

Islamic Liquidity Management: The Way Forward

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Abstract

Even though very small compared with conventional finance, there has been significant growth in Islamic financial services during recent years. It is not surprising that this growth is forecast to continue at a rapid pace. Clearly, there is an expanding demand for these products, and a closely associated desire on the part of banks, including non-Islamic banks, to provide Islamic financial services. As the interest in the subject of Islamic finance increases, there appears the need for innovative and competitive Islamic products which are Sharia-compliant. On the other hand, the development of Islamic finance faces challenging issues. Liquidity management of Islamic financial institutions has been one of the most challenging and discussed issues with regard to the trend outlines above. Especially the short term-liquidity management issue is very problematic for these institutions since it is very hard to find globally accepted, Sharia-compliant, liquid short term instruments that may be used in liquidity management. Recently, there have been attempts to provide these kind of instruments with no (little?) success being recorded as of date. The Islamic financial industry waits in eager anticipation for a solution to the problem that may present a way out of the current impasse.

Keywords: *Islamic finance, islamic liquidity management, IILM*

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Introduction

The Islamic financial system can be defined as a set of financial institutions and instruments (?) used by clients and institutions which provide opportunity for Sharia-compliant economic activities. Islamic Financial Institutions (IFIs) have become popular due to demand for specific financial services and as a result of the accumulation of substantial financial resources by certain Muslim countries. In the medium term, current trends of IFIs' development will be stable, considering that oil-exporting countries continue to receive substantial income and the financial markets of these countries are expected to continue to evolve.

On the other hand, during recent years traditional banks have displayed a great interest in entering the market of Islamic financial products. Thus the majority of multinational banks already have "Islamic windows". This is due to the increase of Muslim populations in developed countries as well as the growth of interest of Islamic investors in the geographic diversification of their investment portfolios. Additionally, as a consequence of global financial liberalization the extent of penetration of IFIs in the US and Western Europe appears to suggest that sooner or later they will potentially become a feature of all countries' financial systems. However, the full operation of IFIs will not be possible without the strengthening of liquidity management and changes in related legislation.

There have been many issues discussed with respect to Islamic finance and banking. In this sense liquidity management has been one of the most-discussed and challenging issues with respect to the above. The main reasons behind this issue coming to prominence are concerns regarding the degree to which liquidity is Sharia-compliant, the lack of properly structured and easily transferable instruments, the necessity for IFIs to maintain higher cash reserves when compared to their conventional counterparts and their holding of a zero-return reserve in their portfolio which harms the profitability and competitiveness of the IFIs. Even though there exist successfully applied local products and instruments which have been customized by the monetary and regulatory authorities to help IFIs overcome this hardship and facilitate their liquidity management, there remains a clear lack of globally-recognized and widely-accepted instruments.

Islamic money markets need to be integrated globally, not only regarding relations between the IFIs themselves, but also with conventional markets in an efficient, Sharia-complaint and simple way to facilitate li-

quidity management for IFIs and to ease the flow of funds between countries and different markets.

Islamic Liquidity Management

Liquidity management can simply be defined as the ability of a financial institution to remain 'liquid' enough to make its payments on time while maintaining an optimal cost-return balance to achieve that purpose by means of selecting and using the most appropriate tools for this aim. Meeting demand for deposit withdrawals and other cash outflows is a visible indicator of its viability. While goals and objectives can differ depending upon the circumstances and environment of the financial institution, a prudent liquidity management should always address ensuring enough liquidity to guarantee the orderly funding of the depositor's needs, providing a prudent cushion for unforeseen liquidity needs and investing liquid funds in a manner which emphasizes the need for security and liquidity. On the other hand, Islamic liquidity management does not differ from conventional liquidity management in terms of purpose and reasoning but with regard to the need to use different tools because of Sharia-compliance concerns. Islamic and conventional banking systems are similar as they are both based on fractional reserve systems and a depositor run on banking system constitutes the greatest risk and challenge to the liquidity management and financial system. But on the other hand development of a new Islamic financial instrument and a new structure to base the instrument on, as well as Sharia concerns, regulatory and tax treatments and leakages of funds in a dual-banking system expose additional risks in terms of developed Islamic liquidity management.

Current Practices

The Task Force on (for?) the Islamic Money Market, established by IFSB in 2008 and whose members consist of central bankers, bankers and regulators, released a technical note regarding the existing practices and infrastructure of the Islamic Money Markets and arrived at some recommendations for more efficient liquidity management. According to this report, in the countries which provided data, IFIs hold two to ten times more excess reserves at central banks as a percentage of their deposits compared to conventional ones so as to be able to remain sufficiently liquid. In other

words, cash is the most used tool by its nature to remain liquid, but this comes at a cost to IFIs. This does not render cash as the optimal choice for IFIs, even though it constitutes the least risky choice, because it deprives the IFIs of a certain yield and flexibility provided by the tools which are used by their conventional peers.

The most common interbank tool which is used to facilitate fund transfer between a cash-surplus IFI and a deficit IFI with a specific amount of yield is the *commodity-murabahah* agreement. An underlying commodity is purchased by the cash-surplus bank and sold to the deficit bank on a deferred basis via an exchange platform such as the London Metal Exchange, Bursa Malaysia or with the assistance of some private companies which provide these kinds of platforms. This arrangement is widely used in all jurisdictions, but not in tradable transactions, even though this is standardised under Sharia Rules. Moreover there is a certain degree of market risk and this may not prove enough for monetary operations. Sukuk (Islamic bonds?) trading is another way of managing liquidity among the IFIs, but it is very rare due to underdeveloped secondary market trading, a tendency to 'buy and hold' and limited issuance of globally recognized tradable sukuk. There are other Islamic contracts such as *wakalah* to manage liquidity and facilitate funds transfer and, of course, spot FX markets are widely used to facilitate liquidity management.

Central Banks or Monetary Authorities of different jurisdictions develop and use different instruments to facilitate liquidity management for IFIs. As is well known, central banks have lending and borrowing facilities for the banks under their purview and can do outright sell and buy of a defined group of instruments for monetary policy purposes if it requires. In order for a bank to borrow from a central bank, it first needs to have a certain amount of collateral. For IFIs there need to exist Islamic securities. Central Bank of Malaysia has the first and only Islamic Interbank Market in the world which represents a real breakthrough in the attempts to facilitate Islamic liquidity management. There are several instruments used in this market which help Islamic financial institutions acquire sound liquidity management within the dual banking system of Malaysia. One of the most widely-used ones is *Mudharabah* Interbank Investment which refers to a mechanism whereby a deficit Islamic banking institution (i.e. an investee bank) can obtain investment from a surplus Islamic banking institution (investor bank) based on Mudharabah (profit sharing). The period of investment ranges from a period of overnight to

12 months, while the rate of return is based on the rate of gross profit before distribution for investment of 1-year of the investee bank. Another instrument is wadiah acceptance which represents a transaction between the BNM and the Islamic banking institutions and refers to a mechanism whereby the Islamic banking institutions place their surplus funds with the BNM based on the concept of *Al- Wadiah*. Under this concept, the acceptor of funds is viewed as the custodian for the funds and there is no obligation on the part of the custodian to pay any return on the account. Moreover when the first Islamic bank in Malaysia began operations in 1983, the bank was unable, among other things, to purchase or trade in Malaysian Government Securities (MGS), Malaysian Treasury Bills (MTB) or other interest-bearing instruments. However, there was a serious need for the Islamic bank to hold such liquid papers to meet the statutory liquidity requirements as well as to place its 'idle fund'. To satisfy both requirements, the Malaysian Parliament passed the Government Investment Act in 1983 to enable the Government of Malaysia to issue non-interest bearing certificates known as Government Investment Certificates (GIC) which have now been replaced with Government Investment Issues (GII). One other important Islamic instrument on the Islamic interbank market are the Bank Negara Malaysia Ijarah Sukuk based on the *Al-Ijarah* or 'sale and lease back' concept, a structure that is widely used in the Middle East, too. A special-purpose vehicle, the BNM Sukuk Berhad as an SPV has been established to issue the sukuk Ijarah. The proceeds from the issuance are used to purchase Bank Negara Malaysia's assets. The assets are then leased to Bank Negara Malaysia for rental payment consideration, which is distributed to investors as a return on a semi-annual basis. Upon maturity of the sukuk, Ijarah SPV then sell the assets back to Bank Negara Malaysia at a predetermined price. On the other hand, the BNM has recently adopted the Collateralized Commodity Murabahah (CMM) which is also widely used and accepted as Shariah-compliant in GCC countries. This instrument can basically be seen as a form of commodity murabahah but CMM requires a borrowing party to present certain eligible collaterals to the lender as a rahn.

On the other hand, GCC Countries have established themselves as important players in the Islamic financial services industry. The GCC Central Banks issue Certificates of Deposits (CDs) for IFIs and this instrument is accepted as collateral by the central banks for Collateralized Commodity Murabahah (CMM) agreements which are used for the purpose

of repo-like lending by the central bank concerned.. As a third alternative, and to cite another example other than Malaysia and the GCC states, in Turkey, the Treasury issues Revenue-Indexed Bonds (RIB) for IFIs and these are used as underlying securities in a SBBA agreement with the Central Bank of Turkey. However, due to concerns related to the degree of their Sharia compliance, RIBs have become a questionable investment tool and IFIs in Turkey. Last year in September 2012, the Turkish Treasury issued its first sovereign sukuk.

Regulatory initiatives

With respect to the regulatory environment, the Islamic Financial Services Board Task Force has stated important recommendations in order to provide for the establishment of a sound and efficient Islamic money market that could facilitate liquidity management by central banks and IFIs. According to these recommendations, the first important issue is to design Islamic money markets and Islamic government-financing instruments harbouring relatively low risk that are simply designed, regularly issued, widely held and accepted and supported by a robust payment and settlement system. The second issue is to incorporate Islamic government-finance instruments as an integral part of the overall public debt and financing programme, and foster the development of an Islamic government securities market. Thirdly, the active use of Islamic government finance instruments in market-based monetary operations of the central bank to manage the liquidity in the Islamic money market is another crucial issue. One other issue to be emphasized is the need to develop efficient trading arrangements and the associated market microstructure for Islamic money and government financial instruments, and develop foreign exchange markets in parallel. Lastly, the provision of supervisory guidance and incentives for effective liquidity risk and asset liability management by IFIs, and the fostering of privately issued Islamic money market securities hold great importance in successful liquidity management.

The Way Forward

Taking into consideration the recommendations proposed by the IFSB and the increasing need for short-term liquidity management in Islamic finance, several central banks, monetary authorities and multilateral

organisations decided to create an international corporation to issue short-term Sharia-compliant financial instruments to facilitate effective cross-border Islamic liquidity management. They named this organisation the International Islamic Liquidity Management Corporation (IILM) By creating more liquid Islamic financial markets for institutions offering Islamic financial services (IIFS), the main goal of the IILM has been established, that of enhancing cross-border investment flows, international linkages and financial stability.

Established in 2010 and headquartered in Kuala Lumpur, the shareholders of the IILM are the central banks or monetary authorities of Indonesia, Kuwait, Luxembourg, Malaysia, Mauritius, Nigeria, Qatar, Saudi Arabia, Turkey and the United Arab Emirates as well as the Islamic Development Bank. In 2012, Saudi Arabia vacated its membership and the share of Saudi Arabian Monetary Authority was divided between Qatar and Malaysia. As an international institution, IILM enjoys a range of privileges and immunities conferred by the Malaysian IILM Act of 2011. Membership of the IILM is open to central banks, monetary authorities, financial regulatory authorities or government ministries or agencies that have regulatory oversight of finance or trade and commerce, as well as to multilateral organisations.

So on the journey forward, with respect to Islamic liquidity management the IILM can play important roles. First of all, the IILM is expected to create globally recognized and highly rated short-term money market instruments in reserve currencies and regularly issued 3,6,12 month tenors with a relatively low risk. An internationally recognized settlement and custodian bank such as Euroclear or Clearstream is expected to be used to ensure a robust and credible settlement provision and to satisfy the warehousing purposes of future sukuk. Secondly, the IILM is supposed to acquire sovereign assets from member countries and finance-member countries. The IILM will consequently become a part of long-term government issuances and play an important role as a financing platform for local borrowing authorities. Hence, the IILM can help governments to issue Islamic securities or sukuk. Moreover, the sukuk of the IILM might be accepted and used efficiently by central banks in their monetary policy applications. For example, central banks might accept the sukuk of the IILM as eligible collateral. In addition, to widen the market base and in order for central banks to have a quality asset alternative in their portfolio, IILM sukuk can be invested and traded in as well as employed for foreign- reserve manage-

ment purposes. It can also be used as reverse repo instrument in tandem with local Islamic securities for the purpose of sterilisation of ample liquidity in both the Islamic and conventional banking systems. IILM sukuk can foster the flow of global Islamic funds as a perfect trade instrument. Considering that Islamic finance is based on trade, IILM sukuk can be traded on secondary markets efficiently through a strongly established chain of primary dealers. Since it is expected that there will be at least one primary dealer from each member jurisdiction within this chain than this will create liquidity and increase the tradability of the sukuk on the secondary market. Hence, through the establishment of a liquid secondary market over time, the IILM sukuk can help facilitate the short-term flow of funds and replace, in particular, costly and operationally burdening short-term cross-border commodity murabahah arrangements. Additionally, as a perfect liquid instrument it can attract conventional money market players, and facilitate the flow of funds between conventional and Islamic markets. Being issued in reserve currencies like USD, IILM sukuk can represent a good alternative as a foreign currency market instrument at the same time. Furthermore, IILM sukuk can serve to help lessen the negative effects of interconnectedness between Islamic and conventional markets as well as between different jurisdictions. Another important factor that should be cited is the way it can assist in creating an Islamic benchmark yield curve in the future and so become an important facilitator of Asset-Liability Management for IFIs considering its short-term, easily tradable, liquid nature. Since Islamic markets are still dependent upon conventional benchmarks in their pricing of Islamic instruments means that IILM sukuk may well prove successful in building a Islamic benchmark curve for the industry. This is currently a feature lacking in Islamic finance.

Conclusion

Islamic Liquidity Management has been one of the most challenging tasks for IFIs as different countries have been trying to facilitate the operations of their local Islamic banking sectors. Even IILM-style initiatives such as the Liquidity Management Center in Bahrain have been established by a consortium of private banks and the IDB has made an effort to set up a short-term sukuk program to facilitate liquidity management for IFIs. Unfortunately, these initiatives have not proved successful so far. IILM is the first initiative which is supported by central banks and

monetary authorities. On the other hand, IILM faces some Shariah-related challenges especially in the sense of the need to find a generally accepted Islamic structure both for the underlying sovereign asset pool and future short-term sukuk. This is in addition to technical challenges such as the financing of high quality sovereign assets to obtain a high rating, the necessity to manage the duration mismatch between short-term liability and long term assets in a shariah-complaint way . IILM has to therefore find innovative ways in accordance with Shariah principles and obtain its members` support so as to overcome these technical difficulties and solve associated problems. Another factor that can contribute to IILM`s success will be a wide acceptance and extensive support of industry players. Fruitful cooperation, collaboration and synchronization between IILM, industry players, central banks and monetary and regulatory authorities will be the key determinant and catalyst in order to foster and facilitate not only domestic, but also cross-border Islamic liquidity management.

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