



Interbank Money Market Operations:

- *developing Shari'ah compliant solutions*
- *potential for Islamic liquidity management*

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Understanding Liquidity Issues in Islamic Finance



General Overview

Surplus of Liquidity

- Liquid: Islamic Financial Institutions (IFI's) are generally more liquid than their conventional counterparts
- Low Returns: Limited short-term investments, hence IFI's earn low returns on liquid assets

Shortage of Liquidity

- Inter-Bank Market: IFI's have limited ability to tap short-term funds to meet cashflow requirements
- Lender of Last Resort: Most banking failures are due to liquidity shortages. There is a need for a "lender of last resort"

Maturity Mismatch

- Long-Term Assets: IFI's main investments are long-term e.g. sukuk, project finance, real estate
- Short-Term Liabilities: IFI's main funding is from short-term customer deposits
- Gap: IFI's have a mismatch risk

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Understanding Liquidity Issues in Islamic Finance



Regional Overview

Malaysian Islamic Inter-Bank Money Market

- Introduced in 1994
- Investments: Government Investment Issues (GII), Bank Negara Malaysia Negotiable Notes (BNNN), Treasury bills, Islamic commercial papers and Islamic Negotiable Instruments

Bahrain

- Rolling monthly programs of short-term Sukuk Al Salam in place since 2001
- Short-term Sukuk complimented by regular issuance of medium-term Sukuk Al Ijarah
- August 2005, separate rolling program of monthly issue of short-term Sukuk Al Ijarah
- CBB first short-term Sukuk over-subscribed by 200%. The trend continues

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Understanding Liquidity Issues in Islamic Finance



Regional Overview

Pakistan

- Islamic banks managing reserve requirements by high cash reserves and low liquidity reserve
- Not a level playing field with conventional banks
 - Limited Shari'ah compliant securities
 - No lender of last resort
- Requirement of Islamic inter-bank market at USD 1.0-1.5 billion (estimate)
- Islamic industry market share in overall assets 4% in 2008, to grow to 12% in 2012
- Issues of WAPDA Sukuk (USD 134 million), Al Zamin Mudaraba, Sovereign Sukuk, Sitara Chemicals and Wateen Telecoms
- 2008: Started Ijarah based Sukuk Program for Islamic Money Market
 - first issue USD 25 million

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Understanding Liquidity Issues in Islamic Finance




Regional Overview

Brunei

- Issuance of short-term Sukuk landmark for Brunei
- Short-term Sukuk issued September 2006- Al Ijarah
- First issue of USD 150 million over-subscribed in one day
- Provided opportunity for investment in Brunei by financial institutions and Takaful operators

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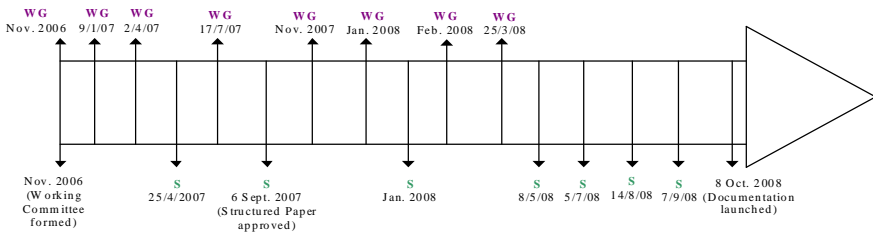
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Liquidity Management Products and Instruments

Commodity Murabaha

➤ Over reliance and future role

IIFM Master Agreement for Treasury Placement (MATP) – project timeline



WG = Working Group
S = Shari'a Meeting

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Liquidity Management Products and Instruments

Wakala and unrestricted Wakala

Wakala has been gaining momentum since 2005


Advantages:

- No commodity
- No brokerage
- Access more banks
- Competitive

Challenges:

- Accounting treatment not favourable to Islamic windows
 - ❑ Off Balance Sheet vs On Balance Sheet
- Credit Issues
- Rate of Return not guaranteed

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Liquidity Management Products and Instruments


Short-term Sukuks

- Liquidity issue: Generally, Sukuk are medium to long-term tenor with inactive secondary market, hence not considered as liquid instruments
- Short-term Sukuk: This essentially passes the risk and return of the Sukuk to the counterparties for short periods
- Central banks promote liquidity: CBB, Brunei, Pakistan etc

Other Short-term Instruments

- Arab Banking Corporation's liquidity management tool (mid 1990's)
- Exchange of Qard Hassan
- CBB's recent liquidity management tool

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Liquidity Management Products and Instruments

Securitisation of Assets (I) – General

- Desire for higher returns
- Opportunity in physical assets
- Securitisation

Securitisation of Assets (II) – Asset Backed Commercial Paper

- Short-term assets
- Potential
- Issues

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Liquidity Management Products and Instruments


Constituents of Islamic Money Market

- New solutions
 - Wakala
 - Unrestricted Wakala
 - Short-term Sukuk
 - Securitisation of Assets
- Developing well suited inter-bank instrument for active inter-bank trading or for monetary operations
- Availability of hedging instruments
- Establishment of a lender of last resort
- A mega bank or central counter-party

Ideal scenario

- IFI's need access to a liquid market of investments with different returns and different maturities

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IIFM I'aadat Al Shira'a (IS) Project Shari'ah Considerations – Way Forward

a) Bilateral Repo Structuring

- Securities – equivalent securities but different serial numbers
 - ❑ Shari'ah View – not possible for two parties to transact using equivalent securities as results in Bai Al Inah
- Undertakings "Wa'ad"
 - ❑ Pricing – 1st sale as pure sale
2nd leg as per formula
 - i) Term Repo – fixed term and on Day 1 prices are determined
 - ii) Open Repo – undertaking can be exercised anytime in a given period
 - iii) Buyer undertakes to sell
 - ❑ Shari'ah View – I'nah on second sale hence not allowed
 - Fixed price raises Riba issue

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IIFM I'aadat Al Shira'a (IS) Project Shari'ah Considerations – Way Forward (cont...)



- Bilateral Repo Possibility
 - Unilateral Wa'ad
 - At Market Price
- Issue
 - Difficult to bridge the gap between market requirement and Shari'ah

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IIFM I'aadat Al Shira'a (IS) Project Shari'ah Considerations – Way Forward (cont...)



b) Tri-Partied Repo

- Undertaking "Wa'ad"
 - Party A (Bank 1) sells to Party B (Independent Third Party)
 - Party B sells to Party C (Bank 2)

Ideally IFSI should have Central Counter Party (CCP) or Independent Third Party to be indentified

- Possible Structure and Considerations
 - Form of Undertaking b/w A & C
 - Unilateral or simple Wa'ad
 - Whether C has right to exercise Wa'ad
 - Contingent or non-contingent contract

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IIFM I'aadat Al Shira'a (IS) Project Shari'ah Considerations – Way Forward (cont...)



- Overview of Tri-Partied Structure
 - Party A sells the securities to an independent Third Party against immediate payment
 - Third Party sells the securities to Party B for immediate payment
 - Party A undertakes to buy back equivalent securities from Party B @ future date and @ cost + profit
- Issues for Consideration
 - Underlying Securities
 - Margin Call
 - Accounting Treatment
 - Broker Credit Risk
 - Income / Dividend Treatment
 - Master Terms
 - Netting Issues

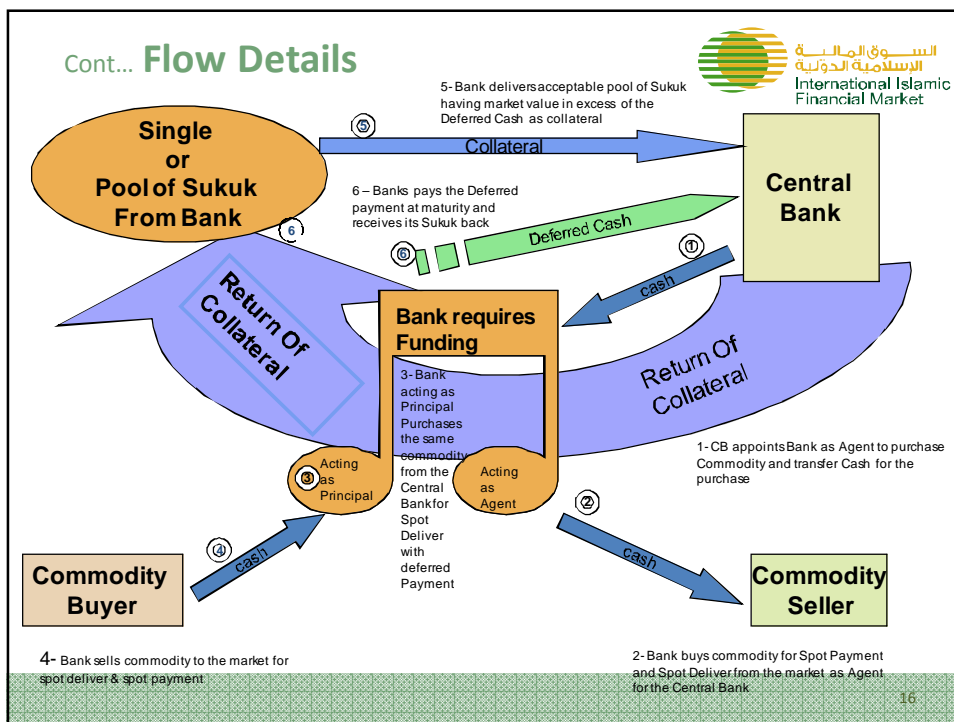
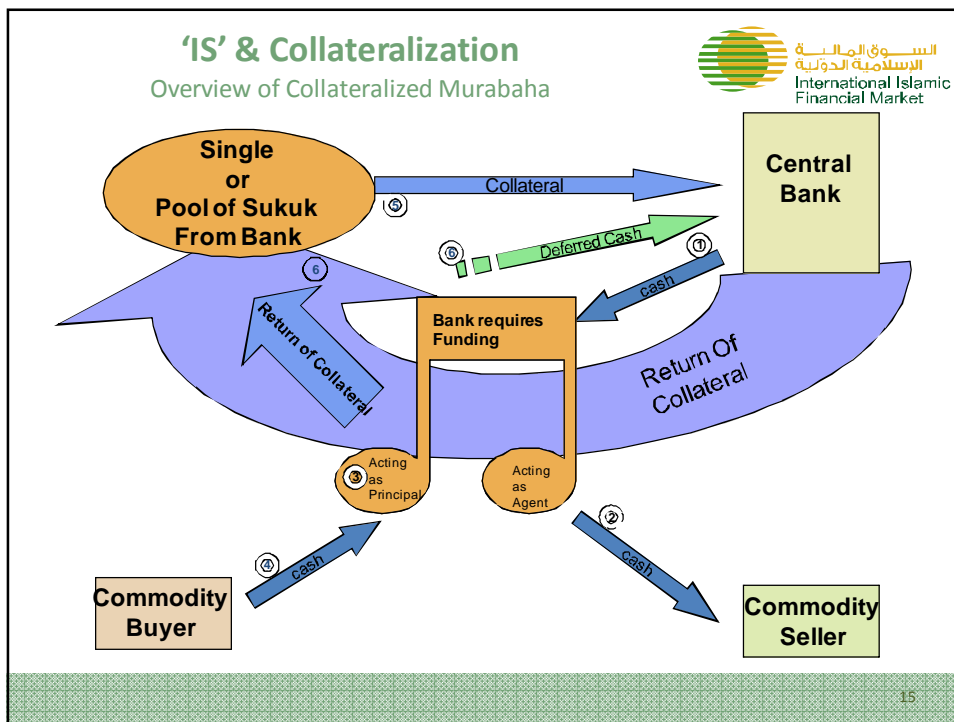
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IIFM I'aadat Al Shira'a (IS) Project Shari'ah Considerations – Way Forward (cont...)



- Tri-Partied global 'IS' Master Agreement is possible if the above identified considerations are developed
- Concerted efforts from all stakeholders required

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'IS' & Collateralization



Transactional Steps

- **Step One** – Both parties agrees on Term of the transaction, the mark up, type of Sukuk, and Margin call parameters (Haircut, Threshold & Base Currency)
- **Step Two** – Central Banks invest \$100 myn Cash for say 1 Month via a Murabaha transaction with a local bank
- **Step Three** – Central Banks receives acceptable Sukuk as agreed by both parties to a value of \$ 110myn to collateralise the exposure and allow 5% variance on both side. Reason to provide 10myn extra coverage is to allow for price fluctuation and to reduce the movement of Collateral back and forth
- **Step Four** – Assuming Collateral fluctuation remains within the band then on the deferred maturity date the Central Bank receives its \$ 100myn + the profit and the Central Bank returns all of the Sukuk Collateral to the Islamic bank

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'IS' & Collateralization



Assuming the Collateral Value Decreases Below the Treshold Variance

- Bank to provide more same or other acceptable Sukuk
- Provide other acceptable Collateral as previously agreed
- Or Provide acceptable Letter of Credit
- Or Provide Reverse Murabaha
- To bring the collateral level back to 110%
- If non of the above agreed instrument is delivered then the Bank will be in Default

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'IS' & Collateralization



Assuming the Collateral Value Increase Above the Treshold Variance

- The Central Bank will Return part of the Sukuk in order to bring it down to 110% of the Murabaha Amount
- Or the Bank may consider not to request this extra amount from the Central Bank if it wishes to leave extra buffer and save of operational cost

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'IS' & Collateralization



Commitment of Both Parties

- At All times during the 1 Month Murabaha a 100% to 110 % collateral cover will be maintained against its Deferred payment exposure
- Any Increase above the 115%, the Bank has the right to call collateral back
- Any Decrease below 105%, the Central Bank has the right to ask for Top up

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'IS' & Collateralization



Notes & Considerations

- The transaction could be between a Bank and Central Bank or Bank and any Financial Institution
- Sukuk could be clearing house based as well as domestic Sukuk
- Rating benefit is taken as implied
- Other securities which could be used as collateral are not considered at this time
- Use of collateral i.e. Sukuk by CB and FI – probably FI is likely to use Sukuk as compare to CB
- Governing Law – seems English law needs to be used
- Clearing system based Sukuk and its treatment ?
- Accounting treatment for collateral assuming leaving pledge or security interest

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'IS' & Collateralization

Documentation, Legal & Regulatory Challenges
to Reach Classical Repo Outcome




Documentation

- Agency Agreement (IIFM MATP) OR Wakala Agreement
- Transfer Instructions
- Purchase Contracts
- Collateral Documentation

Collateral Structure

- Security Interest
 - ❑ Customarily a Security Interest does not transfer title to the assets to the Security Interest beneficiary. Instead the beneficiary would obtain security which it could enforce in the event of default by the Security Interest provider to meet the Secured Obligations or an earlier bankruptcy or other event of default in relation to the Security Provider

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‘IS’ & Collateralization


Documentation, Legal & Regulatory Challenges
to Reach Classical Repo Outcome

Collateral Structure (Cont...)

- Conditions for Security Interest
 - ❑ The Security Interest provider must have the necessary capacity to provide the relevant security interest, and it needs to be practical for this to be checked quickly and easily
 - ❑ Which law governs the formalities for taking security over the secured asset needs to be readily determinable
 - ❑ Readily available documentation so that a Security Interest can be put in place quickly and easily
 - ❑ The Security Interest needs to be robust in the insolvency of Bank

End result Classic Repo type instrument

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‘IS’ & Collateralization

Documentation, Legal & Regulatory Challenges
to Reach Classical Repo Outcome

IIFM Project Team’s View

- Collateralized Murabaha or Wakala comes close to achieving Repo like benefits. However, the project team now invites the market and individual institutions to build from this initial ground work as they feel fit for their own businesses

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