

Liquidity & Risk Management in Islamic Banking

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Issues in Inter-Bank Unrestricted (On Balance Sheet) *Wakalah*



Legal Challenges

- ❑ When restructuring the classical *Wakalah* arrangement, the challenge is therefore to transform the risk of *Wakalah* to rank *pari passu* with a normal senior unsecured obligation of the deposit-taking institution while retaining the key *Shari'ah* feature of no explicit capital guarantee. This could be achieved by amending the *Wakalah* agreement to incorporate the following features:
 - I. *Possibility of Undertakings by the deposit-taking institution relating to the basis on which funds are received and will be dealt with, including early termination if at any time the deposit-taking institution believes that the expected maturity proceeds may be lower than that indicated to the client, i.e. the Wakalah becomes immediately repayable (placement amount plus accrued profit) if there is reduction in the credit quality of one or more assets in Wakalah portfolio or if returns are too low to meet the target profit rate*
 - II. *Compensation to the client for any loss he may suffer due to the deposit-taking institution's failure to comply with the terms of the agreement, including circumstance where it negligently fails to adhere to (i) above.*

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Issues in Inter-Bank Unrestricted (On Balance Sheet) *Wakalah*



Operations/Risk Management Framework

- ❑ It is essential that a comprehensive operational risk process is put in place for on-balance sheet unrestricted *Wakalah* for Islamic inter-bank market
- ❑ The deposit taking institution should implement robust front and middle office systems to monitor compliance with the legal structure and to achieve internal objectives of not having to repay the deposit early thereby adverse impact on liquidity
- ❑ Longer term assets in general produce a higher absolute return than short term assets. At the outset it is imperative that the deposit taking institution formally confirm and record amongst others the following policy decisions through its relevant sanctioning authorities:
 - i. *All "debt" like transactions is automatically deemed components of the Wakalah pool unless specifically excluded. Therefore, the pool typically comprises Sukuk, term financings and money market placements but excludes real estate, equity and quasi equity*
 - ii. *The decision to honor "indicative" profit rates should the Wakalah portfolio return fall below the rate indicated on any Wakalah, whilst recognizing that it would be objectionable to Shari'ah for this to be a condition of the placement*

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Issues in Inter-Bank Unrestricted (On Balance Sheet) *Wakalah*



Operations/Risk Management Framework (continued)

- ❑ Mandate and delegate authorities to a designated individuals and committees, e.g. the Treasurer and Asset & Liability Management Committee (ALCO) to monitor the portfolio daily (Treasurer) and weekly (ALCO) and consider the constituent components (assets and liabilities) of the *Wakalah* portfolio:
- ❑ Include new assets entered into, for example day's Commodity *Murabahah* and *Wakalah* money market transactions
- ❑ Exclude any transactions (assets) where repayment is doubtful or likely to become doubtful. Advisable to agree mark to market thresholds on assets as indicators/guidelines
- ❑ The portfolio return is compared to the returns indicated. If indicated returns fall below the portfolio return this is flagged and a specific decision noted to honor indicative returns. This decision should be post event communicated to the deposit-taking institution's *Shari'ah* supervisory body for recording

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Issues in Inter-Bank Unrestricted (On Balance Sheet) *Wakalah*



Operations/Risk Management Framework (continued)

- ❑ As can be derived from the above, it is recommended that a relative return for *Wakalah* deposits be decided upon. This means that if, say, a 2 month deposit is taken under *Wakalah* at a spread of Libor + 8 bp, as long as the average return of each portfolio asset is greater than Libor + 8 bp for each asset's maturity date, the target return is being achieved for the portfolio as a whole
- ❑ Constant monitoring to the portfolio for any material deterioration in asset quality is essential and required in this process. These deterioration assets should be excluded from the portfolio before losses are sustained
- ❑ The proposed operational process, subject to further development, is key element of making the unrestricted *Wakalah* as on-balance sheet product. The collective investment scheme may be taken as a reference

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Issues in Inter-Bank Unrestricted (On Balance Sheet) *Wakalah*



Indicative Rate of Return & Guarantee on Return

"If the *Wakil* (Agent) makes a profit by the maturity date, the profits belong to the *Muwakkil* (Investor), and the *Wakil* is entitled for *Wakalah* fee in pre-agreed amount or pre-agreed percentage of asset under management. Conversely, if a loss is made this loss is borne by the *Muwakkil* in the absence of gross negligence, fraud or willful default by the *Wakil*"

In a normal market, feasibility reports may be relied on by the *Muwakkil* in order to decide whether to invest with the *Wakil* or not, however where the market is volatile relying on such reports may be a problem. Where the economy is witnessing a downturn, it becomes difficult to rely on predicted rate of return; hence, a methodology based on operational process mentioned earlier could be incorporated to overcome this issue.

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Issues in Inter-Bank Unrestricted (On Balance Sheet) *Wakalah*



Other Issues

A. Capacity Risk

The issue of guaranteeing a minimum return on the *Muwakkil's* investment raises further questions in relation to the capacity of the *Wakil* to give such guarantees and whether or not the *Wakil* can renounce his obligations under the *Wakalah* agreement on the basis of lack of capacity

As per our research most of the institutions are now including the capacity risk clause as a standard clause in their master agreement

B. Mixing of Funds Versus Insolvency

Based on general market practice, when a *Muwakkil* invests money with the *Wakil* under a *Wakalah*, such money is usually mixed with the *Wakil's* own pool of funds. In the event that the *Wakil* becomes insolvent, the *Muwakkil's* money will be mixed with the *Wakil's* other money and may well be treated by the liquidator in certain jurisdiction's law governed insolvency as part of the *Wakil's* liquidation assets. For this reason, in some jurisdictions, where there is an absent insolvency remote trust laws, investors are advised to consider this risk when investing their funds under a *Wakalah* agreement. Due to this reason it is recommended that a reference pool of assets is created and should be managed as per the proposed *Wakalah* operational process.

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Issues in Inter-Bank Unrestricted (On Balance Sheet) *Wakalah*



Other Issues (continued)

C. Changing of the Reference Asset Pool

Changing of the reference asset pool as and when required under operational process guidelines (may have legal implications e.g. under U.A.E. law this can be categorized as discretionary investment rather than a deposit). Moreover, it is proposed that the pool of assets to be treated as reference pool and not investment pool.

Deposit-taking institutions may have several pool of asset and may have a certain pre-agreed method/formula to calculate *Muwakkil's* return from those several pool of asset. Return to *Muwakkil* must be based on actual investment pool with flexibility on calculation method

D. Honoring Indicative Versus Low Portfolio Return

A policy of honoring an indicated profit rate, in the event the portfolio return is lower than the indicated profit rate or certain assets from the reference pool need to be taken out due to not meeting the criteria under the operational process, may have *Shari'ah*, legal, accounting treatment and shareholders implications and these need to be addressed.

On the other hand the requirement of taking *Shari'ah* approval on each instance will become cumbersome and if in principle an Islamic bank's *Shari'ah* board allows then it does not need to approve individual transactions.

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Issues in Inter-Bank Unrestricted (On Balance Sheet) *Wakalah*



Other Issues to be Researched

- (a) What will be required to make the *Wakalah* standard agreement comply with laws of jurisdictions where Islamic finance is practiced?
- (b) Issues related to central bank regulations, accounting treatment, capital allocation need to be studied extensively
- (c) Should operating standard be made as compulsory for using the *Wakalah* document?
- (d) Transfer of risk from fund placing institution back to fund taking institution and its impact to shareholders equity is a critical factor to be addressed in light of *Shari'ah* and also its legal implications
- (e) The possibility of funds taking entity to be able to disclose the asset pool, if required, to the *Muwakkil* in order to address the issue of transparency in most of the *Wakalah* arrangement