

# LIQUIDITY MANAGEMENT IN ISLAMIC FINANCE

Industry Challenges and IFSB's initiatives

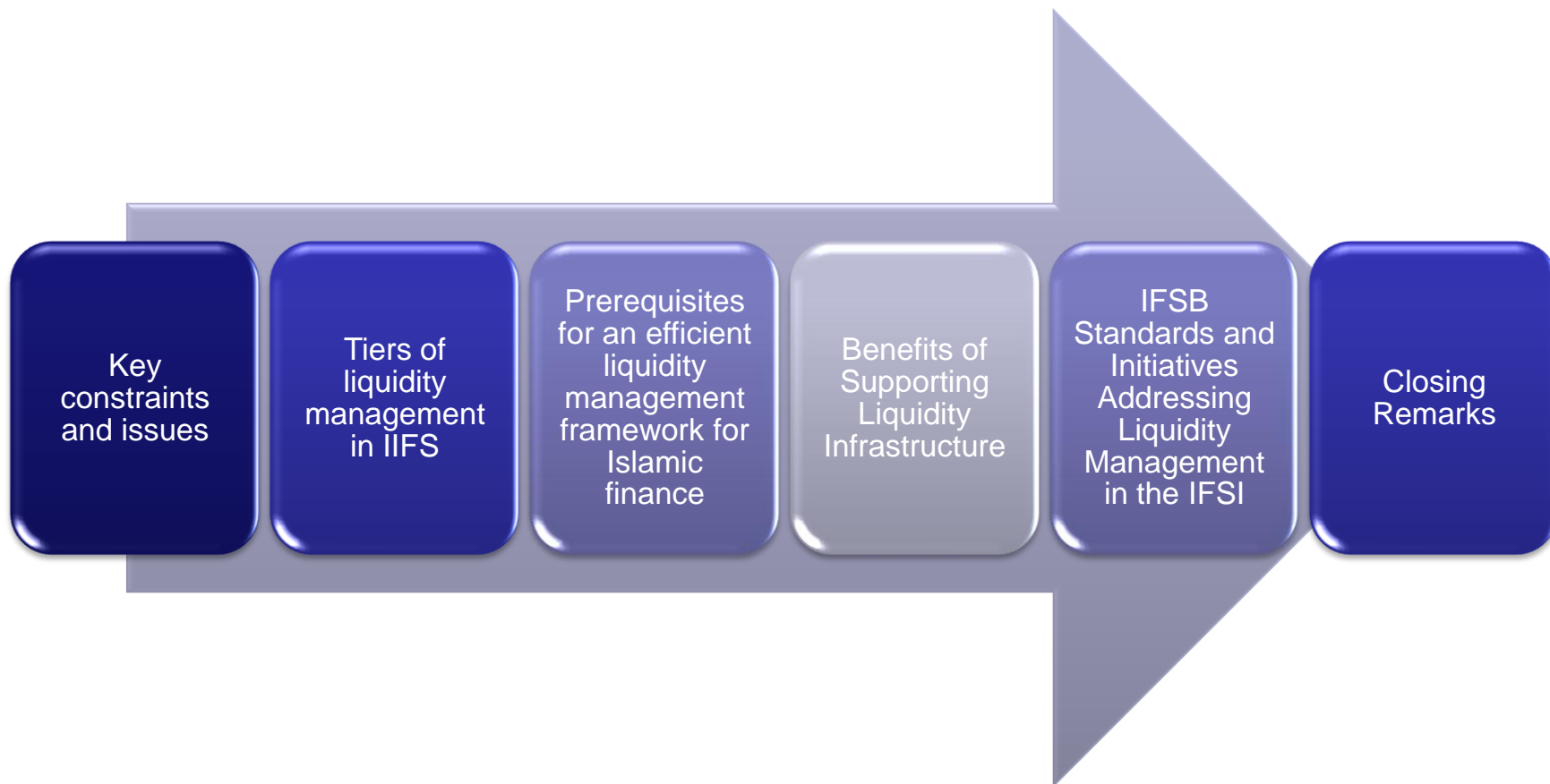
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# Presentation Outline



## Key constraints and issues

The insufficient supply of instruments with desirable characteristics is the core issue in Islamic liquidity management, which in turn causes other sets of problems

Reliance on instruments that are not sufficiently liquid may result in major systemic risk in a crisis situation

Use of instruments that carry large transaction costs reduces the competitiveness of IIFS

Segmentation of the markets between conventional and Islamic finance affects the effectiveness of central bank's monetary operations

## Key reasons for insufficient supply of instruments

Insufficient access to or availability of real assets that could be securitized

A country is too small to generate sufficient volume of assets that could create a benchmark

For large countries with limited number of Islamic banks, the cost of building the infrastructure for Islamic asset securitization may outweigh the benefits

# How to overcome the problem of insufficient supply of assets

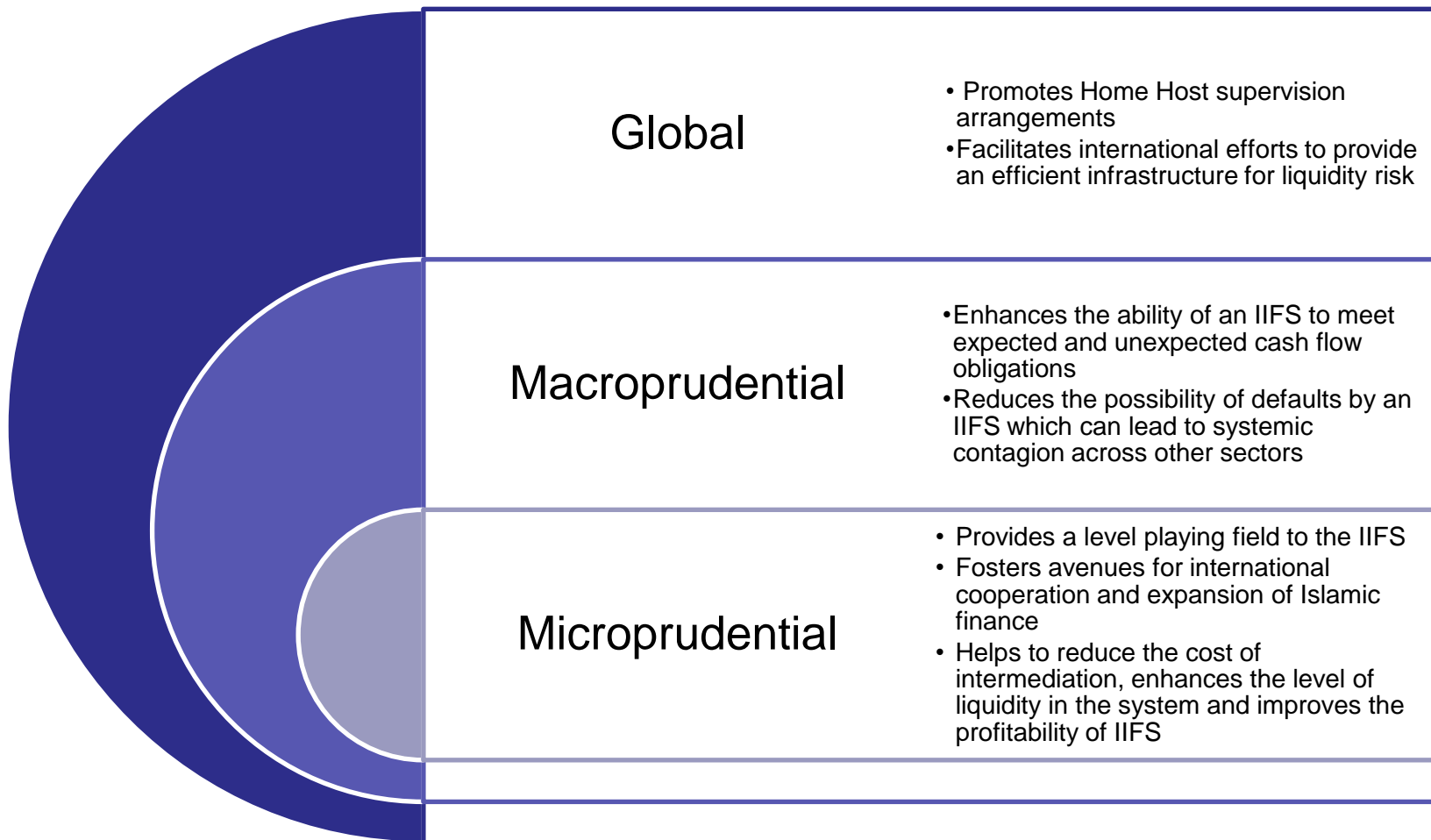
## At National Level

- To implement the recommendations of IFSB Technical Note through appropriate institutional arrangements to build up the volume of assets suitable for securitization and sukuk issuance,
- promote the use of sukuk in monetary operations and integrate the issue procedures in overall public debt management, etc

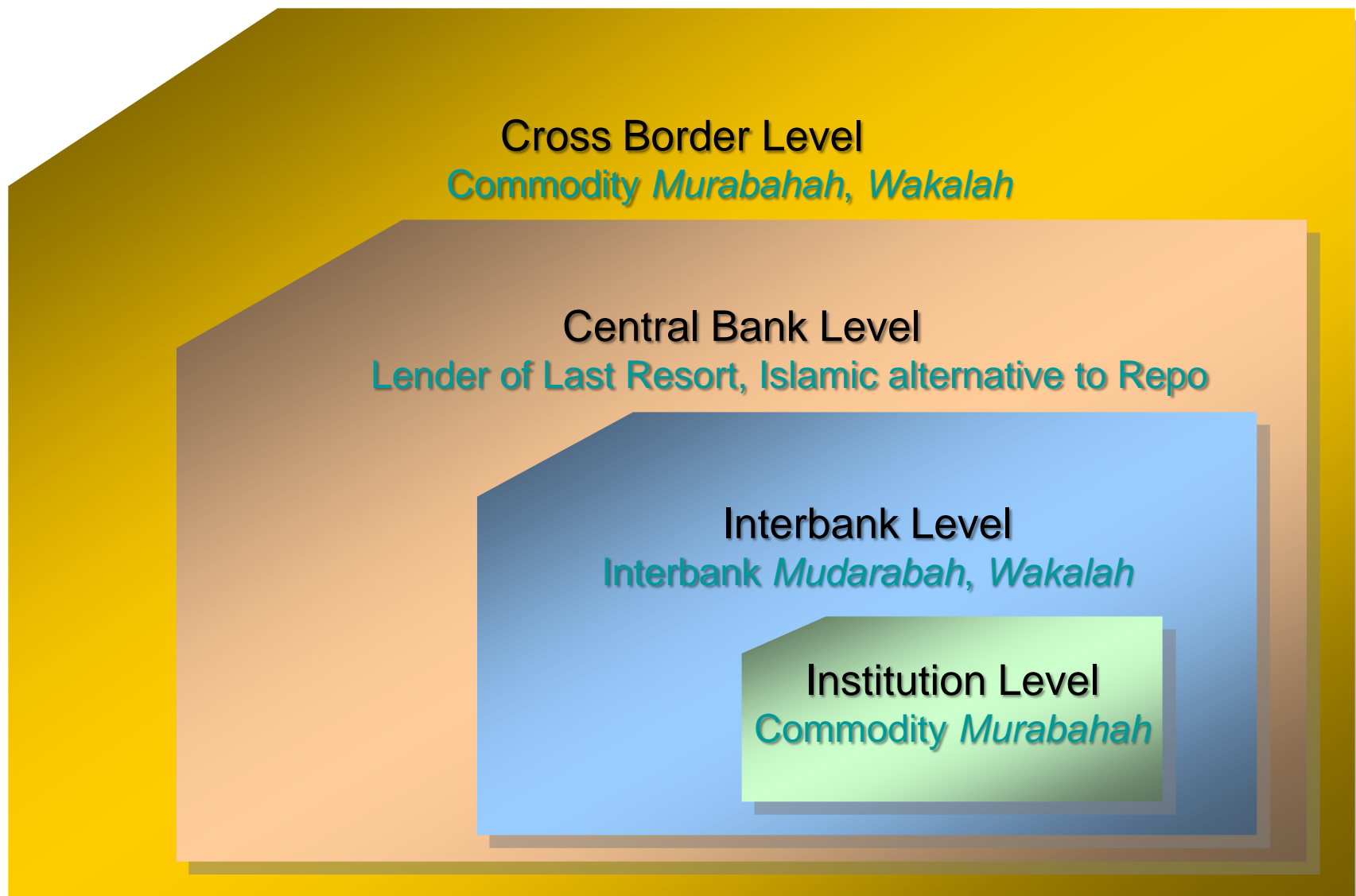
## At Regional & International Level

- To have a regional/international cooperation that can pool available assets and share a common infrastructure
- This infrastructure will be capable of providing high quality instruments with all the desirable characteristics in sufficient volume and help create the needed liquid benchmarks e.g. International Islamic Liquidity Management Corporation (IILM)

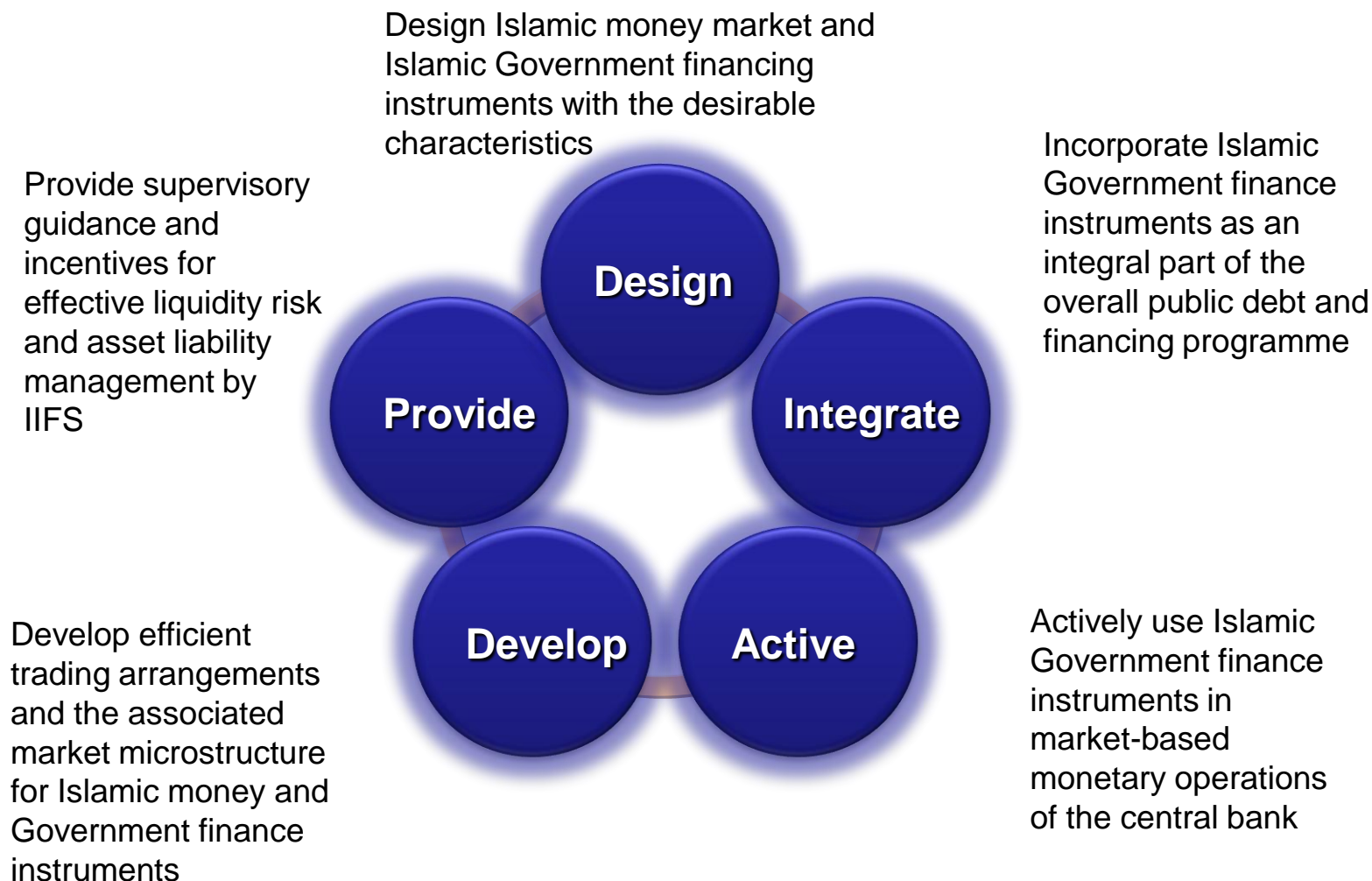
# Benefits of Supporting Liquidity Infrastructure



# Tiers of Liquidity Management



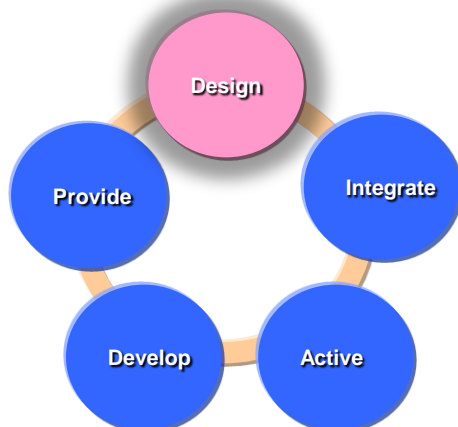
# Prerequisites for an efficient liquidity management framework for Islamic finance





# Design

Islamic money market and Islamic Government financing instruments with the desirable characteristics i.e. relatively low risk, simple in structure, regularly issued, widely held, and supported by a robust payment and settlement system

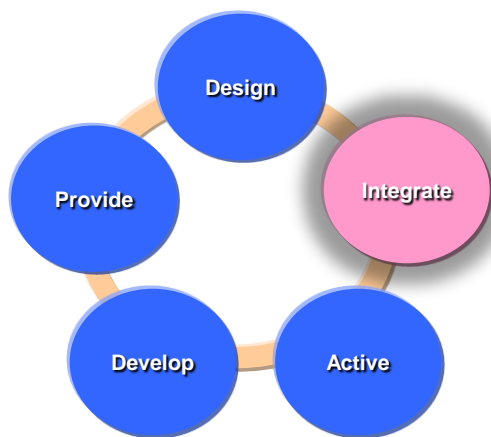


- Instruments with desirable characteristics are not available in sufficient volume and on a regular basis in most countries
- Some central banks still rely on inefficient or non tradable instruments
- Market players are increasingly resorting to *Commodity Murabahah* or some other special arrangements e.g. offsetting balances in the interbank market
- The central bank and the government need to play a stronger role in creating the systemic liquidity infrastructure that can then serve as the foundation for accelerating the development of private sector innovations and making them more efficient

# Integrate

Islamic Government finance instruments as an integral part of the overall public debt and financing programme, and foster the development of an Islamic Government securities market

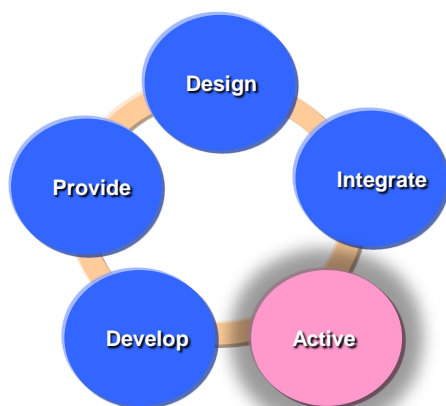
- There is almost no link between Government Islamic instruments and public debt management
- Sukuk issuance is still an isolated activity and still are not integrated with overall public debt management in most countries
- Close coordination is required between sukuk issuance activity, central bank monetary operations, and Government expenditure decisions
- A regular issuance programme for Government financing instruments in key maturities is necessary to help establish a wide investor base, benchmark Islamic securities and domestic benchmark rates of return



## Active

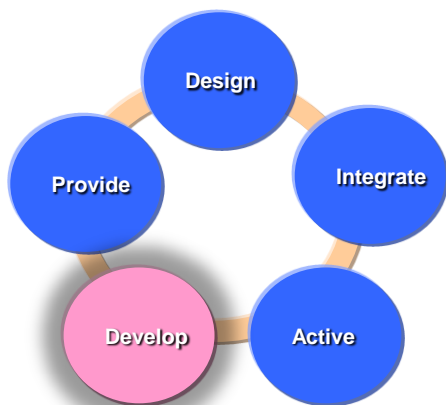
Use of Islamic Government finance instruments in market-based monetary operations of the central bank to manage liquidity in the Islamic money market

- Monetary instruments for IIFS are often distinct from those used for conventional banks
- This segments markets resulting in a weak transmission of monetary policy
- There is a need to also align other monetary policy instruments, such as the Cash Reserve Requirements, remuneration of excess reserves, and liquidity requirements between conventional and Islamic banks
- Central bank's lender of last resort facility that accommodates both IIFS and conventional banks must be in place



# Develop

Efficient trading arrangements and the associated market microstructure for Islamic money and Government finance instruments, and develop in parallel the foreign exchange markets

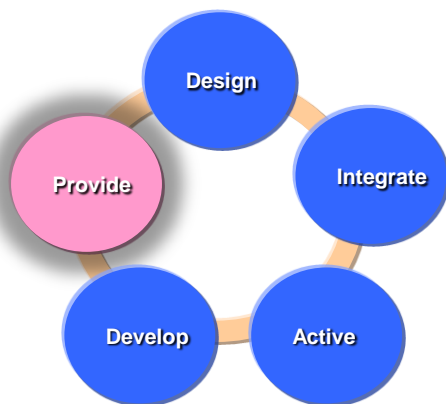


- Either the instruments are non-tradable, or the trading arrangements and market microstructure for available tradable instruments for IIFS are inefficient compared to the conventional money market
- Instruments are mostly held to maturity, and hence no incentive to deal in Sukuk

# Provide

Supervisory guidance and incentives for effective liquidity risk and asset liability management by IIFS, and in parallel foster privately issued Islamic money market securities

- To assist IIFS because of the limited number of players and instruments
- To identify sources of liquidity support mechanisms to the IIFS
- To protect against major reputational risk i.e. a single liquidity management problem in one IIFS may be construed as a major problem in the business model of the industry
- To safeguard the interest of IAH (which contractually absorbs their own risk)



# Securities and Exchange Markets

A vibrant and well managed securities and exchange market catering for *Sharī'ah* compliant instruments

## Securities Market

- Few short-term issuances
- Shortage of supply
- Originator concentration
- Regional fragmentation
- Low secondary market trading
- Low diversity of deal structures
- Possession of securitised assets in default cases
- Differing interpretations of *Sharī'ah* rulings about various types of *Sukuk*

## Foreign Exchange Market

- Low availability or acceptability of *Sharī'ah* compliant hedging techniques e.g. Forwards, foreign currency swaps etc.
- Low convertibility of many currencies in which IIFS may be active

# IFSB Standards and Initiatives addressing Liquidity Management in the IFSI

## Macprudential Surveillance

- IFSB-1 (Risk Management Standard, December 2005)
- IFSB TN-1 (Technical Note on Islamic Money Markets, March 2008)
- IFSB GN-1 (Recognition of Ratings by ECAI, March 2008)
- IFSB-5 (TMD Standard, December 2007)
- IFSB-10 (*Shar'ah* Governance Standard, December 2009)

## IFSI Strategic Direction

- IFSB-IRTI Ten-year Framework and Strategies for IFSI (May 2007)
- IFSB-IRTI-IDB Task Force Report on Islamic Finance and Global Financial Stability (April 2010)

## Infrastructure Initiatives

- Setting up of High-Level Task Force on Liquidity Management (March 2009)
- Facilitated the establishment of the International Islamic Liquidity Management Corporation (Nov 2010)
- Facilitating the Establishment of International Islamic Liquidity Management Corporation (October 2010)

## Ongoing Work

- IFSB Guiding Principles on Liquidity Risk Management
- IFSB Guiding Principles on Stress Testing

## Closing Remarks

Concerted efforts by the supervisory authorities and the IFSB will accelerate the development of a robust infrastructure and effective guidelines for IIFS liquidity management

The role of governments is crucial in order to provide a facilitating environment for this development to take place e.g. facilitating changes in laws and taxes; developing a regular program of *Sukuk* issuance

Greater collaboration among industry players, local and international is the key for further development of liquidity infrastructure for IFSI

Increased efforts on research can lead to new and innovative products, solutions and institutions with better and more acceptable *Sharī'ah* compliance liquidity management framework





Thank you

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