IFSB Seminar
Managing Liquidity in the Islamic Financial Services Industry
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Session 1

Liquidity Management in the Islamic Financial Services Industry:
Risks & Regulatory/Supervisory Issues

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Outline

- Definitions
- Existing international standards
- Funding liquidity
  - IIFS vs conventional financial firms
    - *Shari'ah* constraints on funding transactions
      - Interbank
      - LOLR
    - Rate of return risk => withdrawal risk on Profit Sharing Investment Accounts
    - How IIFS manage the resultant funding risk: excess reserves
- Market liquidity
  - Shortage of *Shari'ah* compliant negotiable papers
  - Limitations of those which exist
    - **Lack of liquid secondary markets & 'hold to maturity' problem**
    - **Duration and market risk**
- Indispensable role of government & central bank
- Implementation of Basel III
- Challenges for market players & for public authorities
- IFSB work in process

Definition of Liquidity Risk

- Liquidity risk is the potential loss to an institution arising from its inability either to meet its obligations or to fund increases in assets as they fall due without incurring unacceptable costs or losses
- Liquidity risk can be categorised into:
  - ***Funding liquidity risk***: the risk that an institution will not be able to meet efficiently both expected and unexpected current and future cash flow and collateral needs without affecting either daily operations or the financial condition of the institutions
  - ***Market liquidity risk***: the risk that an institution cannot easily offset or eliminate a position at the market price because of inadequate market depth or market disruption

Existing International Standards

- Basel III as it emerges
- BCBS *Principles for Sound Liquidity Risk Management and Supervision* (Sep 2008)
  - qualitative standard
- BCBS *International framework for liquidity risk measurement, standards and monitoring* (Dec 2010)
  - Quantitative standard: introduces Liquidity Coverage Ratio & Net Stable Funding Ratio

Liquidity Risk in Islamic Financial Institutions

- IFIs face particular liquidity risks because of
  - The consequences of Shari’ah constraints on types of instrument that they may hold
    - For banks, especially lack of short-term sovereign paper as used in conventional sector
    - For Takaful undertakings, lack of longer-tenor instruments also
  - The absence of institutional means to mitigate these consequences
    - i.e. for banks, lack of Shari’ah compliant interbank market and Lender of Last Resort (LOLR) facility

Funding Liquidity Risk (1)

- Conventional interbank lending is not *Shari'ah* compliant
- *Murabahah* or *Mudarabah* based transactions have been introduced in some markets
  - Both are a bit cumbersome & involve transactions costs (e.g. brokerage commissions for *Murabahah*)
  - Counterparty risk greater for *Mudarabah* based transactions + *ex post* adjustment of cost of funds
- Such facilities are unavailable in many countries
- Funding liquidity problem obliges Islamic banks to have v. high 'excess reserve' ratios compared to conventional banks

=> Negative effect on profitability

Shari’ah Compliant Interbank Transactions (1)

- Commodity Murabahah Transactions (CMT)
  - CMT involve the sale on credit by Murabahah of a notional commodity (purchased through a broker) to a counterparty who sells it immediately for cash (to a broker). London Metal Exchange typically used
  - The counterparty has thus effectively obtained cash on credit up to the contractual payment date
  - Used widely in some countries (see IFSB GN on CMT)
  - May be used by bank
    - To place surplus liquidity with a counterparty
    - To obtain liquidity from counterparty with surplus funds
  - Disadvantages
    - Transactions costs (brokers’ commissions)
    - Additional counterparty risk (exposure to broker)

Shari’ah Compliant Interbank Transactions (2)

- Mudarabah transactions
  - Funds are taken or placed on a Mudarabah (profit sharing & loss bearing) basis
  - ‘Profit rates’ need to be calculated for very short periods – are supposed to be ‘ex post’, not agreed ‘ex ante’, but are just notional
  - Counterparty risk: Mudarabah is not a debt contract; hence (in principle) exposure to losses of counterparty
  - Hence somewhat cumbersome and inefficient

Funding Liquidity (2)

- *Shari'ah* compliant LOLR operations must be based on one of the following:
  - *Mudarabah*
  - *Murabahah(CMT-based)*
  - *Qard* (interest-free but with admin. charge)
- CMT-based LOLR facility available in some countries
- Some central banks don't offer any of the above

Funding Liquidity (3)

- Rate of return & withdrawal risk
  - If it has unrestricted IAH funds invested in medium or long term fixed return assets (e.g. *Murabahah* based mortgages), an institution faces rate of return risk
  - A certain proportion of unrestricted IAH funds may be withdrawn on demand or at short notice
  - If benchmark rates in the market increase, IAH may withdraw funds to place them elsewhere at a higher expected rate of return (withdrawal risk)
- Withdrawal risk may also be related to IAH fear of losses
- Shari'ah compliant (takaful-based) deposit insurance mitigates this withdrawal risk

Funding Liquidity (4)

- Islamic banks' financing assets tend to be more illiquid than those of conventional banks – no secondary market (see Market Liquidity)
- Systemic risk if withdrawal risk leads to liquidity squeeze
  - Various techniques are used by IBs to mitigate liquidity risk
    - **Part of IAH deposit treated as current account**
    - **Use of reserves to 'smooth' profit payouts or cover losses**
    - **Murabahah-based profit rate swaps**
- Need for return-producing liquid assets
  - Sukuk in short supply and tend to be held to maturity
  - Role of IILM Corp (see Market Liquidity)

PSIA deposits vs. CMT-based deposits

- PSIA deposits resemble conventional retail deposits in terms of liquidity
  - Although they can be withdrawn at short notice, a substantial %age remains stable (savings accounts) and doesn’t present refinancing risk
- CMT-based deposits are typically short-term and must be repaid on maturity
  - Hence refinancing risk: under stressed conditions, the repaid deposits can’t be renewed

Market liquidity (1)

- **Lack of *Shari'ah* compliant negotiable short term papers**
  - Salam & Murabahah sukuk not negotiable
- **No liquid secondary market for Islamic financing assets (Shari'ah constraints)**
- **Ijarah sukuk are negotiable but**
  - Not available in many jurisdictions
  - When available
    - Duration/market risk problem
    - Lack of liquid secondary market: need for market makers
    - Islamic banks tend to hold them to maturity
- **Problem of Asset/Liability management and liquidity management for Takaful undertakings**
  - Liquidity needed in takaful funds & for *Qard* facility
  - Need for equivalent of 'long bonds' in Life Takaful

Market liquidity (2)

- Need for programmes of sovereign Ijarah/IMB sukuk issuances of short duration (1, 3 or 6 months with repricing)
  - Would relieve funding liquidity problem (e.g. via REPO substitute?)
  - Link to management of money supply via OMO
- Indispensable role of government as well as central bank
- Issue of availability of public sector assets as backing for sukuk issuances
- Integrated approach indispensable
  - See IFSB *Technical Note*
- Role of International Islamic Liquidity Management Corp.

Regulatory/Supervisory Issues

- Shari'ah compliant liquidity support
  - LOLR facility (CMT-based?)
- Legal/regulatory/infrastructural issues
  - Shari'ah compliant deposit insurance for UPSIA
  - Minimum liquidity requirements for Islamic banks
- Implementing Basel III Liquidity Risk Measurements
  - Not required for several years following a trial period, but should latter start as soon as possible?
- Monitoring by supervisors

Implementing Basel III Liquidity Risk Measurements in Islamic Banks (1)

Liquidity Coverage Ratio (LCR)

- [Stock of *high-quality* liquid assets / Total net cash outflows over the next 30 calendar days] > 100%
  - Currently there is a shortage of high-quality (highly rated) Shari'ah compliant liquid assets
  - The IILM Corp is intended to mitigate this problem

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Implementing Basel III Liquidity Risk Measurements in Islamic Banks (2)

Net Stable Funding Ratio (NSFR)

- [Available amount of stable funding /

  Required amount of stable funding] > 100%

  ALM - Sustainable maturity structure of assets & liabilities over a 1-year time horizon
- Available stable funding = equity, sukuk and *liabilities (+ a %age of UPSIA) expected to be a reliable source of funds over 1-year time horizon* ***under conditions of extended stress***
- Islamic banks don't have longer-term liabilities and PSIA can typically be withdrawn at short notice
- CMT-based term deposits aggravate the problem

Stability of Unrestricted PSIA

- Retail UPSIA may be expected to have liquidity characteristics similar to those of conventional retail deposits – limited refinancing risk
- Not true of CMT-based term deposits: major refinancing risk

Challenges

- **For market players**
  - Improving
    - Asset/Liability management
    - Liquidity management
  - Implementing Basel III for liquidity
- **For public authorities**
  - Creation of supportive liquidity and legal infrastructures, e.g.
    - Shari’ah compliant interbank market
    - Shari’ah compliant LOLR
    - Shari’ah compliant deposit insurance for UPSIA
  - Implementation of IILM Corp facilities
  - Integration of Islamic finance and management of money supply (OMO)

IFSB Work in Process

- Exposure Draft of Standard on Liquidity Risk Management in course of preparation
- No ‘reinventing the wheel’ but adaptation of international standards
- Quantitative measures LCR & NSFR a particular challenge
  - Categorisation and treatment of available Shari’ah compliant assets and liabilities/PSIA
- New IFSB Standard will be issued with focus on qualitative issues
  - without waiting for all of these quantitative issues to be resolved (subsequent TN?)