒ FX Swaps:

Combination of both a FX spot and a FX Forward deal

⇒ Interest Rate Swaps:

Exchange of a Floating against a Fixed Interest rate cash flow

⇒ Bonds:

Negotiable Debt instrument (based on Interest)

...Not applicable to Islamic Banks

- These different mechanisms and instruments are in clear contradiction with Sharia principles:

- ⇒ These instruments refer to the concept of 'riba'

- ⇒ The forward concept is not acceptable

- ⇒ Pure monetary flows (no underlying Assets) are prohibited

- ⇒ Debt instruments are not tradable under Sharia

New Islamic instruments have to be structured in order to meet Islamic banks' needs

Eventual Solutions

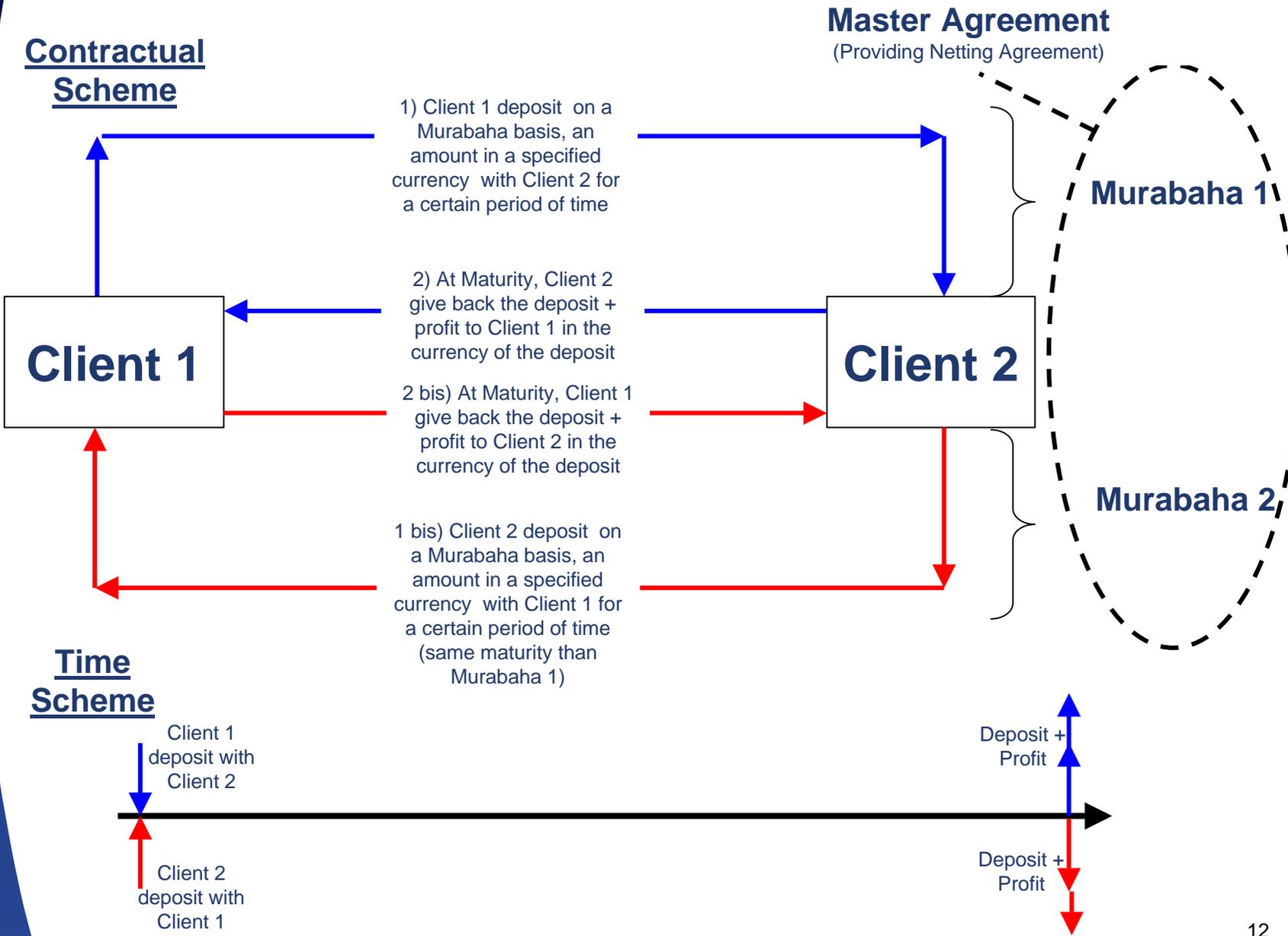
BNP Paribas has developed Sharia-compliant FX & IR swaps:

- **Double Currency Exchange Deposit (equivalent to FX Swap)**
- **Murabahas Profit Exchange (equivalent IR Swap)**

**These Instruments have been approved in principle by
BNP Paribas in-house Sharia Board**

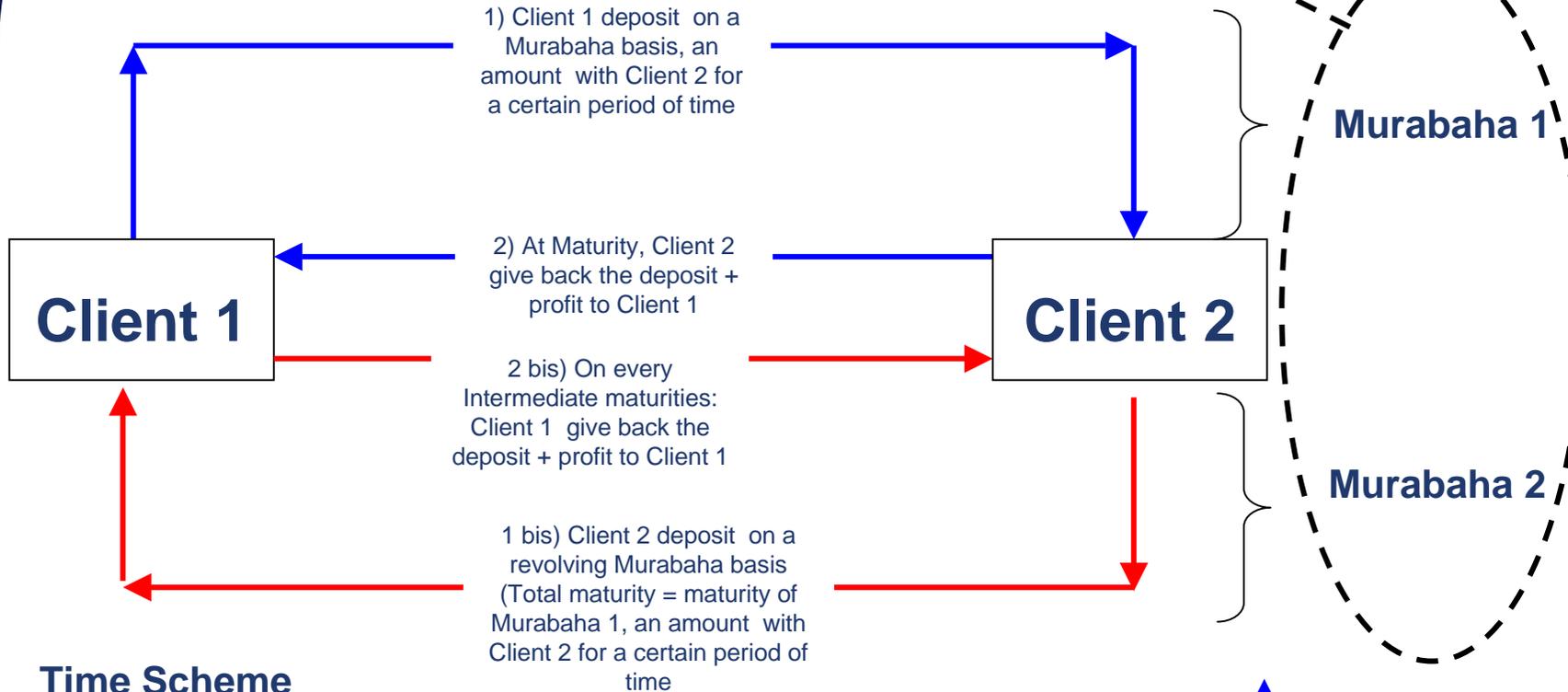
**And are currently at the final stage of the legal
documentation**

The Double Currency Exchange Deposit

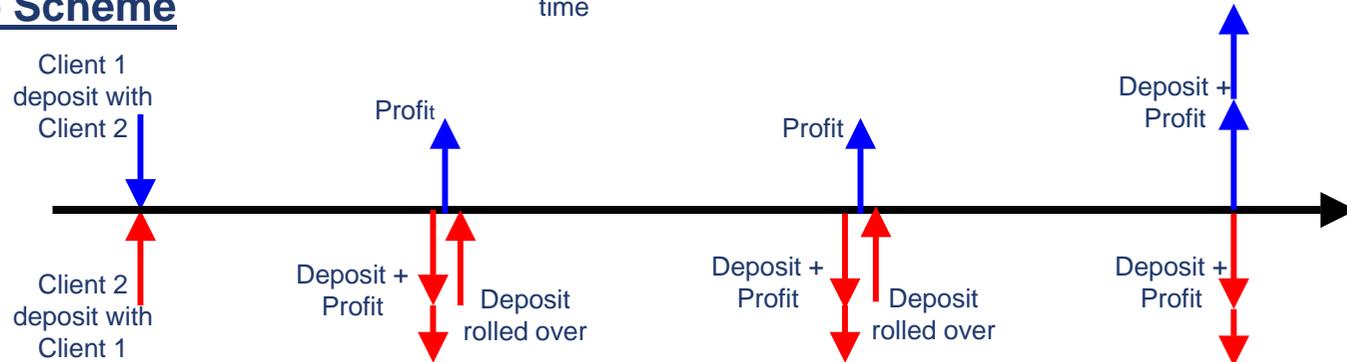


The Murabaha Profit Exchange

Contractual Scheme



Time Scheme



Challenges raised by these structures

⇒ Accounting issues:

Can these structures allow an off-balance sheet treatment, as conventional tools?

Is it compatible with the standards set up by AAIOFI? Need for new standards?

⇒ Legal issues:

Can the agreement be equivalent and as secured as the conventional one? (ISDA agreement)

⇒ Other issues:

Should we allow early settlement / unwinding of the Swap?

Can we consider an endorsement by the IIFM?

Section 3: The Sukuk



Overview of the Sukuk market

- **The Sukuk are another solution to resolve the liquidity risk and Maturity Mismatch.**

- **As of 03/09/2004 The Sukuk market is as follows:**
 - **The world stock of sovereign Islamic bonds raised is around US\$ 3 billion**

 - **In comparison, in Malaysia, the value of outstanding Islamic corporate bonds stands at nearly US\$ 16 billion**

 - ⇒ **Given the growing demand on these instruments, the international Islamic debt capital market still need to be developed (new issues needed)**

The structures

⇒ So far, three structures have been developed on the International Islamic Capital market:

⇒ The Ijara Sukuk

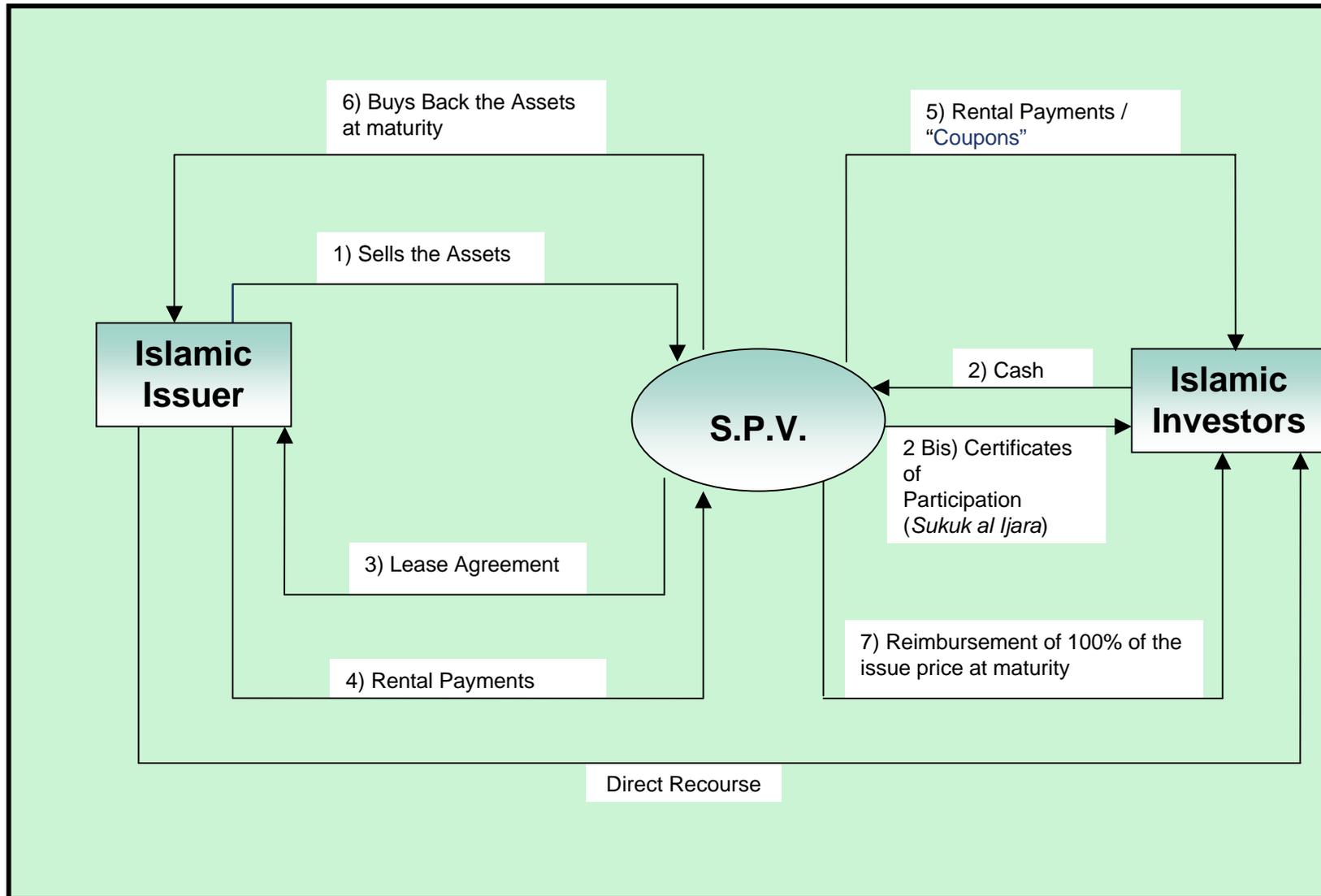
⇒ The Mixed Assets Sukuk

⇒ The Sukuk Al-Salam

The existing structures (1): The Ijara Sukuk

- From a Sharia perspective, the Ijara Sukuk is a widely accepted format of Islamic Bond among Scholars
- Indeed, the following Sharia constraints are observed:
 - It is Asset-Backed,
 - It complies with the principles of Risk-Sharing under Sharia law (through an Ijara) as opposed to the principle of time value for money,
 - The Return on the notes have the form of Rents instead of interest payments.
- Examples of Ijara Sukuk issues:
 - Bahrain Local & International Sukuk (since 2000)
 - Malaysia Global Sukuk (July 2002)
 - Qatar Global Sukuk (2003)

The Ijara Sukuk: The Structure



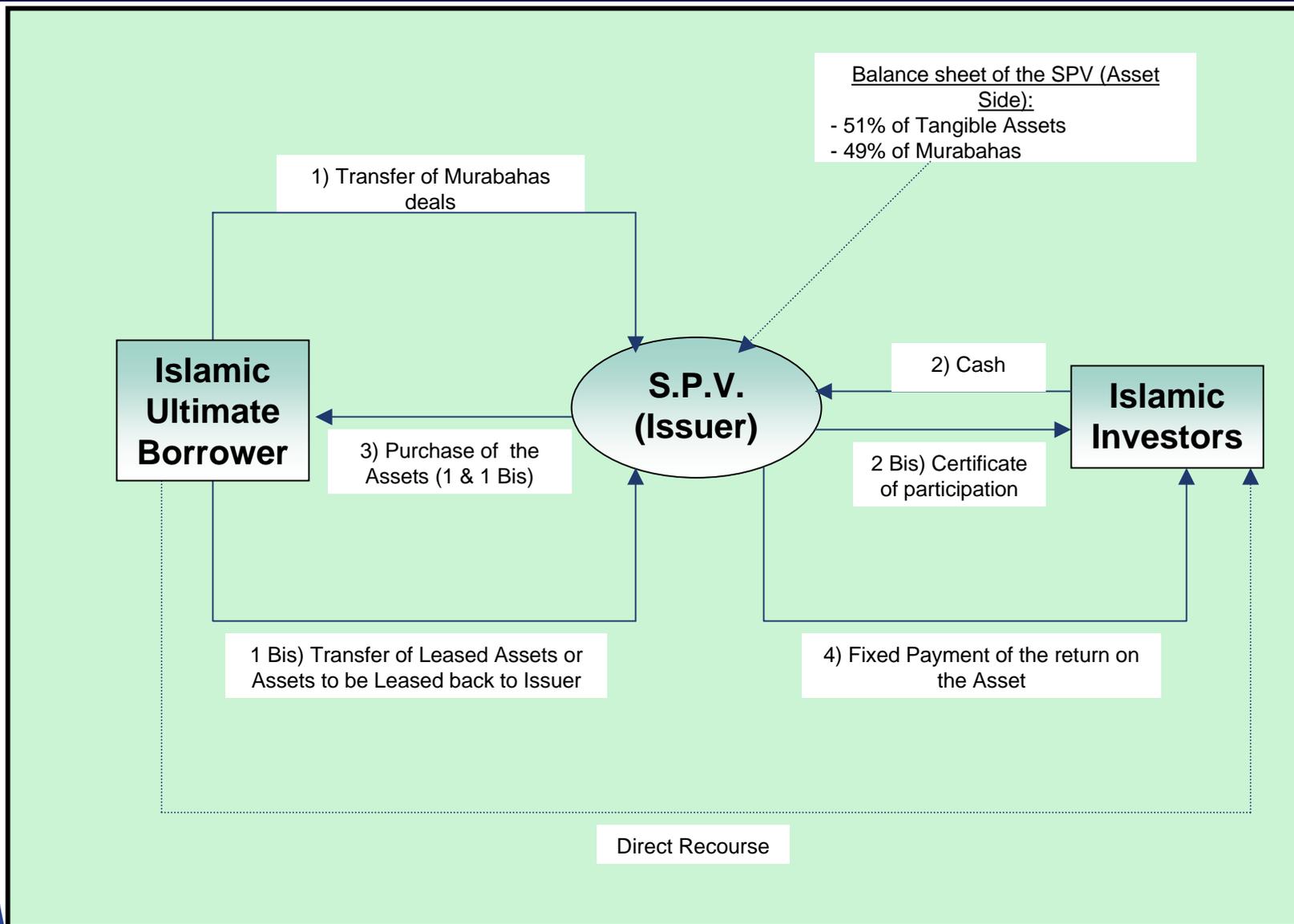
The existing structures: Mixed assets Sukuk

- In terms of structure, the Mixed Assets Sukuk is very close to the Ijara version

- From a Sharia perspective, it is also a widely accepted format of Sukuk among Scholars

- Example of Mixed Assets Sukuk issues:
 - Islamic Development Bank Global Sukuk (July 2003)

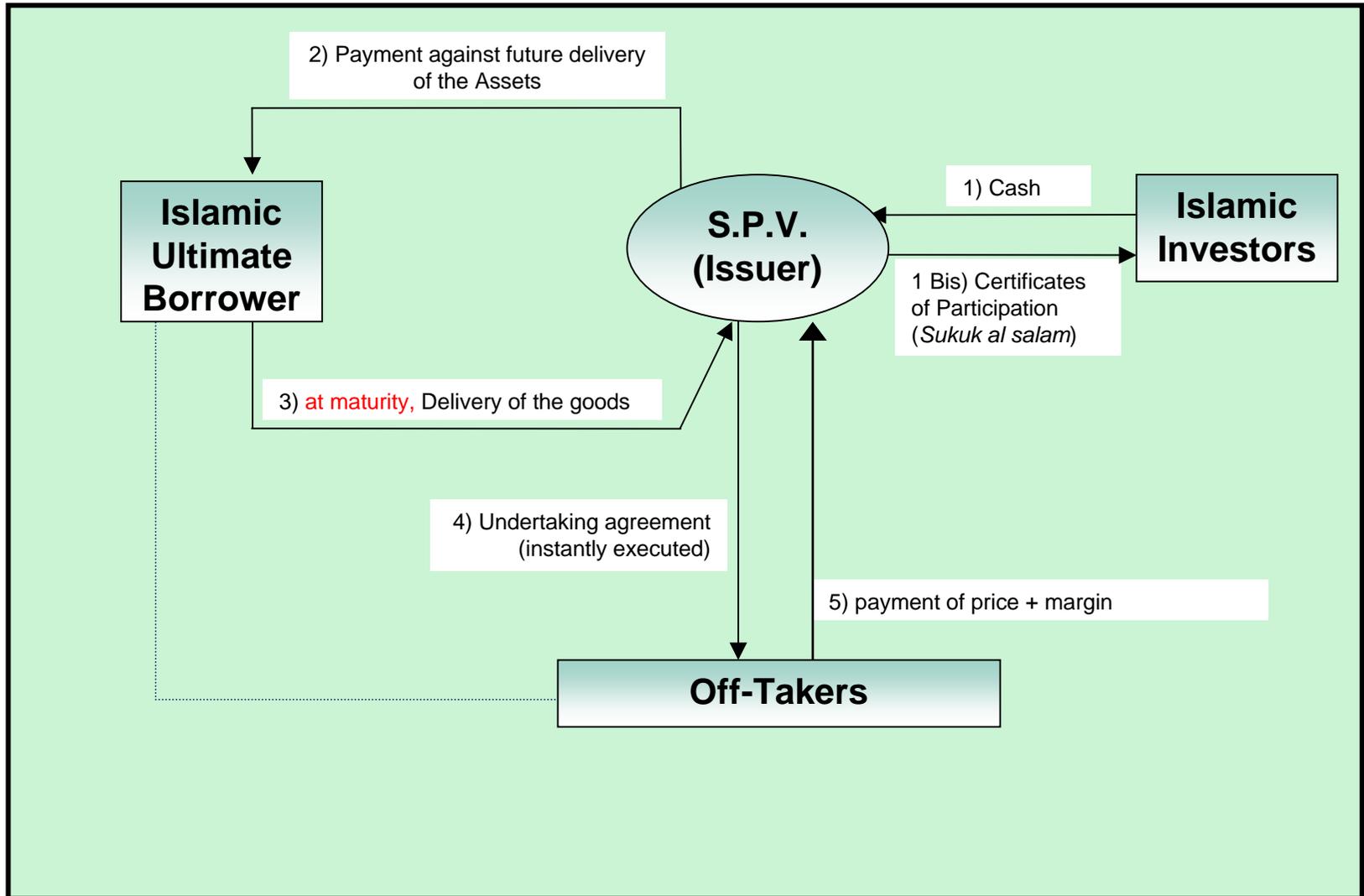
The Mixed Asset Sukuk: The Structure



The existing structures (3): The Sukuk Al Salam

- Al Salam is a transaction where two parties agree to carry out the sale and the purchase of an underlying Asset to be delivered at a future date but at a price determined and fully paid on the day the contract is entered into
- The Sukuk Al Salam structure is a well-accepted structure for short-term money market instruments (the Bahrain Monetary Agency issues 3-months maturity Sukuk Al Salam on a monthly basis)
- On a longer term, this structure still has to be tested with scholars. Tradability of such instrument is also a concern.

The Sukuk Al Salam: The Structure



The challenges and problems of these structures

⇒ Assets issues:

How to structure such type of Sukuk in case the potential Ultimate Borrower have no assets or if available assets are subject to negative pledges?

⇒ Legal issues:

Some jurisdictions do not allow foreigners (investors or SPVs) to own locally domiciled assets

⇒ Tax issues:

The purchase, the lease and/or the buy back of an asset could have important fiscal implications on the transaction

Section 4: A new perspective for Sukuk Structures



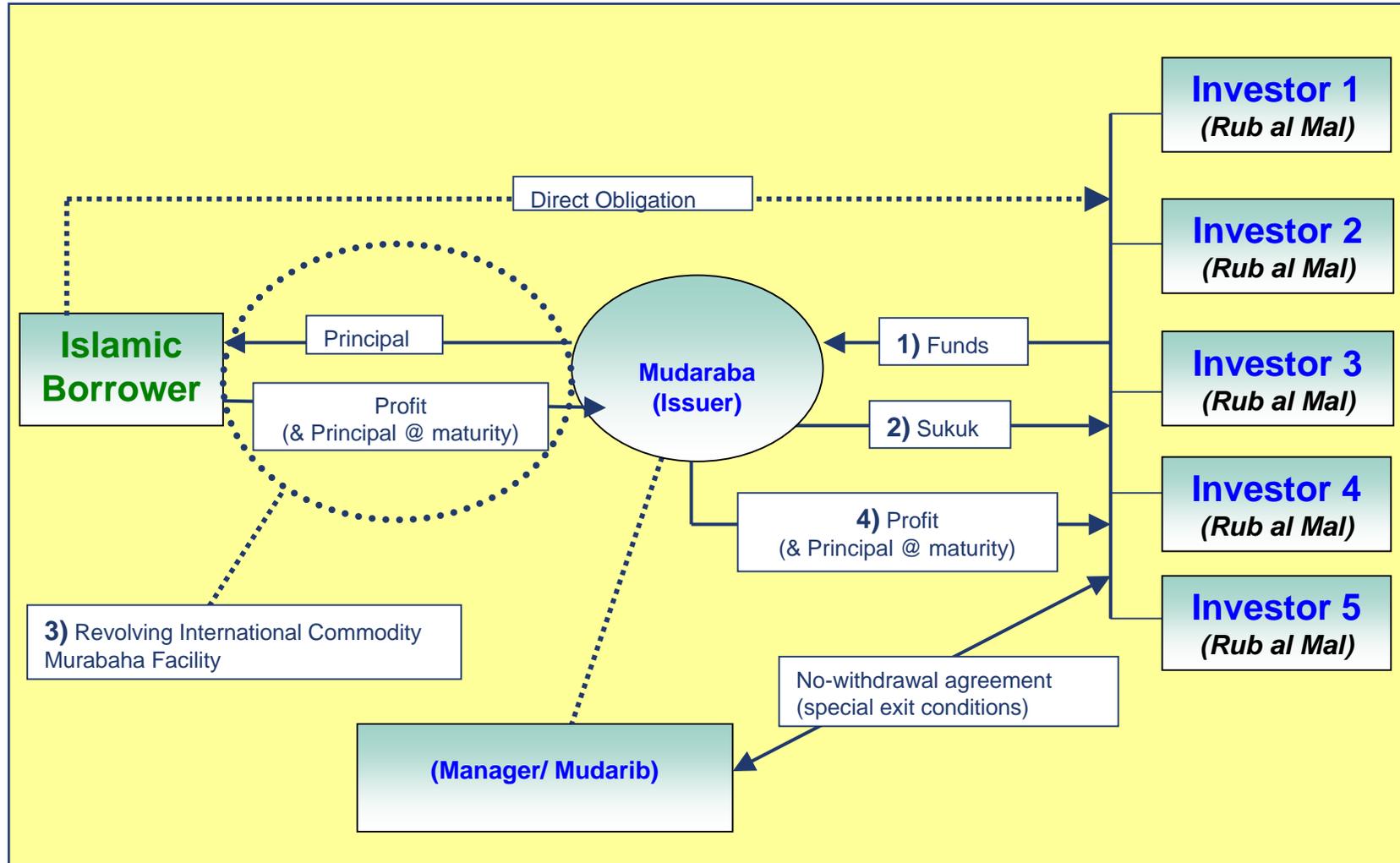
Need for new structures

- Given the problems encountered in Structuring these three types of Sukuk, new structures have to be developed and which will have to respond to the following criteria:
 - ⇒ Compliance with Sharia principles & supported by scholars
 - ⇒ Acceptable to Islamic investors (same features than other Sukuk)
 - ⇒ Structurally enhanced to appeal to crossover investors
 - ⇒ Tradable
 - ⇒ Easily documented and that could facilitate repetition

In this perspective, BNP Paribas has developed a structure that tends to comply with these criteria:

The Sukuk Al Murabaha

Sukuk al Murabaha - The Structure



Sukuk al Murabaha - The Structure

Initial Steps in Setting up the Transaction

- **Step 1:** A Special Purpose Vehicle (Mudaraba) will be set up as the first step in the proposed issue of securities. This Mudaraba will be the issuing entity.
- **Step 2:** The Manager (Mudarib) will, on behalf of the Investors (Sukuk holders), enter into a revolving international commodity Murabaha with the Issuer. The funds raised via the Sukuk are applied towards this Murabaha scheme.

Periodic Profit Distribution

- Profit earned on the revolving Murabahas and accumulated by the Mudaraba will be passed on to the Sukuk holders.

At Maturity

- At the maturity of the Murabaha, the Issuer will reimburse the principal initially invested back to the Mudaraba. The Mudaraba in turn will redeem the Sukuk.

Advantages of the Structure

- **Easy to Structure:**

The Sukuk al Murabaha is easier and faster to structure than a Sukuk al Ijara (Documentation ready for each step of the transaction)

- **No transfer of Tangible Assets:**

Under the recommended structure the Issuer is not required to make any tangible asset transfers to a private entity, even in case of default

- **No due diligence on assets:**

The assets backing the Sukuk al Murabaha structure are commodities priced on the LME which obviates the need for any due diligence on the assets

- **Same rating as the Issuer:**

The international rating of the Sukuk will reflect the direct credit exposure on the Issuer by the Mudaraba and the Sukuk holders. This would give investors a greater level of comfort

- **No return volatility:**

The return (fixed or floating) on the Sukuk is set at launch and is not subject to any change

- **Replicable Structure:**

The Sukuk al Murabaha structure is elegant and is easily replicable

Compliance with Shariah Principles

Reason 1: Sign off by scholars

- The Sukuk al Murabaha structure has already been approved by some prominent Sharia Scholars and large Middle Eastern Islamic Banks.
- This format of Sukuk has already been issued by First Islamic Investment Bank, a Bahrain-based Islamic Investment bank. (US\$ 75 mio, dual tranche: 3 & 5 yrs)
- The Sukuk al Murabaha is a combination of very well known and widely used instruments in the market comprising of the following:

Reason 2: Based on well established Islamic Instruments

- A Restricted Mudaraba in order to use and hold the assets
- Sukuk representing a share in the Mudaraba's Assets
- A Revolving International Commodities Murabaha

Compliance with Shariah Principles (contd.)

Reason 3: New, Shariah Compliant Tradability Feature

- From a Shariah perspective, the structure only allows Sukuk trading at specific dates:
 - Tradability allowed once the underlying Murabaha has matured and before it revolves (usually monthly or quarterly)

- Typically, Sukuk trading during the life of the revolving Murabaha would be considered from a Shariah point of view as debt trading (forbidden)

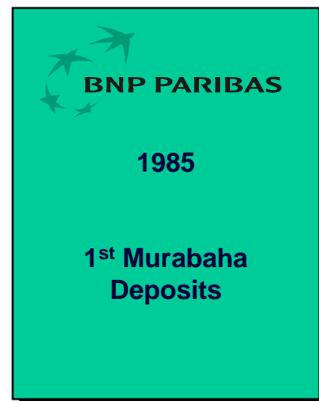
- To assure tradability, BNP Paribas have developed a Shariah accepted additional structure in order to trade the Sukuk at any time and price, giving this Sukuk the same features as any other accepted types of Sukuk

Section 5: BNP Paribas in Islamic Banking

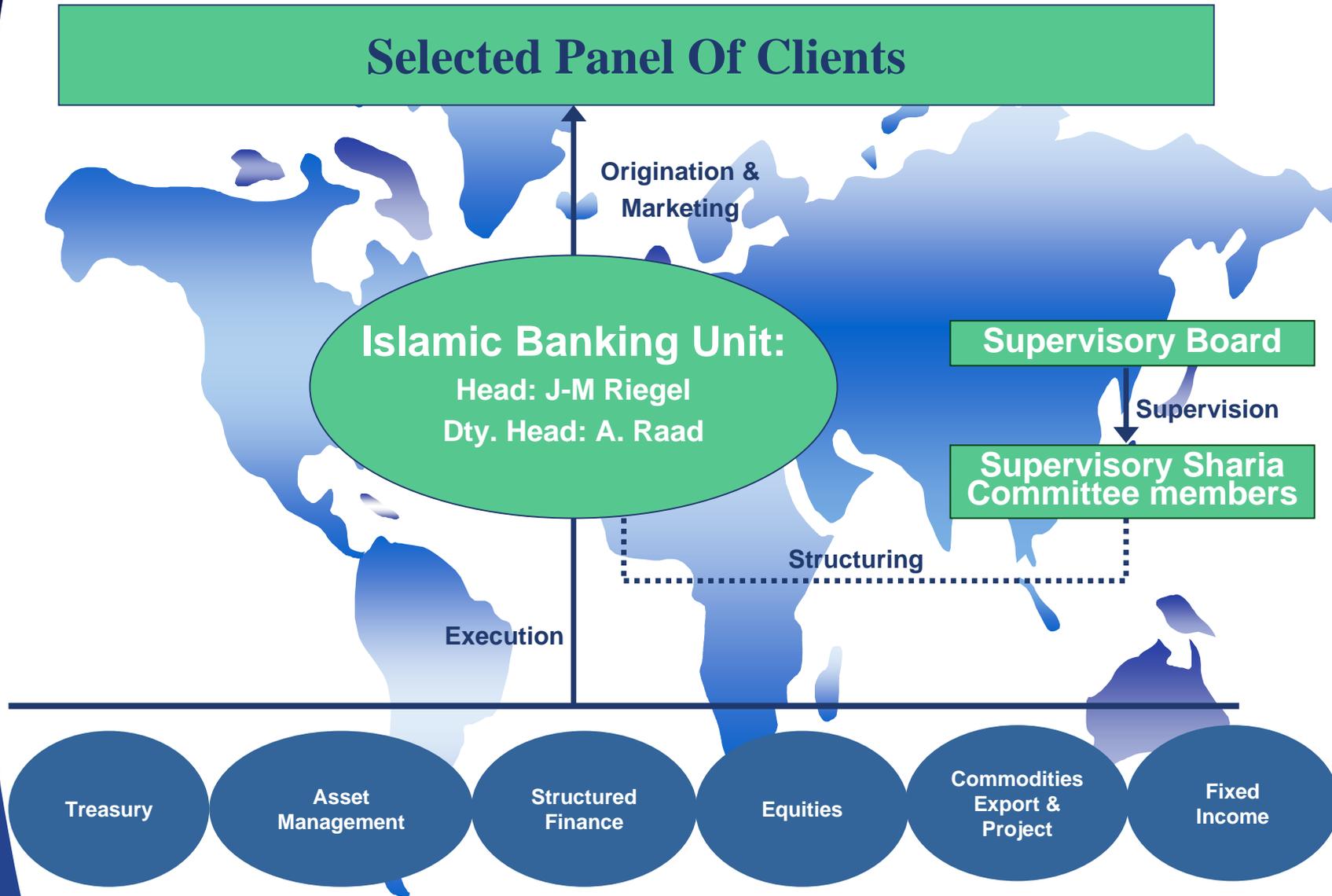


BNP Paribas: 19 years in Islamic Banking

- Islamic Investment Department within BNP Paribas with dedicated multi-product capabilities:
 - Large short term Murabaha deposits base since 1985
 - Co-arranger in Project Finance Islamic tranches
 - First Islamic capital protected fund structured by BNP Paribas
 - One of the first Islamic Equity fund



BNP Paribas' Islamic Banking Unit Organisation



The Sharia Board of BNP Paribas

BNP Paribas SSC is composed of well-known and highly commended scholars and is the first International Bank to include in its Sharia Board scholars from both the Middle-East and Asia (Malaysia):

- *Dr. Nizam Yaquby - Bahrain (Chairman of BNP Paribas' SSC)*
- *Dr. Abdul Sattar Abu Ghuddah – Syria (based in Saudi Arabia)*
- *Dr. Mohamed Daud Bakar - Malaysia*

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