Liquidity management in Islamic financial institutions

The scarcity of liquidity management tools for Islamic banks is a recurrent theme for policymakers and regulators in many jurisdictions that are trying to promote Islamic banking. Given the inherent limitations on Islamic banks, coupled with the fact that Islamic banking is still in its early stages of development, most national banking systems have yet to create the mechanisms to enable Islamic banks to best manage short-term liquidity. HAROON JAN BARYALAY delves further.

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Islamic interbank and money markets (where they do exist) lack the volume and diversification of conventional markets leading to a sectoral disadvantage from the outset. An attendant problem to the scarcity of instruments is the lack of secondary market trading of Islamic financial instruments. The excess liquidity of Islamic banks not only eats into their profitability and therefore their long-term viability, it also dampens the effect of monetary policy interventions in the financial markets by central banks. The onset of Basel III liquidity coverage requirements is likely to exacerbate the problem as Islamic banks will need to maintain high-quality short-term liquid assets.

Malaysia, a pioneer in Islamic banking, established an Islamic interbank money market in 1994 which has evolved into an active market offering a range of Shariah compliant instruments based on Murabahah, Sukuk, Wadiah, Qard and others for Islamic banks to manage liquidity. Malaysia adopts a liberal Shariah interpretation relating to trading in debt which has allowed Islamic banks to offer a diverse range of products.

Some of the commonly adopted instruments and mechanisms used elsewhere are discussed in the following.

Sukuk

Domestic and international Sukuk issuances are an increasingly important tool used to absorb excess liquidity of Islamic banks. Sukuk have the added advantage that, depending on their rating, they can be counted as high-quality liquid assets, thereby helping Islamic banks to meet their Basel III liquidity coverage obligations.

The International Islamic Liquidity Management Corporation (IILM) is an international organization with the specific mandate to issue Sukuk to absorb the excess liquidity of Islamic banks. The IILM issues Sukuk in tenors ranging from three months up to one year which are denominated in US dollars. Such Sukuk can be traded globally through an international primary dealer network, making them highly liquid instruments. A US dollar-based instrument is likely to be less attractive to Islamic banks in countries with strict foreign exchange laws or where currency fluctuations could pose additional foreign exchange risk.

The government of Bahrain has put in place short (six months) and long-term (two to 10 years) Sukuk Ijarah programs as well as a Sukuk Salam program whereby the central bank issues 91-day short-term Sukuk with aluminum as the underlying commodity. The State Bank of Pakistan issues medium-term three-year floating rate government Sukuk Ijarah on behalf of the government of Pakistan and is actively looking to expand its Sukuk issuance program as well as introduce new mechanisms.

Commodity Murabahah

Islamic banks in many jurisdictions including GCC countries use commodity Murabahah for short-term liquidity placement. However, the commodity Murabahah may not be suitable for overnight placements given the time required to consummate the sale and purchase of commodities.

Commodity Murabahah can be used as a replacement for repurchase (repo) and reverse repo transactions. The advantage of commodity Murabahah is that it enables Islamic banks to place funds with conventional banks thereby increasing the size and depth of the Islamic interbank market. The Central Bank of the UAE has introduced an Islamic certificate of deposit based on commodity Murabahah, which is issued in tenors ranging from one week to five years. The disadvantage of commodity Murabahah-based instruments is that they cannot be traded at a value other than par.

Wakalah interbank deposits

As an alternative to Murabahah, Islamic banks have also used Wakalah placement agreements to place funds with other Islamic banks on a short or medium-term basis. Such Wakalah deposits have been used most widely in Oman. A major advantage of Wakalah is that such transactions are cheaper and quicker to execute due to the absence of commodities in the process. The disadvantage of Wakalah is that the returns on a Wakalah deposit can only be determined at the time of repayment, and hence it does not guarantee a pre-determined return to the investing bank. In addition, their status as deposits requiring repayment could be questioned in case of bankruptcy. Furthermore, Wakalah deposits cannot be placed with conventional banks, unless arranged through their Islamic windows and it can be ensured that the funds are used in a Shariah compliant manner.

Conclusion

Although a variety of approaches have been adopted in different jurisdictions, much work remains to be done to diversify the mix of available options for Islamic banks to manage their short to medium-term liquidity and this is an ongoing process. The divergence in Shariah interpretations across different jurisdictions has so far stifled a truly global approach toward tackling this issue. However, standard-setting bodies such as AAOIFI and the IFSB are playing an important role in bridging this gap.

Liquidity management continues to remain at the core of the issues that regulators need to address to ensure the healthy growth and development of the Islamic banking sector.