

Q&A

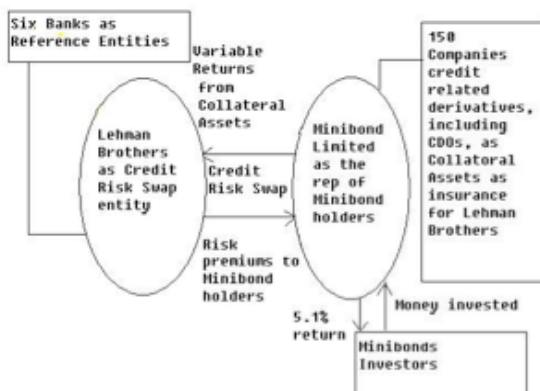
Derivatives and *Shari'ah* Islamic Finance

What are derivatives?

The draft language of the Derivatives Regulation bill now being written by the Financial Services Committee, as of October 24, 2009 is:

OTC derivatives include swaps, which are contracts that call for an exchange of cash between two counterparties based on an underlying rate, index, credit event, or the performance of an asset.

In simpler terms, a derivative is a complicated investment *derived* from a simpler investment. Here is a graphic image of a credit default swap “derivative” created by Lehman Brothers in 2008. The creation of these derivatives by AIG, Lehman Brothers, Bear Stearns, and others was a key factor in the economic collapse of 2008-09, and the need for banks to receive billions of dollars in taxpayer bail out money.



Why? Because as banks tried to quickly sell these “derivatives”, possible buyers had no idea how to value these complicated investments loaded with

swaps and contracts and special purpose vehicles.

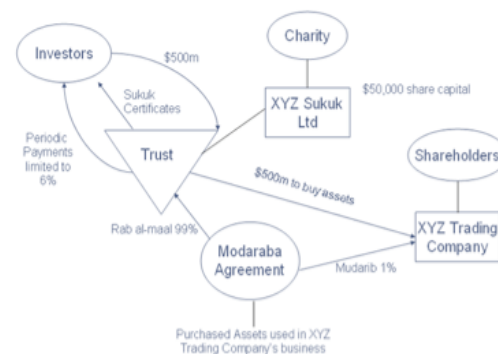
Investors refused to buy them. Hence the name “toxic derivatives”.

Are *Shari'ah*-compliant investments derivatives?

Yes. *Shari'ah*-compliant Sukuk fit the definition of “derivatives” described above in by the Financial Services Committee in Oct 2009. Sukuk are financially engineered complicated swaps and contracts which use Special Purpose Vehicles for the purpose of converting forbidden un-islamic “interest income” to acceptable islamic “lease”, “rent”, or “profit” cash flows. They are complicated investments derived from the simpler concept of an interest-paying fixed income bond.

Here is an example of just one kind of Sukuk Derivative structure, called a Modaraba Sukuk.

Modaraba Sukuk



Sources:

The International Bank for Reconstruction and Development/The World Bank, www.worldbank.org; Malaysia International Islamic Financial Centre, http://mifc.com/index.php?ch=menu_know_icm_sukuk&pg=menu_know_icm_sukuk_struc&ac=11; and Zamil Iqbal, Hennie Van Greuning, *Analyzing Risk for Islamic Banks*, World Bank Publications, November 2007.

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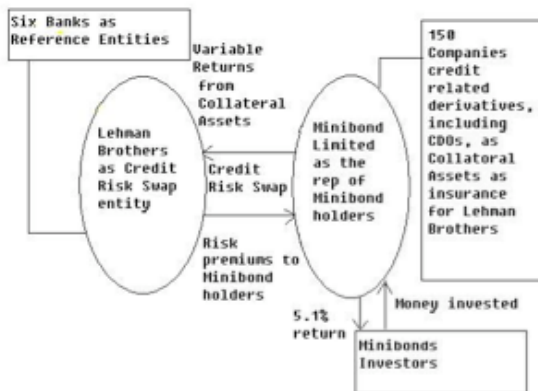
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Q&A

Derivatives and *Shari'ah* Islamic Finance

How many different kinds of sukuk derivatives structures are there?

There are at least 14 different kinds of “sukuk derivatives” structures. These structures are custom created according to the unique assets, terms of swaps, and counterparty contracts.



Give an example that explains how risky Sukuk derivatives are?

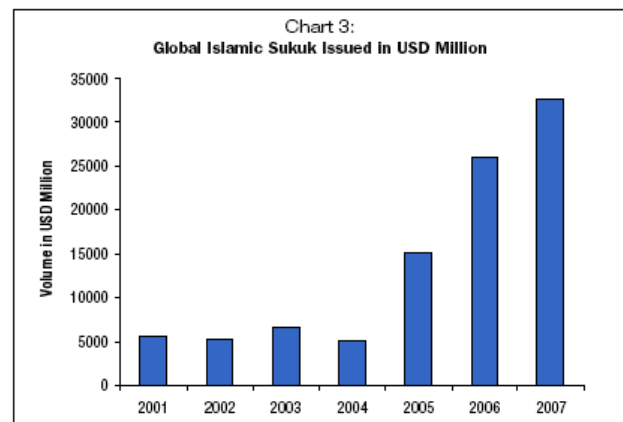
In 2008, when global markets plummeted, prices of Sukuk derivatives (called Islamic Bonds by Wall Street) fell FOUR times as much than investment-grade corporate non-Islamic debt. This shows just how different the risk profiles of Islamic Sukuk derivatives are compared with simple western bonds. There were three defaults in 2008 by the sukuk's market biggest issuer, Nakheel PJSC in Dubai. (http://www.bloomberg.com/apps/news?pid=20601109&sid=aQk0aB_h8SRw)

What are the specific risks of Islamic Sukuk derivatives?

- counterparty risk
- off-balance sheet transaction risk
- host country policy risk
- benchmark risk
- liquidity risk
- default and bankruptcy risk
- interest transfer risk

How fast is the Islamic derivatives market growing?

Almost non-existent a decade ago, the Islamic bond market has grown to \$130 billion, according to Moody's Investors Service. Growth has been exponential in past three years, with a dip in 2008, when three defaults in this market resulted in Islamic sukuk prices falling four times faster than prices for traditional bonds. (http://www.bloomberg.com/apps/news?pid=20601109&sid=aQk0aB_h8SRw).



Sources:

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