

Developments in Islamic Liquidity Management

7.1 Liquidity needs

The global financial crisis demonstrated that the freezing of international capital markets and the significant disruption of interbank and foreign exchange markets caused extensive problems for most banks and their customers in even the most mature economies.

Sustaining access to market liquidity has never been more critical than it is now as the subsequent repercussions of the crisis have resulted in ongoing lock-up and dislocation of the global interbank market, where unsecured, institutional counterparty limits remain in short supply, and those that are available are typically of an uncommitted and short-term profile. Conversely, assuring that any surplus liquidity is placed through appropriate financial contracts and products, and with suitable risk counterparties to ensure ongoing accessibility, is a key priority for all institutions, whichever sector they originate from.

Access to, and management of, wholesale liquidity has always been a fundamental issue for Islamic banks, with liquidity risk a much debated subject. Observers have often identified the lack of a formal market infrastructure and the perceived absence of a Lender of Last Resort (LOLR) as being amongst the major flaws of the contemporary Islamic financial system. Islamic banks have long since demonstrated their resilience to obstacles, most reaching their current stage of emergence without having had the benefit of a fully formed Islamic interbank or capital market to fall back on. Some industry commentators even suggest that Islamic banks were better placed than their conventional peers to weather the impact and repercussions of the global financial crisis. However, the Shari'a compliant banks certainly had no immunity to it and were faced not only with the familiar challenges that they had to address and overcome throughout the relative nascency of the Islamic financial industry, but also some additional ones that were posing unprecedented problems for the conventional financial system and many of its most sizeable, highly rated and established banking institutions.

7.2 Liquidity risk

In order to assess some of those challenges, and evaluate the implications of them, it is necessary to familiarise with the essential features of liquidity risk. It is a financial risk that results in potential loss to a bank arising from its inability to meet its obligations or to fund assets as they fall due. Liquidity risk can be further segregated into:

- i. Market liquidity risk;
- ii. Asset liquidity risk;
- iii. Funding liquidity risk.

There are many factors that may cause a bank or financial institution to lose liquidity:

- i. The markets on which it depends are directly subject to loss of liquidity (market liquidity risk);
- ii. The financial institution's own assets cannot be liquidated or monetised at short notice (asset liquidity risk);
- iii. A lowering of the bank's credit rating or another material, adverse event causes its counterparties to withdraw lines (funding liquidity risk).

Liquidity risk is extremely difficult to isolate as it tends to compound other risks, such as market and credit risk. Such was the impact, and subsequent repercussions, of the financial crisis for almost all banks that global regulators are rewriting the rules with a focus on liquidity risk, and the additional stipulations presented through Basel III are also in rollout. Banks are already, and will continue to be, compelled to adopt revised liquidity ratios whichever financial system they operate in and the products and processes to manage and assure liquidity, subject to ongoing scrutiny and review.

7.3 Management of wholesale liquidity

In the absence of a fully functional alternative to the global money and short-term capital markets, the

focus of Islamic institutional liquidity management has revolved around individually negotiated, bi-lateral interbank arrangements and limits. Since the emergence of contemporary Islamic finance, the murabaha contract has been a mainstay for liquidity placement.

Historically, murabaha has been a dependable contract for placing surplus or short-term, wholesale liquidity and, because of its perceived flexibility, became a preferred contract for bilateral arrangements between banks. Although a risk/profit profile equivalent to the risk/yield profile of a money market deposit can be achieved by utilising murabaha, it is a receivables-based financing contract that typically involves the purchase and subsequent onward sale of an asset on deferred payment terms and, outside of Malaysia, is not deemed eligible for secondary trading by the Shari'a authorities.

Critics of the contract believe that long-term reliance has hindered the development of more sophisticated, Shari'a validated liquidity management instruments. They consider that the necessity to negotiate individual, bilateral agreements in respect of each facility in order to account for institutional preferences has not enhanced the standard market environment that would be better placed to afford Islamic financial institutions greater protection against liquidity risk. Supporters argue that the contract has become embedded in core Islamic financial services, in both the wholesale and retail sectors, and has hastened the expansion of the system during the past four decades because of the extensive uptake and usage by banks, institutions and wholesale market players from both financial systems. In any event, the established, conventional global money markets have been ineffective in ensuring access to and circulation of liquidity, both during and following crisis.

Dual financial system participation in murabaha based transactional activity has also resulted in what is perhaps one of the most significant successes from the sustained endeavours of Islamic financial system stakeholders to seek market standardisation. In 2005, the Bahrain-based International Islamic Financial Market (IIFM), a central industry body founded through the collective efforts of the Islamic Development Bank, Autoriti Monetari Brunei Darussalam, Bank Indonesia, Central Bank of Bahrain, Central Bank of Sudan and the Labuan Financial Services Authority, and with its primary focus being the global standardisation of Islamic financial products, documentation and related processes for the Islamic capital and money market, initiated a working group. This group comprised of regulators, banks and other market players relevant to Shari'a compliant treasury services and focused on the development of a formalised template for murabaha documentation, with processes that would assist in greater standardisation of the contractual and trade execution practices of banks transacting in the Islamic interbank market. Not only was the scale of collaboration and level of global participation a first for the industry, the selected steering group was able to benefit from the comments and input of various market supervisors, international lawyers and rating agencies, plus the Shari'a oversight of both the IIFM Shari'a Advisory Panel and scholars relevant to those Islamic institutions that elected to participate. The resultant Master Agreement for Treasury Placement (MATP) was validated and published for utilisation by the

institutional market in 2007. It has since been adopted as market standard by banks from both the Islamic and conventional financial systems, as well as regulators and supervisory authorities relevant to each.

Notwithstanding this, murabaha is essentially a financing contract that has been necessarily adapted to meet the requirements of Shari'a compliant, wholesale treasury and capital market activity. As such, its application to placement of wholesale bank liquidity has tended to be concentrated in assets of lower risk profile and lower yield performance. The process of migrating the structure for purpose can result in an additional layer of expense for intermediary services, such as those of agents and asset facilitators, and the cost of credit enhancement instruments, such as third party undertakings in the form of standby letters of credit, promissory notes or bills. These can cause a drag on profitability not apparent in parallel contracts and instruments found in the conventional financial system.

7.4 Liquidity management funds

Despite the perceived deficiencies, in the absence of a more effective instrument, bilateral murabaha agreements evolved into collective investment schemes at any early stage and, thereafter, into authorised funds. Most of the latest generation products benefit from authorisation in credible, regulated jurisdictions and some from ratings by international agencies. Eligible investments for many Shari'a compliant liquidity funds also include sukuk but most are over-weighted to murabaha due to insufficient access to tradable paper.

As authorised funds, those with higher ratings are invaluable to investors looking to place short-term funds or fund managers seeking to place surplus cash in compliance with prevailing regulatory or asset allocation stipulations. If the investment product is also very liquid, with appropriate redemption frequency and low volatility, it can be a useful tool for any institution focused on maintaining its core liquidity ratios through allocation to high quality liquid assets (HQLAs).

Creating products and facilities suited to placement of overnight and short-dated liquidity has also presented the industry with one of its most enduring challenges. One of the more recent and innovative treasury management products originated to address this requirement is Standard Chartered Saadiq's overnight sweep account facility. This murabaha based clearing account has offered Islamic banks and financial institutions a much needed solution for placement of overnight, surplus cash with an assured daily redemption facility. Initially launched for US dollars, 2012 has seen the product rolled out for Euro investment too.

Global asset management trends also changed dramatically in response to the financial crisis, as highlighted throughout 2009, in particular, when the industry experienced investor panic and a flight to liquid, "safe" assets. Accordingly, a number of sponsors of Shari'a compliant funds sought to deliver products with a profile that replicated or targeted an AAA money market fund.

Whereas these developments were certainly welcomed by the market, challenges included:

- i. The ongoing lack of access to eligible securities; at the time of writing AAA rated sukuk in issuance did not exceed USD10 billion;
- ii. Addressing daily redemption thresholds and variable net asset values (NAVs), which private investors and other asset managers may accommodate. However, these features are not such a good fit with liquidity management needs of banks and Islamic financial institutions seeking certainty in the structures. They need to deploy core liquidity efficiently, rather than depending upon complex fund structures that can be operationally cumbersome, and with the ability to redeem less assured;
- iii. The involvement of various third party service providers, which increases administration costs and again causes a drag on return.

There have, however, been a couple of notable and successful launches during recent years. In mid 2010, the UK branch of Qatar Islamic Bank (QIB) launched the first liquidity management fund for Islamic investors to gain an AA rating by Standard and Poor's. Although available to professional investors as part of the QIB's wealth management offering, key features include a constant NAV, daily liquidity and a profit target benchmarked against one month LIBOR, thereby raising the fund's profile as an eligible investment for Islamic banks and financial institutions seeking to manage liquidity without volatility and compelled, for regulatory purposes, to hold HQLAs.

The Bank of London and the Middle East (BLME) launched its own Shari'a compliant US dollar income fund in mid 2009. The Luxembourg domiciled SICAV-SIF is, again, available to professional and institutional investors and seeks to achieve its target net profit, benchmarked against US dollar LIBOR + 1 per cent, through allocation to a diverse portfolio of Islamic money market instruments and sukuk. In the three years since launch, the fund has become a top percentile performer, and ranked 6 in 2012 by Lipper Hindsight of 763 US dollar global money market funds over a three year period.

7.5 Liquidity management and the Islamic financial system and infrastructure

Returning to the impact of the historical absence of an efficient, Islamic capital market infrastructure, the role played by government and central banks in supporting the system, and assuring liquidity remains within it, has been and remains crucial. Basel III, as noted previously, is having a major impact on banks from both financial systems as it rolls out but that impact is perhaps greater on Shari'a compliant banks. The BCBS International framework for liquidity risk measurement, standards and monitoring introduced liquidity coverage and net stable funding ratios in 2010, which, although designed

for conventional banks, will be similarly applicable to Islamic counterparts in jurisdictions that adopt the standards and have authorised banks to operate in both financial systems.

To maintain parity, the Kuala Lumpur based standard setting body, the Islamic Financial Services Board (IFSB), has been working to ensure that Islamic financial industry practice is comparable with international practice and is expected to issue further Islamic financial industry standards in this regard. Additionally, collaboration between the IFSB and the Islamic Development Bank led to the formation of the Islamic Financial Stability Forum in April 2010.

In October 2010, another high level, industry wide collaboration by 11 central bank authorities and 2 multilateral organisations resulted in the incorporation of The International Islamic Liquidity Management Corporation (IILM) with authorised capital of USD1 billion, of which USD75million was paid in. Based in Kuala Lumpur, the IILM commenced operations on 1 January 2011, with its mission being to enhance and improve availability of Shari'a compliant liquidity management instruments. IILM aspires to provide innovation in the liquidity management space by providing a platform for regular dialogue between the Corporation and its government members thereby supplementing and enhancing the transparency of the infrastructure and governance of liquidity management products and processes within the Islamic financial system.

The unique advantage of the IILM is the governmental backing plus the participation of 2 multilaterals whose independent bond issues have been rated higher than some member countries. The IILM expects to be proactive in achieving a benchmark yield curve and facilitating cross border liquidity flows and, by ensuring regular issuance of HQLAs, will ultimately provide Islamic banks and financial institutions with the liquidity management tools that the industry has long been seeking. It also aspires to assure access to lower cost funding through monetisation of assets, enabling banks to meet regulatory stipulation for liquidity buffers, and helping to address the unresolved issue of a recognised LOLR. The IILM had anticipated its first issuance in 2011, but the enormity of the undertaking did not permit this target to be met. Recent statements suggest that the first issuance will take place in the first half of 2013.

7.6 New developments in Shari'a compliant liquidity management

This chapter has thus far focused on the historical challenges that the Islamic financial sector has faced in producing a complete set of liquidity management tools, and reviewed various, recent initiatives of its institutions and industry bodies in finding solutions to meet that demand. There remain, of course, some unresolved situations although work is in progress. Amongst those is the final development of a widely accepted, Shari'a compliant repurchase (Repo) type product that the market has long since indicated it perceives as being a priority for addressing the short-term liquidity management requirements of Islamic

financial institutions.

IIFM has been a central player, initiating a process as far back as 2007 to identify the key factors that were prohibiting approval of the Islamic Repo, with the aim of resolving them and, thereafter, promoting the development of an additional product. IIFM's first step was, again, to conduct an industry wide dialogue to support its research. This embraced a subsequently convened working group of industry practitioners, lawyers, and expert financial institutions from both financial systems, with guidance from the members of the IIFM Shari'a Advisory Panel.

Throughout the protracted discussions, the biggest challenge was to find a workable and internationally acceptable Repo structure, or *i'aadat al shir'a*, which would achieve Shari'a validation, whilst also being deemed viable from the operational perspective of institutions in the market. As part of the ongoing research process, extensive consultation has taken place with banks and wholesale financial institutions, as their knowledge and practical experience is important in ensuring that the proposed structure and guidelines will gain wide international acceptance.

IIFM shared the findings and conclusions of its working group through the IIFM White Paper on *i'aadat al shir'a* (Repurchase) & collateralisation possibilities which was published on 28th July 2010, after more than two years of research. The aim of the paper was to facilitate further development work by the industry, based upon the recommended structuring possibilities. The paper included two recommendations to develop the following liquidity management tools: collateralised product and three party *i'aadat al shir'a*.

7.6.1 Collateralised product

Since the publication of the White Paper, several institutions, domiciled in various jurisdictions, have tested the viability of a collateralised liquidity management product arranged under IIFM's guidelines. IIFM's intention was that Shari'a compliant securities, such as sukuk, might be utilised as a feasible, alternative collateral for liquidity management purposes. Following positive feedback, IIFM widened its working group to include additional stakeholders (including custodians, administrators and accountants) to deliberate the issues and seek basic consensus of approach in addressing them. A market consultative meeting was held in mid July 2012 where it was established that a collateralised murabaha structure, based on conventional tri-party collateral arrangements, was the most appropriate direction for the industry to take. The intention was that collateralised murabaha arrangements will ultimately enable financial institutions to make more efficient use of holdings or portfolios of liquid, Shari'a compliant securities.

The murabaha structure was considered best suited to the purpose because of its aforementioned international acceptance as an evolved, credit based financial instrument with wide, cross border application. IIFM noted that these factors have previously caused a number of its development initiatives to focus on murabaha, as it best supports the primary objective of transactional and operational standardisation. However,

further review of the potential application of alternative contracts to support collateralised product is being undertaken. Drafting of documentation is currently in process with the input of banks and also established tri-party agents, custodians and industry regulators. IIFM targets publication of the product standard in early 2013.

From the perspective of the securities that will underpin collateralised transactions, sukuk are now very familiar as an asset class and many banks hold sukuk in their portfolios, with prime issues often being held to maturity because of perceived commercial, yield and risk benefits. Sukuk are potentially eligible as collateral but currently the majority of sukuk in issue are domestic, illiquid or with price disclosure that is somewhat opaque. Additionally, the cross-border market infrastructure for issuance, listing and trading of sukuk is still working towards completion. Greater standardisation is being sought at both regulatory and legal levels and there is still much work in progress throughout many of the Islamic financial industry's core market territories.

Shari'a compliant equities that are held in longer-term portfolios might present an additional possibility. Currently, equities are usually underweighted in the Islamic bank portfolio. Reasons may include regulatory impact or asset class and risk aversion. However many of the regional, equity capital markets most relevant to the industry have expanded and deepened within recent years with market order, stability and regulation coming to the fore.

Notwithstanding the financial crisis, the global equity markets are even deeper. Shari'a engagement and oversight has resulted in a diversity of highly rated, liquid and market tradable equities, indices and equity based exchange traded funds that have been screened for Shari'a compatibility and deemed eligible for investment. In this asset class there is no significant additional requirement for creation of new infrastructure, be it in relation to financial regulation, tax or law, outside of that already established by the relevant securities market authority.

7.6.2 Tri-party *i'aadat al shir'a*

Tri-party repurchase arrangements are presenting an ongoing challenge, particularly from a Shari'a authenticity point of view with many esteemed scholars disagreeing on the creation of an Islamic Repo. IIFM is continuing in its efforts with certain jurisdictions and institutions to develop a product under the guidance of its own Shari'a Advisory Panel.

Islamic banks may profess that they are not yet fully qualified or comfortable in managing assets for bilateral, collateralised facilities but, again, it may be the global equity asset class that would be most readily adapted to effective management in the context of traditional tri-party collateral arrangements. Global collateral managers frequently confess to being challenged by administering and applying valuation to murabaha and unlisted sukuk, but quoted equities are transparent and no additional process is required to existing and established process, provided stocks confirm to Shari'a stipulations. Again given the huge global scale and depth of the market, it goes some way to explaining why this remains a key

agenda item for the market and IIFM.

7.7 Conclusion

The products, structures and mechanisms that Islamic wholesale market participants originate and deploy for liquidity management purposes is likely to remain a high priority focus for the foreseeable future. Structures such as murabaha and tawarruq continue to play a significant role in meeting the requirement for short-term, recurrent cash management services where bank counterparty risk dominates; however the various deficiencies of those contracts in delivering effective treasury management solutions have been discussed earlier.

In creating appropriate solutions, it is important that a distinction is made between a bank treasury requirement for efficient management of cash and short-term liquidity and the requirement of a low risk investment portfolio. Although adding depth and diversification to the market, many of the independent initiatives previously launched for the purpose have lacked in certain critical areas such as size of capital, capacity, rating or cross-border market credibility. In reviewing a number of notable product successes, problems such as ongoing access to HQLA's and impact of redemption barriers were also highlighted.

Regulators will undoubtedly have an ongoing and central role to play, especially outside of the core Muslim markets, where it can still be difficult for Islamic banks to establish and operate effective liquidity management structures within the constraints of existing financial regulation. Certainly in a number of international jurisdictions, including the UK, positive work has been undertaken but, again, it is probably the issue of an Islamic bank having insufficient access to AAA rated investment securities so as to maintain its core liquidity in HQLAs that has posed one of the biggest concerns especially as the only eligible paper does not surpass 10 billion US dollars in aggregate.

Although there has been much coverage of the increase in aggregate sukuk issuance in 2012, as far as government securities are concerned, few Middle Eastern sovereigns have established a yield curve to develop local bond markets when compared to more developed markets in Europe and even some emerging markets in Asia. In most of the core jurisdictions for Islamic financial services, central banks can issue Shari'a compliant paper if they wish and some, for example in Bahrain, Qatar, UAE and Malaysia, have but it has not always been recurrent or of sufficient volume. Furthermore, the issuance of Shari'a compliant sovereign paper that is short-term and tradable, and equivalent in profile to a treasury bill, is even scarcer. To date, only the Central Bank of Bahrain has issued short-term paper regularly, but it has not always been in tradable form, e.g., the 90 day tenor salam sukuk which is again issued through a structure deemed ineligible for secondary trading by Shari'a scholars in the Middle East.

Although historically Islamic banks have maintained excess liquidity, this is sometimes no longer the case and certainly can no longer be taken for granted. Accordingly, relevant central banks have recently

made concerted efforts to underpin Islamic banks' recourse to market liquidity with facilities normally available from an LOLR. This, in turn, has caused Islamic banks to refocus on placement of suitable collateral in support of such facilities and heightened the need to finalise validated IAS arrangements.

Other than ongoing regulatory support, the contribution of Shari'a scholars remains crucial to sustaining the development of the Islamic financial system, its infrastructure and products. For market participants, the necessity is to continue to strive for consensus through access to a diverse group of individuals who are qualified to review and opine on issues relevant to its expansion across the global financial marketplace and who possess the requisite knowledge of essential factors such as local legal infrastructure and regulatory requirement to support that process.



numerous achievements in 2012

<p>The Best Islamic Bank in Indonesia</p> <p>Islamic Finance News & Redmoney</p>	<p>Best Islamic Banker of the Year</p> <p>Global Islamic Finance Award and Edbiz Consulting</p>	<p>Annual Report Award (ARA) 2011</p> <p>BI, Bapepam LK, BEI, Directorate General of Taxation, KNKG, IAI, BEI, Ministry of Finance</p>	<p>Best Islamic Bank Award</p> <p>The Asset Asian, Hongkong</p>	<p>The Most Popular Brand (Islamic Banking)</p> <p>Markplus & Marketeers Magazine</p>	<p>Word of Marketing Award</p> <p>SWA Magazine & Onbee Marketing</p>
<p>The Best Sharia Bank 2012</p> <p>Investor Magazine</p>	<p>Best Brand Platinum Award</p> <p>SWA Magazine & Survey MARS</p>	<p>Platinum Award</p> <p>Infobank Magazine</p>	<p>Indonesian Women Survey Award</p> <p>Kartini Magazine</p>	<p>The Best Islamic Bank in Indonesia</p> <p>Asiamoney</p>	<p>The Best for CEO Commitment</p> <p>Dunamis</p>
<p>ABFI Institute Award</p> <p>ABFI Institute Perbanas & Group Tempo Magazine</p>	<p>The Best Islamic Retail Bank in Indonesia</p> <p>The Asset Asian, Hongkong</p>	<p>Service Quality Award</p> <p>Service Excellence Magazine</p>	<p>The Best Islamic Trade Finance Bank Award</p> <p>The Asset Asian, Hongkong</p>	<p>The Most Trusted Company Based on Corporate Governance Perception Index (CGPI)</p> <p>SWA Magazine & IICG</p>	<p>The Best Bank in Human Capital</p> <p>Perbanas Institute & Women Review</p>