Islamic liquidity management finds a new cross-border focus

Islamic financial institutions and regulators are creating a new international architecture to manage Islamic liquidity. **WRITER** *James Gavin*

Liquidity management is an essential building block in creating a sustainable and stable Islamic financial industry. As the size of the sharia-compliant industry increases, growing attention is being given as to how the sector can better manage this rich pool of Islamic liquidity.

Bank liquidity derives from the asset side of the balance sheet – endogenous liquidity – and the exogenous side, the bank's deposit base. Islamic banks have a disadvantage in the first category, but enjoy a significant advantage in the second category.

However, Islamic financial institutions (IFIs) lack the full array of flexible liquidity management tools. "Islamic banks have more deposits than they have assets naturally, as there are more sharia investors who want to put money into Islamic banks than there are instruments that can easily transfer that to the asset side of the balance sheet," says Brandon Davies, a director at UK-based sharia-compliant Gatehouse Bank.

LONG VERSUS SHORT TERM

IFIs face an asset-liability gap, with a shortage of long-dated assets that align with the long-term nature of the investments. While IFIs' main investments are long-term, such as in sukuk or project financing, their main funding source is short-term, from customer deposits. The result is a maturity mismatch.

With a shortage of longer-dated assets and interbank liquidity, the industry faces the challenge of creating an infrastructure that could support liquidity management strategies and thereby capture the opportunity provided by the Islamic finance sector's large capital pools.

There is now a growing focus across the industry of the need to facilitate greater interaction and linkages among IFIs and bolster cross-border Islamic liquidity management.

The industry recognises that widening the Islamic pool of securities available to manage risk more effectively is a priority. Consequently, IFIs are actively developing products to facilitate effective liquidity management. Improvements in the internal liquidity management operations are also being supported by efforts to create a deep and active Islamic money market.

"Many Islamic banks, including Kuwait Finance House (KFH), work either through their asset management team or through their treasury or structured product teams to develop solutions. As a result, we have seen the development of sukuk funds and liquidity management funds. However, they usually do not address the main segment of liquidity management that is the most important to address: the very short-term or overnight segment," says Lilian Le Falher, executive manager at KFH Bahrain.

Efforts are underway at the national level to develop new liquidity management strategies. "At least for Malaysia, we have a robust Islamic liquidity management system that works simultaneously from product varieties, payment systems, market players and most importantly comprehensive regulatory frameworks that govern Islamic financial practices," says Hijah Arifakh Ohman, managing director and CEO of Hong Leong Islamic Bank.

"These have made Malaysia quite unique compared to other Islamic financial centres and it also shows the commitment of the government in developing Islamic finance to a higher level," says Mrs Hijah.

Continuous efforts to develop a robust Islamic liquidity market should encompass both the retail and wholesale market. "At this point, more emphasis has to be given to growing retail deposits which is crucial in forming a solid liquidity foundation for Islamic banking. The main area is to develop the infrastructure in terms of globally accepted sharia structure, standard transaction documents and legal enforceability of contract not to mention competitive pricing vis-à-vis conventional products," says Mrs Hijah.

Regulatory initiatives are making headway, with the development of an Islamic version of the International Swaps and Derivatives Association (ISDA) that will facilitate the creation of a liquidity management framework.

WAVE OF INNOVATION

Regulators and institutions are continuously focusing on ensuring that the new set of liquidity management tools and platforms are sharia-compliant to retain the confidence of scholars and consumers alike.

"One of the key challenges is to develop liquidity management tools that are in compliance with what I called the spirit of sharia rather than just being stamped 'sharia-compliant'. This is the key challenge because on one side sharia requires ideally a certain level of risk-taking and real assets to be involved, and on the other side, regulators and board/senior management of Islamic banks require bank liquidity to be held in non-risky very liquid assets. Matching both sides' requirements and expectations is very challenging, if at all possible," says Mr Le Falher.

A simple and practical solution that could help widen the Islamic asset pool would be to simply issue more Islamic paper, for example through the regular euro medium term note programmes. Good quality IFIs across the globe are also

"ISLAMIC BANKING IS TOO REGIONALLY AND LOCALLY FOCUSED. WE NEED TO FOCUS ON INTERNATIONALISING THE SECTOR" actively considering issuing Islamic securities especially sukuk (Islamic bond).

However, warns Mr Le Falher, this trend could be just a consequence of extraordinary favorable market conditions with all time low interest rates. "In order to help the overall industry in its liquidity management, we need to see new [sukuk] issuances and active secondary trading," he says.

Another trend largely promoted by international banks active in Islamic banking is to create Islamic repurchase agreements – repos – that will help Islamic banks manage liquidity in sukuk. In August 2010, Barclays Capital introduced Islamic repos for its Malaysian and Middle Eastern customers.

In 2008, Bursa Malaysia – Malaysia's national exchange – launched the Bursa Suq Al-Sila', an end-to-end sharia-compliant commodity trading platform based on commodity murabaha, which is an Islamic money market instrument that can be traded using palm oil as the underlying commodity. Commodities such as palm oil can be used as assets to back Islamic loans to better manage short-term liquidity.

Others are also joining in the effort to develop a sharia-liquidity management framework. The United Arab Emirates central bank in May 2010 announced plans to launch new liquidity facilities through the issuance of Islamic certificates of deposit (CDs), with maturities of one week up to one year. The new Islamic CDs are based on the commodity murabaha concept and will be offered in daily auctions.

MAKING A BREAKTHROUGH

It is now becoming increasingly important for IFIs of different jurisdictions to embark on key initiatives that would facilitate a more effective and efficient cross-border liquidity management. "Islamic banking is too regionally and locally focused and therefore there are local pools of liquidity or illiquidity. What we need to do is focus on internationalising the sector," says Mr Davies. "We have a benchmark price for bank assets on which we can base loans, and a benchmark price for bonds on which we price bond issuances to assess credit. All these things are the building blocks we need, but we need to do them internationally." In addition, Mrs Hijah says, "There is a need to have a stronger form of liquidity management agreement between all financial centres, at least between the Islamic countries and IFSB members."

"TO HELP THE INDUSTRY, WE NEED TO SEE NEW [SUKUK] ISSUANCES AND ACTIVE SECONDARY TRADING"

Efforts are underway to create an international architecture for Islamic liquidity management. A key recent development announced by the Islamic Financial Services Board (IFSB) was the establishment of the International Islamic Liquidity Management Corporation (IILM), which took place at the IMF-World Bank Annual Meetings in Washington DC. The primary objective of IILM is to issue sharia-compliant financial instruments in order to facilitate more efficient and effective global liquidity management solutions for institutions offering Islamic financial services, as well as to facilitate greater cross-border investment flows of sharia-compliant instruments.

"Currently, central banks and the Islamic Development Bank are taking the Islamic 'IMF' role to ensure the success of the IILM. The IILM should be recognised as a AAA-grade institution for sukuk issuances and investments" says Mrs Hijah.

The IILM is seen as a major breakthrough in the Islamic financial industry development as it will provide liquid short-term sharia-compliant instruments that would further promote the competitiveness and resilience of Islamic financial services globally. This initiative is a significant development as it is a collaborative effort involving central banks from several jurisdictions and multilateral institutions from different parts of the world.

"The creation of liquidity instruments is not simply an aid to banks being able to manage their own liquidity but also an enormous aid to the development of the whole market itself because it will improve significantly our ability to rationally price credit," says Mr Davies.

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