International
Finance & Treasury

WORLD TRADE Executive
International Business Advisories™
Law • Finance • Tax • Energy

Weekly Report for International Finance Executives

July 23, 2001
Vol. 27, No. 30

Last Days for NCUs

What to expect during the final changeover to the euro; preparing for the challenges ahead.

Geoffrey Yeowart, Lovells

The final milestone on the road to economic and monetary union is now in sight for twelve out of fifteen member states of the European Union. On "€-Day"—January 1st, 2002—euro bank notes and coins will be put into circulation in Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, The Netherlands, Portugal and Spain. National currency units (NCUs) will then cease to be used, except for cash payments.

Although existing national notes and coins will continue in use for cash payments, they will be progressively withdrawn and cease to be legal tender by the end of February, 2002, at the latest.

The final stage of the changeover to the euro will involve not only a huge logistical exercise, but will also raise fresh issues. Market practitioners and businessmen with assets or liabilities denominated in national currency units will be affected, whether they are based inside or outside the euro area and need to be prepared.

The Tasks Ahead

The final changeover will involve major tasks in particular for institutions with retail banking business. The most time-intensive areas will be:

See *NCUs*, Page 3

Structured Trade Finance

Techniques for use in emerging economies create enhanced market opportunities and minimize commercial risks.

André Soumah, Audit Control and Expertise

The traditional approach to lending and credit analysis by commercial credit institutions is founded upon a stance of risk aversion. Audited financial statements form one basic report from which the borrower's creditworthiness is typically assessed. However, the increasing complexity of businesses and their operating environments now require that this and other lending and credit analysis guidelines be supplemented.

The lender may now need to know the company's transaction cycle, in order to ascertain quality and liquidity of assets forming the basis of repayment. It is from this requirement that the notion of asset-based lending (and derivation of structured commodity trade finance) was developed and later popularized during the 1980s.

Monitoring of collateral, with a particular form of due diligence for each client / account, becomes essential in the context of these financing arrangements. This would ensure lender control over disbursements in line with collateral, to ensure that the appropriate loan to asset ratio is maintained. Third party involvement enables specialized experience and skills for more viable lending.

See *Trade*, Page 14

IN THIS ISSUE

Biting the Bullets

More than just one unpleasant truth has to be confronted in the course of resolving the latest crisis in Argentina.

Scott E. Pardee

A strong message has finally gotten through to the politicians and power brokers in Argentina: investors around the world are fed up with dealing with that country's financial crises.

Indeed, Economy Minister *Domingo Cavallo* had to sit down with domestic investors to make sure they would tender for a treasury-bill auction, so it seems that Argentine investors feel the same way.

In the history of international finance, whenever there has been a crisis somewhere, Argentina is caught up in it and is calling for help.

In the history of international finance, whenever there has been a crisis somewhere, Argentina is caught up in it and is calling for help. It doesn't matter whether the problem originates from Europe, the U.S., Latin America, or, more recently, even Asia.

Many of Argentina's crises are homegrown, but the call for help is always the same. Without help, Argentina will devalue its currency, go into default on its debt, and leave investors with massive losses. Over the past decade, Argentina has made many strides forward, politically and economically, but it remains crisis-prone.

In seeking to resolve crises, we talk in terms of fiscal and monetary policies and the exchange rate. But the reason Argentina is crisis-prone runs

See *Bullets*, Page 4

Exchange Strategies

Monetary policy and Argentina become points of peril for the dollar outlook. This could produce a gap for the euro to "run to daylight."

Brendan Murphy

Markets have penciled in a 25 basis point rate cut at the next *Federal Reserve Board* policy meeting on the basis of *Alan Greenspan*'s more or less downbeat economic assessment to Congress last week. We continue to believe there is a good chance he will surprise again, by cutting a half point off the 3.75 percent Fed funds rate.

Greenspan has to consider the risk that consumer sentiment and spending may start to reflect the economic strain.

Argentina's situation has stabilized to some extent, but that has not been eliminated as a risk to global markets, even though the contagion was relatively contained. More important, Greenspan has to consider the risk that consumer sentiment and spending may start to reflect the economic strain.

For that reason, the July employment report—coming out in the first week of August—will be a critical data point, as will retail sales and the various measures of consumer sentiment.

Manufacturing clearly is in a recession, and, as Greenspan himself noted, technology invento-

See *Strategies*, Page 4

International
Finance & Treasury

The International Business Information Source™
(ISSN 1070-9215)
Vol. 27, No. 30
July 23, 2001

EDITORIAL OFFICE
WorldTrade Executive, Inc.
P.O. Box 761
Concord, MA 01742-0761 / USA
(978) 287-0301 Phone
(978) 287-0302 Fax
www.wtexec.com

PUBLISHER
Gary A. Brown, Esq.
MANAGING EDITOR
George T. Cassidy
CONTRIBUTING EDITOR
Scott P. Studebaker, Esq.
DIRECTOR OF MARKETING
David L. Kagan

PUBLISHED WEEKLY (EXCEPT THE FIRST WEEK OF SEPTEMBER AND LAST WEEK OF DECEMBER) FOR SUBSCRIBERS ONLY

SUBSCRIPTION INFORMATION: Annual subscription: US$1295 (add $50 for non–US postage) Single copy: US$26

***NCUs*, from Page 1**

- distribution and handling of euro notes and coins;
- completion of the changeover in the retail payment system;
- conversion of internal accounting and related systems;
- preparation and presentation of banks' external accounts in euro;
- conversion of customers' bank accounts (including loans and deposits) to euro;
- conversion to euro of automated teller machines;
- replacement of physical payment products such as checkbooks and giro forms;
- training of staff to deal with the euro changeover; and
- informing customers and the public about the final changeover.

Relatively few existing bank accounts in the euro area have been converted to euro and few new euro accounts have been opened. Many banks in the euro area still maintain their internal accounting in NCUs, although some have converted to euro already or plan to convert by the end of 2001. A considerable amount of detailed preparation work is necessary in order to complete the changeover.

The Broad Approach

On November 8th, 1999, the ***Council of Finance Ministers of the European Union*** (ECOFIN) adopted a common statement on the introduction of euro notes and coin, setting out common principles for member states to follow.

Member states will endeavor to ensure that the bulk of cash transactions can be made in euro by the end of the first two weeks of 2002. The period of dual circulation of the former national currencies and the euro should last between four weeks and two months. Member states may facilitate the exchange of old notes and coin after this time.

Financial institutions, and other key players, can be provided with euro notes and coin in advance of January 1st, 2002, to facilitate the changeover, but these should not be put into circulation before that date. Limited quantities of euro coins can also be made available to the public in participating member states during the second half of December, 2001, to enable them, particularly those in the more vulnerable sectors of society, to familiarize themselves with the new coins.

These principles are intended to ensure a common approach to the cash changeover, while allowing each member state to tailor implementation to its own specific circumstances. Member states have already produced their own national changeover plans.

Current Status of the Euro

The euro is already a currency, but a non-cash currency. The introduction of euro notes and coins will be the final stage of the transition to full economic and monetary union for "in" member states.

The euro was substituted for "in" national currencies on January 1st, 1999, but notes and coins in NCUs—commonly referred to as legacy currencies—continue in circulation during the transition period which ends on December 31st. They are treated as denominations of the euro.

So, Deutschemark notes and coins continue to be legal tender in Germany, and French francs continue to be legal tender in France, but each is treated as a sub-unit of the euro. The conversion rate between the euro and the national currency unit of each participating member state was irrevocably locked from January 1st, 1999, at the rates shown in the accompanying table.

The period of dual circulation of the former national currencies and the euro should last between four weeks and two months.

The euro was introduced into Greece on January 1st, 2001. The conversion rate between the euro and the drachma has been irrevocably locked from that date at the rate of €1:GDR340.750.

When euro notes are introduced officially on January 1st, 2002, they will have legal tender status in all participating member states. They will be issued by the ***European Central Bank*** (ECB) and central banks of participating member states. National notes and coins must cease to be legal tender within their relevant territories by June 30th, 2002, but this dual legal tender period may be shortened by national law. The Netherlands has shortened this to January 28th, 2002, while Ireland and France will end the dual regime on February 9th and 17th, 2002, re-

Fixed Relationships of NCUs with the Euro as of January 1st, 1999

NCU	ISO	Parity
Austrian schilling	ATS	13.7603
Belgian franc	BEF	40.3399
Deutschemark	DEM	1.95583
Finnish markka	FIM	5.94573
French franc	FRF	6.55957
Irish pound	IEP	0.787564
Italian lira	ITL	1936.27
Luxembourg franc	LUF	40.3399
Netherlands guilder	NLG	2.20371
Portuguese escudo	PTE	200.482
Spanish peseta	ESP	166.386

See *NCUs*, Page 8

***Bullets*, from Page 2**

deeper. It is rooted in the huge disparity between what the country could be and what it is.

For most people in international finance, just one visit to Buenos Aires, and hopefully out to the Pampas and to lake retreats like Bariloche, is enough to win you over. The place is beautiful, full of natural resources, and has a temperate climate. You find yourself making many friends, quickly, and if you want a nightlife, it is there. You become addicted to Argentine beef. You conclude that someday this country will be an economic powerhouse.

Sure, there are inconveniences, but back in your office in New York, London, or wherever, when someone suggests that you take a business trip to Argentina, you will not say "no." That is, unless it is the third trip in a month, dealing with a problem.

The Argentine economy is broken into major enclaves, and the people in these enclaves don't seek common ground with others.

The *argentinos* you meet will feel the same way about their country, except that they have to put up with the inconveniences every day, and for that reason many leave. The ones who stay are skilled in selling you on their country and their product lines. Even though you may have lost money in Argentina before, they persuade you that this time it will be different.

In reality the Argentine economy is broken into major enclaves, and the people in these enclaves don't seek common ground with others. It is agriculture versus industry; states versus the federal government, labor unions versus everyone else (including the 15 percent unemployed).

Argentina now has a working political democracy, but the fight over relative shares continues. Past president *Carlos Menem* essentially ruled by decree, working with Cavallo to make much-needed reforms. The current president, *Fernando de la Rúa*, is a conciliator and was foundering until he also turned to Cavallo.

Cavallo is using the debt crisis to force the leaders of many of these enclaves to bite bullets they should have bitten long ago. Last week, he convinced the state governors that they can no longer run huge deficits expecting gullible investors to buy and hold their paper, and they agreed to long-delayed measures to reduce their deficits.

We can criticize elements of Cavallo's fiscal, monetary, and foreign exchange policies, but most of what he is doing is a holding action, buying time. He still needs to break the vicious circle that private investors, Argentine and foreign, won't make new commitments until the economy starts growing, and until they do so, it won't grow.

Time will help, but this time, the people of Argentina will have to rely on their own resources. ❑

Scott E. Pardee is Alan R. Holmes Professor of Monetary Economics at ***Middlebury College****, Vermont. He has taught finance at* ***MIT Sloan School of Management*** *and the* ***University of Chicago Graduate School of Business****. Mr. Pardee has served as Chairman of* ***Yamaichi International (America) Inc.*** *and as Senior Vice President at the* ***Federal Reserve Bank of New York****, where he was Manager for Foreign Operations of the Open Market Committee.*

***Strategies*, from Page 2**

ries continue to build. Therefore the U.S. economy could face some difficulty returning to a trend rate of growth in the second half. With oil prices softer and wage pressures abating in response to well-publicized and large corporate layoffs—not to mention the staffing decimation in computer and telecommunications firms—inflation concerns probably are overstated.

Real interest rates need to be closer to zero to ensure global recovery. Greenspan could exceptionally effect a 25 basis point inter-meeting easing if July jobs data are worse than expected.

European growth has flattened, and Europe will have to work through the same economic trough as the U.S.

Despite the general tone of discouragement, exacerbated by grim corporate earnings reports and some prominently bleak forecasts from chief executives like IBM's *Lou Gerstner*, we still believe the economy can work its way out of the slough of despond in the second half of this year. It does needs a strong kick in the late second quarter, with participation by the corporate sector and Wall Street, and it is hard to see a catalyst for such a development from any source but the Fed.

Federal tax rebates going out through the summer will provide some support, if not enough firepower, to do the trick without a strong Fed signal. A return to the more encouraging data stream of mid-June would permit a token 25 basis point August easing.

Time for a Euro Move?

The euro may have another window of opportunity if ***European Central Bank*** (ECB) president *Wim Duisenberg* doesn't slam it shut with some market-offending comment.

European growth has flattened, and Europe will have to work through the same economic trough as the U.S., coming out of it later. However, the high-tech devastation is less extensive in Europe, for the simple reason that the high-tech sector is considerably smaller, though there are certainly some notable points of pain.

European inflation has shown signs of peaking, according to the economists, which could encourage the ECB to trim its repo rate from 4.75 percent to 4.50 percent, encouraging Europe to

See *Strategies*, Page 6

Bank of America's World Value of the Dollar as of July 20th

The table below gives the rates of exchange for the U.S. dollar against various currencies as of Friday, July 20th, 2001. The exchange rates are middle rates between the buying and selling rates as quoted between banks, unless otherwise indicated. All currencies are quoted in foreign currency units per U.S. dollar except in certain specified areas. All rates quoted are not intended to be used as a basis for particular transactions. *Bank of America* does not undertake to trade in all listed foreign currencies, neither does *Bank of America* assume responsibility for errors.

EUR=$0.87125 SDR=$1.25922 3-month LIBOR 3.67 3-month SIBOR 3.64 6-month LIBOR 3.70 6-month SIBOR 3.73

Country	Currency	Value of U.S. Dollar	Country	Currency	Value of U.S. Dollar	Country	Currency	Value of U.S. Dollar
Afghanistan	Afghani (c)	4750.00	Georgia	Lari	2.06	Pakistan	Rupee	63.675
Albania	Lek	147.50	Germany	Mark	2.2449	Panama	Balboa	1.00
Algeria	Dinar	78.182	Ghana	Cedi	6957.925	Papua N.G.	Kina	3.3613
American Samoa	US$	1.00	Gibraltar	Pound *	1.4289	Paraguay	Guarani (d)	4300.00
Andorra	Peseta	190.9739	Greece	Drachma	391.1047	Peru	Nuevo Sol (d)	3.496
Andorra	Franc	7.5289	Greenland	Krone	8.5219	Philippines	Peso	53.15
Angola	Kwanza (4)	18.2458	Grenada	E. Car. $	2.70	Pitcairn Island	NZ Dollar	2.4137
Antigua	E. Car. $	2.70	Guadeloupe	Franc	7.5289	Poland	Zloty (o)	4.2265
Argentina	Peso	1.00	Guam	US$	1.00	Portugal	Escudo	230.1085
Armenia	Dram	556.23	Guatemala	Quetzal	7.8365	Puerto Rico	US$	1.00
Aruba	Florin	1.79	Guinea Rep.	Franc	1952.50	Qatar	Riyal	3.6405
Australia	Dollar	1.9446	Guinea Bissau	Franc	752.8918	Rep. Macedonia	Dinar	64.045
Austria	Schilling	15.7937	Guyana	Dollar	180.50	Rep. Yemen	Rial (a)	161.458
Azerbaijan	Manat	4631.00	Haiti	Gourde	23.25	Ile de la Reunion	Franc	7.5289
Bahamas	Dollar	1.00	Honduras	Lempira (d)	15.49	Romania	Leu	29448.50
Bahrain	Dinar	0.377	Hong Kong	Dollar	7.7998	Russia	Ruble	29.282
Bangladesh	Taka	57.65	Hungary	Forint	285.395	Rwanda	Franc	434.40
Barbados	Dollar	2.00	Iceland	Krona	101.125	San Marino	Lira	2222.4046
Belarus	Ruble	1293.00	India	Rupee (m)	47.116	Sao Tome/Principe	Dobra	8203.50
Belgium	Franc	46.3012	Indonesia	Rupiah	11145.00	Saudi Arabia	Riyal	3.7504
Belize	Dollar	2.00	Iran	Rial (o)	1752.50	Senegal	CFA Franc	752.8918
Benin	CFA Franc	752.8918	Iraq	Dinar (o)	0.3124	Seychelles	Rupee	5.618
Bermuda	Dollar	1.00	Ireland	Punt *	1.1063	Sierra Leone	Leone	1899.095
Bhutan	Ngultrum	47.116	Israel	New Shekel	4.198	Singapore	Dollar	1.8233
Bolivia	Boliviano (f)	6.619	Italy	Lira	2222.4046	Slovakia	Koruna	48.8755
Bolivia	Boliviano (o)	6.07	Jamaica	Dollar (o)	45.55	Slovenia	Tolar	250.54
Bosnia Herz.	Konv. Marka	2.2449	Japan	Yen	123.305	Solomon Is.	Solomon $	5.291
Botswana	Pula	5.7356	Jordan	Dinar	0.7108	Somali Rep.	Shilling (d)	2620.00
Bouvet Island	Krone	9.1523	Kazakhstan	Tenga	146.10	South Africa	Rand (c)	8.255
Brazil	Real	2.505	Kenya	Shilling	78.94	Spain	Peseta	190.9739
Brunei	Dollar	1.8233	Kiribati	Aus. Dollar	1.9446	Sri Lanka	Rupee	90.20
Bulgaria	Lev	2.2269	Korea, North	Won	2.20	St. Christopher	E. Car. $	2.70
Burkina Faso	CFA Franc	752.8918	Korea, South	Won	1305.70	St. Helena	Pound *	1.4289
Burundi	Franc	844.924	Kuwait	Dinar	0.3069	St. Lucia	E. Car. $	2.70
Cameroun	CFA Franc	752.8918	Kyrgyzstan	Som	49.101	St. Pierre/Miq'lon	Franc	7.5289
Canada	Dollar	1.5413	Laos	Kip	7600.00	St. Vincent	E. Car. $	2.70
Cape Verde Is.	Escudo	121.25	Latvia	Lat	0.63	State Cambodia	Riel	3835.00
Cayman Is.	Dollar	0.82	Lebanon	Pound	1514.00	Sudan	Pound (c)	2560.00
Cent. Af. Rep.	CFA Franc	752.8918	Lesotho	Maloti	8.255	Sudan	Dinar	256.00
Chad	CFA Franc	752.8918	Liberia	Dollar	1.00	Suriname	Guilder	981.00
Chile	Peso (m)	663.85	Libya	Dinar	0.5357	Swaziland	Lilangeni	8.255
Chile	Peso (o)	518.37	Liechtenstein	Franc	1.7236	Sweden	Krona	10.5835
China	Renminbi	8.2768	Lithuania	Litas	4.0006	Switzerland	Franc	1.7236
Colombia	Peso (o) (1)	2304.05	Luxembourg	Franc	46.3012	Syria	Pound	53.4668
CIS	Ruble (m)	29.282	Macao	Pataca	8.0572	Taiwan	Dollar (o)	34.98
Comoros Rep.	Franc	564.6689	Madagascar	Franc	6565.00	Tanzania	Shilling	890.00
Congo Rep.	CFA Franc	752.8918	Malawi	Kwacha	73.00	Thailand	Baht	45.74
Congo Dem. Rep.	Franc (3)	4.4999	Malaysia	Ringgit	3.80	Togo Rep.	CFA Franc	752.8918
Costa Rica	Colon	329.57	Maldive Is.	Rufiyan	11.77	Tonga Is.	Pa'anga	2.1556
Cote d'Ivoire	CFA Franc	752.8918	Mali Republic	CFA Franc	752.8918	Trinidad/Tobago	Dollar	6.09
Croatia	Kuna	8.1241	Malta	Lira *	2.1908	Tunisia	Dinar	1.465
Cuba	Peso	1.00	Martinique	Franc	7.5289	Turkey	Lira (7)	1328500.00
Cyprus	Pound *	1.5223	Mauretania	Ouguiya	254.54	Turks & Caicos	US$	1.00
Czech Republic	Koruna	38.809	Mauritius	Rupee	29.55	Tuvalu	Aus. Dollar	1.9446
Denmark	Krone	8.5219	Mexico	New Peso	9.31935	Uganda	Shilling	1784.60
Djibouti	Franc	175.00	Moldova	Lei	12.9305	Ukraine	Hryvnia	5.3693
Dominica	E. Car. $	2.70	Monaco	Franc	7.5289	United Kingdom	Pound *	1.4289
Domi. Rep.	Peso	16.30	Mongolia	Tugrik (m)	1097.00	Uruguay	Peso (m)	11.3925
Ecuador	Sucre (o) (2)	1.00	Montserrat	E. Car. $	2.70	U.A.E.	Dirhan	3.6729
Egypt	Pound	3.9485	Morocco	Dirham	11.6727	Uzbekistan	Sum	775.00
El Salvador	Colon (d)	8.752	Mozambique	Metical	21550.00	Vanuatu	Vatu	141.80
Eq'tl. Guinea	CFA Franc	752.8918	Myanmar	Kyat	6.757	Vatican City	Lira	2222.4046
Estonia	Kroon	17.9013	Namibia	Dollar	8.045	Venezuela	Bolivar (d)	723.235
Ethiopia	Birr (o)	8.335	Nauru Is.	Aus. Dollar	1.9446	Vietnam	Dong (o)	14911.00
European EMU	Euro*	0.8713	Nepal	Rupee	74.8288	Virgin Island BR	US$	1.00
Faeroe Is.	Krone	8.5219	Neth. Antilles	Guilder	1.79	Virgin Island US	US$	1.00
Falkland Is.	Pound *	1.4289	Neth. Antilles	Florin	1.79	West. Samoa	Tala	3.4904
Fiji	Dollar	2.2994	Netherlands	Guilder	2.5294	Yugoslavia	New Dinar (6)	68.2197
Finland	Markka	6.8244	New Zealand	Dollar	2.4137	Zambia	Kwacha	3715.00
Fr. Pacific Is.	Franc	136.8893	Nicaragua	Gold Cordoba	13.40	Zimbabwe	Dollar (5)	55.50
France	Franc	7.5289	Niger Rep.	CFA Franc	752.8918			
French Guinea	Franc	7.5289	Nigeria	Naira (m)	113.00			
Gabon	CFA Franc	752.8918	Norway	Krone	9.1523			
Gambia	Dalasi	16.10	Oman Sultanate	Rial	0.3851			

(n/a) Not Available. * U.S. Dollar per national currency unit. (a) Parallel. (c) Commercial. (d) Free market. (f) Financial. (m) Market. (o) Official. (1) Colombian peso allowed to float freely on 9/27/99. (2) Ecuador adopts U.S.dollar. (3) Congo Democratic Republic, formerly Zaire Democratic Republic, Congolese franc is new currency. (4) Angolan kwanza revalued on 12/13/99. (5) Zimbabwe dollar delvalued by approximately 24 percent on 2/8/00. (6) Yugoslavian new dinar is now "managed float," linked to euro/mark. (8) 7urkish lira allowed to float freely on 2/22/01.

Strategies, from Page 4

follow the U.S. out of the downturn.

That is all highly speculative, however. No one can say with any certainty how the two economies will shape up in absolute or relative terms in the second half of this year.

We had thought that the dollar's safe-haven status combined with the concerns about introduction of the physical euro in January would leave the dollar with an edge albeit if by default. In the event, U.S. corporate earnings lamentations could discourage capital flows into U.S. stocks through the third quarter (barring a late-summer rally predicated on the Fed scenario outlined above) and European companies under earnings pressure aren't likely to be making U.S. acquisitions with quite the same gusto as previously. This could take pressure off the euro and allow it to move into a somewhat less undervalued trading range closer to $0.90, though we hesitate to suggest that the euro is yet capable of levels over that barrier.

The U.S. corporate earnings lamentations could discourage capital flows into U.S. stocks through the third quarter.

Even at last week's closing level of $0.8715, there was plenty of skepticism out there as to the euro's ability to hold its gains. ***Citibank***'s strategy team expects the euro to disappoint one more time, based on fundamentals (an anticipated U.S. cyclical upturn) and technical factors (an overbought euro based on the two-month high in net long positions by non-commercial participants at the IMM, as well as euro call pricing).

Elliott Wave analyst *Steven Poser* at ***Poser Global Market Strategies*** says the euro rally could be over, given a seemingly complete wave pattern (with sufficient ambiguities to require a confirmatory leg down).

We would not write off the euro this time, though we would certainly maintain stops around $0.8525 to preserve marginal gains on the portfolio, looking for value again on a $0.83 handle or possibly the low $0.84's. If the euro has limited upside potential, it may at least be in a longer-term ratcheting-up move. So the most important information to be had from this maneuver may be its floor upon correction.

Dollar strength is still the market's governing principle. But there are enough straws in the wind, fundamentally, technically and politically in terms of emerging Bush administration monetary policy nuances, to warrant keeping an open mind on the euro. Why shouldn't the euro trade with a $0.90 handle, after all?

A move through $0.90, perhaps encouraged by the Bush administration if not the Fed, could help the U.S. technology sector draw down inventories by encouraging investment in the next business cycle by European businesses and consumers (it's hard to see much demand coming out of Asia).

Actual and Forecast FX Ranges, *F&T* Outlook for Major Currency Pairs
(Exchange Rates from Thomson Financial/IFR, Boston)

Currency Pair	*Prior Range*	*Forecast Range*	*Last Week*	*Last Seen*	*Change (%)*	*Two-Week Outlook*
USD/Euro	0.8485–0.8790	0.8525–0.8875	0.8530	0.8715	+2.17%	Neutral
DEM/USD	2.2251–2.3050	2.2038–2.2942	2.2929	2.2442	–2.12%	Neutral
JPY/USD	122.65–125.65	122.25–125.75	123.80	122.90	+0.73%	Positive
JPY/Euro	106.25–108.60	105.50–109.50	105.55	107.05	–1.42%	Positive
JPY/DEM	54.32–55.53	53.94–55.99	53.97	54.73	–1.42%	Positive
USD/GBP	1.3925–1.4355	1.4000–1.4500	1.4065	1.4300	–1.67%	Neutral
GBP/Euro	0.6070–0.6180	0.6050–0.6150	0.6060	0.6095	–0.58%	Neutral
DEM/GBP	3.1648–3.2221	3.1802–3.2328	3.2274	3.2089	+0.57%	Neutral
CHF/USD	1.7150–1.7805	1.7100–1.7800	1.7720	1.7255	+2.62%	Positive
CHF/Euro	1.5010–1.5145	1.5000–1.5200	1.5115	1.5035	+0.53%	Neutral
SEK/Euro	9.1822–9.2968	9.1500–9.3000	9.2490	9.2891	–0.43%	Neutral
CAD/USD	1.5320–1.5470	1.5250–1.5500	1.5270	1.5435	–1.08%	Positive
USD/AUD	0.5040–0.5185	0.5000–0.5200	0.5045	0.5070	–0.50%	Positive
MXN/USD	9.0970–9.3800	9.0500–9.3500	9.3550	9.1460	+2.23%	Neutral
BRL/USD	2.4440–2.6070	2.3500–2.4500	2.5410	2.4490	+3.62%	Cautious

Foreign exchange pairs given per U.S. convention. Percent change refers to numerator in respective currency pair; positive change means that the denominator, or base currency, has gained. Outlook refers to base currencies, with the exception of the Canadian dollar, Mexican peso and Brazilian Real; in those cases it refers to the two-week outlook for the CAD, MXN or BRL against the USD.

A firmer euro would alleviate ECB inflation concerns and pave the way to further rate cuts. Though last week's ***Group of Seven*** (G7) communiqué did not mention foreign exchange, the thrust of G7 policy often emerges in the aftermath of such gatherings as officials drop comments which markets then parse.

The market is certainly primed for comments favoring a weaker dollar, but will the fuse be lit?

Dollar-Yen Higher Again

The correction in dollar-yen has probably run its course, though the market could thrash around in the ¥122 to ¥123 area over the next couple of weeks, through the Japanese Upper House elections and their aftermath, as economic policy ramifications are sorted out.

Consensus expects *Junichiro Koizumi*, the reform-minded Prime Minister, to receive an effective mandate through the balloting, though the irony of rewarding his inept and entrenched ***Liberal Democratic Party*** (LDP) cannot be lost on Japanese voters. Be that as it may, Koizumi must deliver a convincing reform package in short order after the election or lose the astonishing popular appeal which is his greatest strength.

Beyond this, ***Bank of Japan*** (BoJ) Governor *Masaru Hayami* stated that "an early execution of the first reform measures is needed" for the BoJ to consider easing policy further. "The question of (monetary policy) comes after demand is strengthened," Hayami said.

We would not underestimate the capacity of the LDP or the Japanese bureaucracy to impede Koizumi's progress in implementing reforms. No doubt, the LDP establishment regards him as a conveniently charismatic face to present to a jaded public. However, he is also a dangerous maverick, and they will seek to re-establish the Old Boy principle of governance at the first opportunity.

Koizumi, as well as the more seasoned members of his cabinet, such as *Heizo Takenaka*, the economy minister, appear to understand the power that he can wield at this point in Japan's long economic decline. The new cadre seems to be ready to exercise that power in the name of the consensus of voters as opposed to that of LDP elite.

Based on what we have seen of Koizumi so far, we would expect him to roll out a substantive package of reform measures and economic initiatives quite soon after the election—in days, not weeks. He has had his honeymoon with the electorate. Now, he needs to produce, or he will lose both momentum and the popular support that he will need once the reforms start to bite. Therefore the move in dollar-yen and euro-yen could be quick, if Koizumi moves as we anticipate and the market decides to trade on that.

Japanese participants will be a critical determinant in the move, so it will be interesting to see if dollar-yen rallies out of the box on July 30th, as the market grapples with the election results. An alternative scenario would involve euro-yen becoming the favored vehicle, if a dollar-mood takes hold during the run-out from the tumultuous Genoa economic summit.

Swiss Franc Technical Warnings

Dollar-Swiss franc has apparently generated some alarming technical signals.

Market News International quotes ***Brown Brothers Harriman*** technical analyst *Jerry Ficchi* as saying a sustained move beneath the pair's 200-day moving average, at CHF1.7220, is a "sell" signal. Weekly momentum studies are clearly falling and monthly studies are starting to follow suit. Ficchi sees an eventual test of the CHF1.6675 level, though on an intermediate to long-term view, but sees that as the limit of the move on an initial attempt.

Citibank technicians see "ominous developments" in the pair, suggesting it may have completed a five-wave Elliott sequence up from the October, 1998, low. However, the fifth wave failed to set a new high, forming some suspicious technical patterns in the charts including a "gravestone *doji*," which sounds like trouble, though we are not candlestick adepts.

> ***Bank of Japan*** **Governor** ***Masaru Hayami*** **stated that "an early execution of the first reform measures is needed" for it to consider easing policy further.**

What does make sense to us is that dollar-Swiss is sitting on its 55-week moving average at CHF1.7179 (last week's close CHF1.7255), reminiscent of the position in July, 1998, when a big dollar-Swiss franc correction ensued.

"A weekly close below this 55-week average would suggest an acceleration down to the 200-week average" at CHF1.5630, the Citibank team concludes.

Given Swissie's traditional role as a harbinger of moves in dollar-mark, we would stay tuned. ❑

Foreign exchange analysis and recommendations by Brendan Murphy, founder and chief executive of ***fxotica.com****, The Global Currency Channel.* ***Market News International****, New York, and* ***Thomson Financial-IFR****, Boston, have provided information and data for this report.*

***NCUs*, from Page 3**

spectively. The other euro zone member states will end the dual regime on February 28th, 2002.

Approximately €14 billion in euro notes and €50 billion in euro coins are being produced for use as of January 1st, 2002. Billions of existing national currency bank notes held both inside and outside the euro zone will have to be withdrawn from circulation. Large amounts of "under the mattress" and black market money are expected to be spent over coming months, or converted into a currency that will continue to exist after the end of the year.

End of the "No Compulsion" Principle

The substitution of the euro for each participating national currency on January 1st, 1999, did not in itself alter the denomination of existing contracts. When a contract stipulated a particular currency unit for payment, payment would continue to be made in that currency unit during the transition period, unless the parties otherwise agree or unless the amount is payable by crediting the recipient's account.

> **Corporate issuers of bonds and other debt securities in NCUs have been slow to re-denominate their securities voluntarily.**

In cases in which an amount denominated in euros or in the NCU of a participating member state is payable within that same member state by credit to the creditor's account, the debtor has a choice: he can pay in either of those units.

This option is currently exercisable when, for instance, an amount in French francs is payable within France by crediting it to the creditor's bank account in Paris, even if the payment originates—or one or both parties are located—outside France. It would not apply if an amount in French francs is payable to an account in a different member state, such as an account in Frankfurt.

The option would also not apply if the amount were denominated in a currency different to that of the member state where the account is credited. For instance, a Deutschemark debt could not be discharged under this option by a payment in euros to a bank account in Paris, unless otherwise agreed by the parties.

The reason for this limitation is that the receiving bank should be obliged to convert only between the euro and the NCU of the member state where the account is located.

The position will change fundamentally from January 1st, 2002. NCUs will cease to exist. Instead all non-cash payments must be made and received after that date only in euros.

The unit of account in which a monetary obligation is expressed may be voluntarily re-denominated during the transition period, from a participating NCU to the euro. If they have not been not previously re-denominated, all contracts and other legal instruments existing at the end of the transition period in NCUs will be treated as if references to them were to euro units at the fixed conversion rate.

This principle, widely known as the "read as euro principle," will be of central importance.

The mandatory rounding rules laid down in the euro regulations will also apply. These rules provide that monetary amounts paid or accounted for when a rounding takes place after a conversion into euro shall be rounded up or down to the nearest euro cent. If the application of the conversion rate gives a result that is exactly half way, the sum is rounded up.

Re-denomination of Securities

Corporate issuers of bonds and other debt securities in NCUs have been slow to re-denominate their securities voluntarily to the euro. There has been some debate whether issuers will need formally to re-denominate on January 1st, 2002, or whether they can simply rely on the "read as euro" principle.

The ***European Commission*** (EC) has stated that formal re-denomination is not essential, although it may be desirable to re-denominate, and then re-nominalize, to avoid having holdings stated in awkward decimal figures.

Another question is how interest on bonds denominated in NCUs will be calculated. Will interest be calculated on the amount of the bond as "read as euro," or on the original amount of the bond in its NCU, with the amount of interest so calculated being converted to euro?

The Commission has recommended the first approach as most consistent with the "read as euro" principle. This is expected to be followed in Germany, Italy, The Netherlands and Austria, but not in Belgium and Greece. The ***Euroclear*** and ***Clearstream*** systems have opted for the second approach, in order to avoid any possible change to present calculation terms for bonds.

The difference between the results of the two approaches is likely to be small. It will be left to national law to determine which should be followed.

Company Share Capital and Accounts

Similar questions apply in relation to companies incorporated in the euro area with share capital denominated in legacy currency units. If this is not voluntarily re-denominated before the end of 2001, will it need to be formally re-denominated to euro on January 1st, 2002?

The EC has stated that this is not essential unless and until a company decides to increase its capital or issue new shares. New shares must be issued in the euro as of January 1st, 2002.

Again, the method of implementation will be decided by national law. In some member states, all share capital will be automatically re-denominated at the end of the transition period.

Company accounts for periods ending before January 1st, 2002, can be prepared either in NCUs or euro (even if they are filed in 2002 or later), unless otherwise required by national law. Only a minority of member states, e.g., France and Greece, are expected to insist on all accounts filed after January 1st, 2002, being in euro.

Checks and Travelers Checks

Industry guidelines have been issued by the ***European Credit Sector Associations*** for checks and travelers checks. Briefly, no check should be issued in a NCU after December 31st. Any checks dated after December 31st in a national currency—for instance, a post-dated check—are likely to be returned, with a request that they be replaced by euro checks.

Deadlines for clearing national currency checks will vary among member states, ranging from February 28th to early July, 2002. Bankers and customers will be encouraged to ensure that cross-border checks specify the denomination of the check and the country of its origin.

The sale of travelers checks in NCUs after September 1st will be strongly discouraged. Travelers checks will cease to be sold altogether after December 31st. Banks accepting NCU travelers checks should present them to the issuer, or the bank representing the issuer, by Friday, February 15th, 2002, through the normal clearing procedure. They will then be paid and cleared by February 28th, 2002.

The introduction of euro checks will not lead to check clearing systems being reorganized on a pan-European basis; this will continue on a national basis. Therefore, a euro check drawn on a bank in Germany will continue to be cleared through the German clearing system. In cases in which a euro check is drawn on a bank in one country in order to make a payment in another country, the check will be treated as a foreign check in the second country and the recipient is likely to incur a collection charge.

Payments in the UK

While the UK is outside the euro zone, payments may be freely made in euro in the UK, if mutually agreed by the parties to a contract or if the contract confers on one party the option to pay in euro.

In practice, after January, 2002, the euro is expected to become the most widely used foreign currency in the UK for businesses. Although a party to a UK domestic transaction is not obliged to accept a check drawn in euro, it may do so if it wishes.

Historical Information

Many large companies with substantial operations in the euro area currently keep internal records in one or more national currencies. A major logistical exercise is likely to be involved in converting those records from national currencies to the euro and many companies wish to carry out this change on a phased basis or to avoid the need for conversion altogether.

After January, 2002, the euro is expected to become the most widely used foreign currency in the UK for businesses.

The question arises whether companies may continue to maintain their internal records in national currencies after December 31st. This may have accounting and regulatory implications, as well as legal implications. The general view of the EC is that internal accounts, historical data and records relating to transactions entered into prior to January 1st, 2002, may continue to be maintained in NCUs after that date, unless required to be converted to euro by national law.

Austria, Belgium, France, Finland, Ireland, The Netherlands, Portugal and Spain have already stated that there is no obligation under their national law to convert historic data and records. Greece and Italy are expected to require conversion.

If information is reported externally on such matters as the amounts of non-re-denominated bonds or shares, it must be expressed in euro as of January 1st, 2002.

Greek Entry

Greece became an “in” member state on January 1st, 2001, and will move to full changeover to euro at the same time as “first wave” states, on January 1st, 2002.

The ***Hellenic Bank Association*** ceased publishing Athens inter-bank offered rate (ATHIBOR) on December 28th, 2000. Under a framework law passed by the Greek Parliament in September, 2000, references to ATHIBOR as a benchmark rate in existing documentation will be replaced, un-

See *NCUs*, Page 10

***NCUs*, from Page 9**

less otherwise agreed by the parties, by references to euro inter-bank offered rate (EURIBOR).

Similarly, transactions referring to ATHIBID and ATHIMID will be settled on the basis that ATHIBID equals EURIBOR minus 6 basis points and ATHIMID equals EURIBOR minus 3 basis points.

The ***International Swaps and Derivatives Association, Inc.*** (ISDA) has produced a specific protocol for existing OTC derivatives denominated in Greek drachma. This is modeled on the protocol produced by ISDA in 1998 for the first wave. It deals with such matters as contract continuity, replacement of price sources and changes to business days. The deadline for adherence to the protocol was December 15th, 2000.

Dual pricing is now widespread in the euro area, although doubts have been expressed about its effectiveness.

Dual Pricing

This practice is now widespread in the euro area, although doubts have been expressed about its effectiveness. Consumers appear to have paid less attention to euro pricing than expected. Further thought is being given to how labeling can be used effectively to teach consumers about the euro.

Some member states, including France, are considering reversing dual pricing during the latter part of 2001, by showing the price first in euros and then in NCUs. The EC intends to address this question in a further recommendation.

Usage of the euro (outside financial markets) is increasing but is still limited. It will accelerate markedly as the final conversion to the euro approaches.

Planning for the Changeover

The launch of the euro was a technical success and orderly transition was achieved in financial markets, in changing systems to trade in euro and to process euro payments. Usage of the euro (outside financial markets) is increasing but is still limited. It will accelerate markedly as final conversion to the euro approaches. New transactions that are currently carried out in NCUs will have to be carried out in euro as of the end of the transition period, and many businessmen may choose to make this switch in advance of 2002. For example, they will need to decide:

- when during 2001 they start to write new contracts in euro rather than NCUs;
- whether they wish formally to re-denominate and re-nominalize their bonds, debt securities or share capital denominated in NCUs and, if so, when;
- when to convert bank accounts and standing settlement instructions to euro;
- whether they should, as a precaution, maintain one account in each relevant national currency for, say, the first quarter of 2002, in order to catch any late or misdirected payments;
- when they will start to issue checks in euros and buy travelers checks in euros;
- whether they will continue to maintain internal records and historical data for transactions in a NCU or to convert them to the euro;
- whether they will show prices in dual currency units; and
- what staff training will be required.

It is essential that every businessman identifies how the changes will affect his business and prepares for them well in advance. ❑

*Geoffrey Yeowart is a partner of **Lovells**, based in London. He is a member of the Bank of England's City Euro Group and H.M. Treasury's Euro Business Advisory Group. The views expressed in this article are the author's personal views and do not constitute legal advice in relation to a particular transaction or situation. This article is an updated version of an article first published in the "Journal of International Financial Markets," No. 1, 2001.*

Foreign Exchange Market Options Data

Provided by *Bank of America*

				Implied Volatility for At–the–Money Options					
	7/20/01	Year Ago	% Chg. $ Value	1 Week	1 Month	2 Month	3 Month	6 Month	1 Year
EUR/USD	0.8750	0.9347	6.39%	12.0/13.0	11.7/12.0	11.7/12.0	11.8/12.1	11.8/12.1	11.9/12.2
USD/JPY	123.33	108.62	13.54%	9.1/10.1	9.6/ 9.9	10.0/10.3	10.1/10.4	10.3/10.6	10.6/10.9
GBP/USD	1.4292	1.5148	5.65%	8.1/ 9.1	8.4/ 8.8	8.5/ 8.8	8.6/ 8.9	8.7/ 9.0	8.8/ 9.1
USD/CAD	1.5400	1.4715	4.66%	6.0/ 7.0	6.3/ 6.7	6.3/ 6.6	6.2/ 6.5	6.1/ 6.4	6.0/ 6.3
AUD/USD	0.5130	0.5871	12.62%	13.0/14.0	13.0/13.4	12.9/13.2	12.8/13.1	12.5/12.8	12.3/12.8
USD/CHF	1.7220	1.6586	3.82%	11.5/12.5	11.1/11.4	11.1/11.4	11.1/11.4	11.3/11.6	11.4/11.7
USD/MXN	9.1870	9.3350	–1.59%		12.0/13.0	12.1/12.9	12.1/12.9	12.1/12.9	12.1/12.9
USD/BRL	2.5040	1.7950	39.50%		24.4/25.7	22.5/23.6	20.5/21.5	18.0/19.0	17.0/18.0
USD/HKD	7.7994	7.7970	0.04%		–0.1/ 0.5	–0.1/ 0.5	0.0/ 0.4	0.3/ 0.6	0.4/ 1.4
EUR/JPY	107.92	101.41	–6.42%	11.5/12.5	11.8/12.1	12.1/12.5	12.3/12.6	12.6/12.9	12.7/13.2
EUR/CHF	1.5064	1.5496	2.79%	4.0/ 5.0	4.2/ 4.5	4.2/ 4.5	4.2/ 4.5	4.2/ 4.4	4.2/ 4.5
EUR/GBP	0.6118	0.6169	0.83%	8.3/10.3	9.0/ 9.3	9.0/ 9.3	9.0/ 9.3	9.0/ 9.3	8.9/ 9.3

Implied Volatilities

As expected, we saw a lot of U.S. MNC activity, using these levels to hedge long euro exposure. However, there seemed to be more interest in option spreads, rather than outright purchases of euro puts.

In EUR/GBP, yesterday's bearish close leaves a topping pattern in place. Implied vols are softer.

CAD vols remain in the mid-6's, despite spot above 1.54. There are barriers in the mid-1.54's and this seems to be adding some gamma to the market.

Islamic Banking and Finance

Demystifying the principles that govern access to capital throughout the Islamic community.

Warren Edwardes, Delphi Risk Management Consulting

It is simply an accepted fact that there are sufficient Muslim investors and borrowers, in both Islamic and non-Islamic countries, to warrant the attention of traditional banks. Institutions that seek to serve such clients stand to capture a potentially profitable slice of a still relatively-untapped market.

I seek to clear away some of the mystery, showing how some such Islamic products can fit alongside a conventional banking system. Thereby, the combination can either serve a Western bank's retail and wholesale clients, or help a corporation that is offered Islamic funds. Some non-Islamic financial or exporting institutions may also find it prudent to use Islamic finance so as to curry favor in Islamic markets, thereby easing entry or enhancing business.

Basic Principles

There are two tenets that provide the foundation for Islamic finance:

- interest, usury or *Riba* (terms used interchangeably) is prohibited; and
- social and ethical features incorporated in the system avoid undesirable investments and enhance trade.

The prohibition of *Riba* is akin to usury laws in Western countries, a ban on excessive interest.

What I would call "pure" Islamic banking, appears to be similar to venture capital finance, non-recourse project finance or ordinary equity investment. The investor takes a share in the profits, if any, of the venture and is liable to lose his capital. It involves investing but not lending.

Some products are more Islamic than others. Just as in tax management, numerous products have been developed to meet the letter, but not necessarily the spirit, of the regulations.

An example would be the process of converting interest into capital gains for tax purposes. Early Islamic investors were content to deal with zero-coupon bonds or discounted Treasury bills, receiving the foregone interest in the form of capital gains.

In the mid-1980s, the "Islamic" client bought a low interest-rate currency or even gold from the bank. This was placed on deposit interest-free. Simultaneously, the currency or gold was sold forward, with the forward reflecting the fact that no interest is paid on the deposit.

Such locked-in capital gains are now usually regarded as interest for tax purposes. Similarly, many such devices of converting interest to capital gains are increasingly unacceptable to the Islamic authorities. It has been my personal observation that about 85 percent of Islamic banking as practiced involves some form of predetermination of profit or "mark-up" that, while acceptable to individual Islamic authorities, would be regarded as capital gains to most fiscal authorities.

For some institutions, appearances are important in terms of being seen to be Islamic in the eyes of their customers, shareholders and regulators. Even when there is a guaranteed return generated through a "mark-up" scheme, the linking to an underlying trade transaction is deemed "a good thing."

Just as there is no central, global fiscal authority, there is no Islam-wide authority that determines what is *Hallal* (acceptable) and what is *Haram* (prohibited). This creates the exposure that some will go around "opinion-hunting" to get Islamic approval for their schemes, just as Western banking business moves from one tax jurisdiction to another.

As in tax management, numerous products have been developed to meet the letter, but not necessarily the spirit, of the regulations.

Beyond the question of interest are ethical issues. Islamic investments exclude tobacco, alcohol, gaming and other "undesirable" sectors.

Islamic investors, by and large, are motivated in their choice of investments by much the same criteria as their Western ethical counterparts. The search for acceptable investments is balanced by natural risk-aversion. Islamic borrowers also demonstrate a reluctance to give away a share in the profits of their enterprise.

It is therefore not surprising that most Islamic banking takes the form of one type of

See *Islamic*, Page 12

***Islamic*, from Page 11**

mark-up or other rather than profit sharing. But Islamic banking is still very much a fledgling industry, with only 20 years of practice.

Key Islamic Financial Instruments

Mudaraba: Under the principle of "no pain, no gain," no one is entitled to any addition to the principal sum if he does not share in the risks involved. The capital provider, or *rabbulmal*, may '"invest" through an entrepreneur, borrower or *Mudarib*, hence the name of the structure.

Profits are shared on a pre-agreed basis but losses, if any, however, are wholly suffered by the rabbulmal. The *Mudaraba* financing structure is similar to non-recourse project finance.

Shirka: *Shirka* is a partnership between two or more persons. There are two types, *Shirka al-milk* (non-contractual) and *Shirka ul-uqud* (contractual).

In the case of the contracting partnership, bounds are set. If the entrepreneur falls beyond these bounds, then he is liable for the loss.

Musharaka: Financing through equity participation is called *Musharaka*. In this case, the partners or shareholders use their capital through a joint venture limited partnership to generate a profit.

An Islamic form of leasing is called *Ijara*. As in Western leasing, there may be an option to buy the goods built into the contracts.

Profits or losses will be split between the shareholders according to some pre-agreed formula, but the split would not necessarily be linked to the investment ratio. Technically, there are no fixed rules, though the use of the investment ratio is deemed fair. However, the allocation has to take into account resources contributed by each party, not necessarily financial such as experience and expertise.

Mudaraba and *Musharaka* represent the desired forms of Islamic banking even though their current use is not dominant.

Murabaha: This is also known as *Morabaha*. The majority of Islamic financial transactions do not involve a share of profit but incorporate a locked-in return. Most are mark-up structures such as *Murabaha*. In my opinion, it is similar to the "repo," or sale and repurchase, agreements used in the West.

In a *Murabaha* transaction, the bank finances the purchase of an asset by buying it on behalf of its client. The bank then adds a mark-up in its sale price to its client who pays for it on a deferred basis.

The "cost-plus" nature of *Murabaha* sounds very much like the "interest into capital gains" structures used by tax evaders. However, Islamic banks are supposed to take a genuine commercial risk between the purchase of the asset from the seller and the sale of the asset to the person requiring the goods. It is therefore argued that the services provided by Islamic banks are substantially different from those of moneylenders.

Many organizations pragmatically use LIBOR as the reference basis for their mark-ups, as being the market rate for funds with a small percentage for the firm's profit.

Ijara: An Islamic form of leasing is called *Ijara*. The bank buys machinery or other equipment and leases it out under installment plans to end-users.

As in Western leasing there may be an option to buy the goods built into the contracts. The installments consist of rental for use and part-payment.

Baisalam: When a manufacturer seeks to finance the production of goods, he seeks *Baisalam* financing. This involves the bank paying for the manufacturer's goods at a discount before they have been delivered or even produced. It is thus similar to bankers' acceptance financing in the West.

Baisalam involves advance payment for goods to be delivered later. There is no sale unless goods exist at the time of the deal, except in cases in which goods are defined and a date is fixed. This sounds like a variation on commodity futures. However, a central condition is the advance payment and parties cannot reserve the option of rescinding the contract. If there is a product defect on delivery then there is redress.

Baisalam is typically used for the purpose of funding agricultural production, i.e., to help a farmer buy seed, and receiving a portion of the crops to sell at market.

Key Features of Islamic Banking

There are five key features that characterize Islamic banking, as described in the following paragraphs.

Interest free: Avoidance of interest has been abused by those who merely seek to be seen to be Islamic bankers. Many convert interest into capital gains and find a Koranic justification. The rules have been tightened progressively as they have been in tax avoidance.

Trade related: I am not going to criticize trade-related, "legally Islamic" devices, converting interest to capital gains. Any such instruments have to show some underlying commercial need and therefore probably go some way towards the Islamic objectives. There are Western parallels, involving commercial paper and bankers' acceptances, which also have to be trade-related.

Many emerging markets, under their exchange control regimes, insist that all overseas financing or foreign exchange transactions have to be trade-related.

Equity related: Pure Islamic banking involves profit and loss sharing or equity participation in the *Mudaraba* and *Musharaka* structures. There is no pre-determined interest income for the lender, or, in this case, the investor. The investor's return is uncertain.

The idea sounds attractive and represents just the sort of venture capital financing many in the West have been demanding of their risk-averse banks.

No exploitation: Devices can be created so that pre-determined "interest" can be made to look like pre-determined capital gains, and a tiny bit of uncertainty can also be introduced into the equation. Under all circumstances, however, there is also a requirement to avoid exploitation.

What if, under a profit sharing arrangement, because of the entrepreneur's poor bargaining position and the banker's monopoly status, the bank received 95 percent of a venture's profits? Would this be deemed Islamic?

Surprisingly, perhaps it would. This is because there do not appear to be hard and fast rules that determine fair profit sharing ratios or define "exploitation."

Ethical investments: Islamic investments have to avoid undesirable sectors. In this respect, Islamic banking is little different from many Western "ethical" investment funds. There is a considerable overlap between such funds' objectives and those of many of the Islamic investment funds.

Conclusion

While Islamic bankers have sought to avoid excessive risk through *Murabaha*, *Ijara* and *Baisalam*, the essential element of most such deals is the linking to a genuine identifiable trade transaction. Islamic finance seekers thus have to open themselves up to their banks even more than their Western counterparts and can only obtain finance for genuine needs.

Firms or individuals cannot borrow to repay another bank. General-purpose finance or borrowing for consumption, overdrafts and "swing lines" do not exist. Profit and loss sharing structures, i.e., *Musharaka* and *Mudaraba*, are difficult to obtain.

Such business is not unknown in Western banking. It is called "investment banking."

Almost all forms of Western banking have Islamic counterparts. There are Islamic versions of repos, leasing, unit trusts, installment purchases, equity investments, venture capital and non-recourse project finance. There are also non-Islamic parallels to ethical investment fund management.

Perhaps replacing the exotic Arabic terminology with its English analogue will lead to a greater understanding of Islamic banking. It also appears that, given a choice between a pure Islamic bank and a highly-rated reputable international bank providing the same service, Islamic clients would rather go to the one that has a brand name than the one that provides Islamic-only services, without the brand name and rating.

Pure Islamic banking involves profit and loss sharing or equity participation in the *Mudaraba* and *Musharaka* structures.

For the latter reason, I see Western banks increasingly and successfully providing Islamic banking and financial services. ❑

Warren Edwardes is CEO of ***Delphi Risk Management****, a London-based financial instrument innovation and risk management consulting firm. Mr. Edwardes, a regular contributor to F&T, has been involved with Islamic banking since 1985 and has been elected a Fellow of* ***The Institute of Islamic Banking and Insurance****. He has spoken at, and chaired, Islamic banking conferences, and is regularly quoted on the subject. This article is an abridged version of Appendix 4 of his book,* Key Financial Instruments: Understanding and Innovating in the World of Derivatives. *Copyright is retained and it is reproduced here by permission of the publishers, Financial Times Prentice Hall, and the author. Those interested in obtaining additional information about Islamic banking and finance can visit the Delphi Web site at* www.dc3.co.uk*; the complete text of the Appendix is available on-line at* www.dc3.co.uk/islamicbanking.htm*, and Warren may be contacted by e-mail at* we@dc3.co.uk *direct.*

Trade, from Page 1

Importance of Credit Analysis

A bank's loan portfolio comprises the bulk of its assets and provides the major source of its earnings and profits. Sound banking practices require strong assurances that loans will be repaid. Lending activities are governed by the requirement for maximum safety of the bank's loan portfolio, and the low return characteristic of low-risk investments.

Credit analysis serves to screen loan propositions and monitor continuing lending relationships. This identifies risks in a lending situation, draws conclusions as to likelihood of repayment, and helps to structure a loan facility reducing perceived risks and providing the bank a margin of profit. Credit analysis is essentially risk analysis.

Expansion and increasing complexity demand better and longer range planning by managers, and evaluation of that planning by bankers.

Financial statements provide a rich mine of data. Expert evaluation of historical financial statements provide indicators that may foreshadow difficulties or predict the likelihood of success in repayment of a bank loan at some future time. Therefore, they should be an essential element for the day-to-day knowledge of a business, its operations, and management, the most useful tools available to bankers for credit analysis when they are accurate.

In the past, lenders made successful loans without having financial statements to assist in evaluating creditworthiness of a client. What they lacked in detailed information they made up in personal knowledge of clients and their business activities, their management ability, ethics and character.

These lenders became familiar with the nature of the client's business. They understood what it took to manufacture and sell the product and areas of risk in the operation. They developed personal knowledge of the local business environment—economic trends, political and legal environment, and industry and business practices and norms. In today's business world, such personal knowledge, gained through experience and personal proximity to the customer, is neither practical nor possible.

"Asset-based lending" should entail strong emphasis on collateral controls of liquid assets by the lender or a third party management company.

The growth of business, both in size and complexity, has diluted the ability of one person to be the sole decision maker and know all that is going on in the business. In addition, the increasing size and complexity of the banker's marketplace has diluted the banker's ability to acquire complete personal information about each loan proposition.

This same process of expansion and increasing complexity demands better and longer range planning by business managers, and an evaluation of that planning process by bankers.

Financial statements have evolved as primary tools to assist business managers in operating the business (internal financial statements) and to assist outside investors and creditors in evaluating the business management (published financial statements). They should be, first and foremost, a reflection of a company's decisions and should not be viewed as isolated, self-contained statements of fact.

Each company has a unique asset transaction cycle, which is determined by the nature of the business and how it operates in the marketplace. Studying what is involved in a particular company's asset transactional cycle provides a basis by which to understand and evaluate its financial statements.

In our firm's experience as credit support managers, we have found that one of the important factors in the analysis of a company's asset investment is the quality, and liquidity, of the assets. Since the lender is interested in lending to a business on an ongoing concern basis, the control, monitoring and evaluation of liquidity is important to measure the credit worthiness of a client.

The Appropriate Choice

In emerging markets, the most appropriate lending rationale should be asset-based lending.

Before the 1980s, asset-based lending was narrowly defined. It simply involved granting operating funds against a borrowing company's trading assets-accounts or notes receivable, chattel paper or documents, and leases besides equipment.

Such loans either pay out on a short-term basis or revolve up and down based on the changing level of the borrower's collateral. This type of loan seemed to fit neatly into the floating lien concept as defined by the *Uniform Commercial Code*, which gives a financial institution the right of a perfected security interest in constantly changing collateral.

During the 1980s, however, the term "asset-based lending" took on a broader connotation. Lenders started to group all company assets—whether tangible or intangible, or real or personal property—and other types of credits such as amortizing term loans, into the "asset-based" category.

In our view, "asset-based lending" should consist of extending credit against a company's balance sheet assets—particularly liquid current assets— on a collateral margin basis, with strong emphasis placed on collateral controls of these assets by the lender or third party management company.

I do not consider lending against real estate as true "asset-based lending," for several reasons:

- real property is subject to state statutes, not the Uniform Commercial Code;
- real property has many different lending parameters versus other assets within a commercial borrower's balance sheet; and
- there is only a limited need to control and monitor assets that are fixed and immovable, compared to assets such as accounts receivable and inventory, which are liquid.

Finally, we do not consider asset securitization part of asset-based lending, because this has more to do with debt and security issues backed by loans and assets in raising capital that fall more into the realm of investment banking.

The Danger of Fraud

One of the great dangers of my definition of asset-based lending is that fraud will be perpetrated on the lender by pledging fictitious invoices, false inventory reports, or by diversion of collections. Fraud often comes about when a businessman is put under pressure because of a series of losses, or when, because of personal problems, one or more of the directors of the company over-extend themselves with the bank or finance company.

In spite of the fact that deliberate frauds are infrequent, the lender should always be alert to the fact that they can happen. When they do, they may lead to serious losses before being detected. Frauds may be perpetrated in so many ways that it is pointless to try to list them all.

No lender should relax its vigilance because the borrower objects to the necessary research, or because the lender has a “gut feeling” the borrower is completely honest. What a person or a company did yesterday is history, but what will be done tomorrow is unpredictable. The weakest defense that a lending officer can give after a fraud has been discovered is that he or she did not think it necessary to maintain at least routine checks on the borrower.

Supervision and Policing of Collateral

Daily supervision and policing of collateral is of prime importance. One of the aspects of accounts receivable and asset-based lending that makes it both fascinating and challenging is that each client and its account is different, so each account requires a particular form of due diligence, which can alter with changing circumstances. Imagination, practical business experience, realism, and the knowledge of a borrower’s business will dictate the type and number of tests and reviews that are needed to inspire and maintain the lender’s confidence in the borrower and the pledged collateral.

Care must be taken, however, that over-zealousness in this respect does not unnecessarily harass the borrower.

Checks and verifications keep the lender informed on what is currently happening to the collateral, rather than waiting for quarterly audits, verification reports, or statements that reveal what happened weeks or months ago.There is a real need to keep up to date on the status of the collateral and the requirement to make prompt corrections or adjustments whenever there appears to be any irregularity or diminution in value.

Third-Party Controls on Collateral

Often, it is to the lender’s advantage to establish third-party controls on overseeing the movement, in and out, or release of inventory collateral as a safety measure in assuring its availability and existence as stated. Such controls are also a good way for the lender to control advances and make adjustments to the value of disbursements or quantity of collateral held. This ensures that the loan-to-asset ratio is maintained by use of warehouse receipts, and borrowing base certificates illustrating the quantity and value of stocks held by a third party.

Each client and account is different, so each requires a particular form of due diligence, which can alter with changing circumstances.

Another type of independent, third-party control service, adopts the method of certified inventory reporting, which is similar to providing a base certificate. These companies prepare such reports reflecting the incoming and outgoing movement of inventory and accounts receivable.

Under such arrangements, the bank may often require a floor level of inventory to be maintained at all times. This third-party reporting service program is not as stringent as a warehouse receipt. Field warehouse arrangements and certified inventory control programs may be monitored and conducted on the borrower’s premises.

Insurance for Inventories

As with any loan secured by goods, it is essential to protect inventory collateral against hazard loss. It should be noted that an insurance company never pays 100 percent of the amount insured. It pays only 90 percent, so the insured should “gross up” the insurance coverage accordingly.

Inventories should be protected by fire and extended-coverage insurance. An appropriate mortgagee clause in favor of the bank should also be endorsed on policies, identifying the lender as sole loss payee as its interests may appear.

Often, it is to the lender’s advantage to establish third-party controls on overseeing the movement, in and out, or release of inventory collateral.

The customer should be obligated to pay the total premium cost of these policies, while the bank, being the loss payee, should receive any insurance proceeds as a result of damage or loss to the goods because of its collateral interest.

Lenders need to know that loans will be used for the purpose intended and should have confidence that it will be repaid on time and in full. There are several third party service companies in existence capable of identifying and mitigating your transactional risk while controlling and monitoring your end-to-end trade flow. ❑

---

*André Soumah is Managing Director of Geneva-based **Audit Control and Expertise** (ACE), a firm that provides third-party control and support services for structured trade finance arrangements like those described in this article.*

UK Torpedoes Global VAT Taxation of European E-Commerce

Multinational accounting and consulting firm ***Deloitte Touche Tohmatsu*** recently reported that the UK has opposed a revised proposal by the Swedish presidency of the ***European Union*** (EU) to apply value-added tax (VAT) on e-commerce. Instead, UK authorities have put forward an alternative recommendation for a moratorium on taxation of e-commerce.

The UK's rejection of the proposal is a blow to the Swedish presidency, which requires the unanimous approval of all member states to tax e-commerce transactions. As a result, it is unlikely the proposed VAT directive will ever come into effect. It is also unlikely the other member states will agree to a moratorium.

According to the Swedish proposal, non-EU businesses supplying digitized products to private individual consumers within the EU would be liable for VAT, thus leveling the playing field between non-EU suppliers and their EU competitors. In order to alleviate the administrative burden of multiple VAT registrations, non-EU businesses supplying digitized services only would be required to register for VAT purposes in one EU member state for all their supplies. The revenue from the registration would be redistributed among the EU member states through a clearinghouse-type system.

The ***European Commission*** has been exploring ways to tax electronic transactions for the past five years. Non-EU suppliers of music, games, books and software that can be downloaded from the Internet will welcome the UK move because they will not have to charge VAT. The fact that we seem to be several years away from applying tax to these types of electronic transactions also means that EU suppliers of digitized products to consumers will be encouraged to relocate offshore to save tax.

Hidden Risks in Credit Derivatives?

The ***Bank of England*** has warned that the fast-growing credit derivatives market could concentrate risk in ways hidden from regulators, posing a threat to the stability of the few international financial institutions that dominate the market.

The "Financial Times" notes that, in its recently published semiannual financial stability review, the UK central bank says that a weakening global economy could test the banks, securities houses and insurers involved in credit derivatives.

The Bank also published research showing the cost of banking crises to be larger than previously thought, with the subsequent loss of output amounting to between 15 and 20 percent of GDP. The research also shows it takes much longer for developed economies to recover from the after-effects than emerging markets, in which the greater scale of banking crises forces much quicker responses.

The Bank's review will say that the new derivatives, which transfer credit risk between financial institutions, have the potential to increase overall robustness of the global financial system. But the market, which it estimates as approaching $1 trillion in the amount covered, is not yet fully mature and has yet to be tested during a slowdown.

Several possible problem areas are identified in the review, which could cause transfer of risk arrangements to break down. These include the wording of the documents that underpin the transfers, particularly on pre-l999 trades.

Some participants are worried about willingness to pay off non-banking institutions taking on risk. Banks place a high priority on prompt settlement, while insurers, which are playing an increasing role in accepting risk, place a greater emphasis on discouraging fraudulent claims.

The report says derivatives can also make it harder for regulators to monitor credit risk as it passes from the banks that make the loans to institutions that accept it. It also warns that lenders may be slower to help in corporate and sovereign debt restructuring if they have transferred the risk through derivatives.

It concludes that financial stability authorities need to track the redistribution of credit risk from banks to non-banks such as insurers. ❑

