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Contents

DEMOCRACY AND SOCIO-ECONOMIC INCLUSION IN NIGERIA: REDUCING THE MUTUAL EXCLUSIVITY THROUGH ISLAMIC MICROFINANCE <i>Abideen Adeyemi Adewale, Razali Haron</i>	1
AN INVESTMENT APPRAISAL OF INTERNATIONAL MARITIME ASSETS FOR MALAYSIAN ISLAMIC FINANCIAL INSTITUTIONS – THE CASE FOR EQUITY FINANCE <i>Adam Abdullah, Rusni Hassan, Salina Kassim</i>	27
<i>SHARI'AH</i> ISSUES IN GOLD TRADING AND GOLD RELATED SCAM SCHEMES <i>Azman Mohd Noor</i>	61
CLASSIFICATION OF DEFAULTERS IN THE PAYMENT OF DEBT IN ISLAMIC BANKING PRACTICES <i>Annan Hasan, Muhamad Nasir Haron, Mohd Faysal Mohamed, Budeeman Mana</i>	85
FUNDAMENTALS, UNIVERSE CREATION AND APPRAISAL OF MAJOR <i>SHARI'AH</i> - COMPLIANT STOCKS SCREENING METHODOLOGIES <i>Buerhan Saiti, Khaliq Ahmad</i>	105
OWNERSHIP STRUCTURE OF FAMILY-OWNED FIRMS AND DEBT FINANCING. EVIDENCE ON <i>SHARI'AH</i> -COMPLIANT FIRMS IN MALAYSIA <i>Razali Haron</i>	139
TOWARDS PROVIDING THE BEST <i>SHARĪ'AH</i> GOVERNANCE PRACTICES FOR <i>WAQF</i> BASED INSTITUTIONS <i>Rusni Hassan, Syed Musa Bin Syed Jaafar Alhabshi, Adnan Yusoff</i>	165
PUSHING THE FRONTIERS OF ISLAMIC FINANCE THROUGH SOCIALLY RESPONSIBLE INVESTMENT <i>SUKUK</i> <i>Salina Kassim, Adam Abdullah</i>	187
EXPLORING MULTI-DOMAINS OF ISLAMIC FINANCE EDUCATION CURRICULUM <i>Syed Musa Bin Syed Jaafar Alhabshi</i>	215
TOWARDS THE DEVELOPMENT OF <i>SHARĪ'AH</i> COMPLIANT HIGH QUALITY LIQUID ASSETS FOR ISLAMIC FINANCIAL INSTITUTIONS <i>Engku Rabiah Adawiah Engku Ali, Umar A. Oseni, Muhd Ramadhan Fitri Ellias, Muhamad Nasir Haron</i>	233
IMPACT ASSESSMENT OF ISLAMIC MICROFINANCE ON THE RELIGIOUS, ETHICAL AND SOCIAL WELL-BEING OF PARTICIPANTS: A CASE STUDY OF PAKISTAN <i>Khaliq Ahmad, Adewale Abideen Adeyemi, Muhammad Nauman Khan</i>	265
NOTES ON CONTRIBUTORS	297

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TOWARDS THE DEVELOPMENT OF *SHARĪ'AH* COMPLIANT HIGH QUALITY LIQUID ASSETS FOR ISLAMIC FINANCIAL INSTITUTIONS

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Abstract

Islamic banks are required to be able to access and hold sufficient levels of High Quality Liquid Assets (HQLA) as part of Basel III requirements. Such HQLA are specifically meant to allow the Islamic banks to raise funds in money markets in the event of liquidity shortage or in some cases for the funding of new profitable investments. Against this backdrop, this study examines existing efforts in developing Sharī'ah-compliant HQLA and the challenges Islamic financial institutions are facing in assessing such liquid instruments. Beside the laudable efforts of a policy-driven supranational institution in developing Sharī'ah-compliant HQLA, there has not been much effort in the global Islamic finance industry to develop more HQLAs. As a matter of fact, it is the overarching dearth of such Sharī'ah compliant HQLA for liquidity management that led the Bank of England to commence work on the feasibility of introducing central bank liquidity facilities such as the proposed Sharī'ah compliant fund based deposit in 2015 which is expected to be ready for implementation by Spring 2018. This study also finds that experts have considered the potential of gold as HQLA for bank's liquidity management.

Keywords: High Quality Liquid Asset, Basel III, liquidity management, Islamic banks

1. Introduction

The financial crisis that began in 2007 was said to be attributable to a number of causes and had impacted the financial market and its regulation in many unprecedented ways. The crisis exposed a wide range of problems and issues, including lacunas and weaknesses in the regulation and risk management of financial markets. In relation to liquidity and liquidity risk management, for instance, the Basel Committee on Banking Supervision (BCBS) confirmed that, “many banks – despite adequate capital levels – still experienced difficulties because they did not manage their liquidity in a prudent manner.”¹ The BCBS stressed that the crisis drove home the importance of liquidity to the proper functioning of the financial market generally, and the banking sector in particular.

Thus, in response to the serious repercussion of the global financial crisis in 2007-2008, a number of measures at the micro and macro level have been proposed to enhance the stability of the financial markets. Basel III was the major focus in order to strengthen global capital and liquidity. Although Islamic banks and financial institutions were not directly affected by the financial crisis of 2007,² they are admittedly operating within a global and interlinked financial system. Thus, when the impact of the financial crisis started to overspill to other segments of the economy, causing a decline in commodity and property prices as well as general economic slowdown, the performance of Islamic financial

Disclaimer: The views expressed in this paper are those of the authors and do not necessarily reflect the views or policies of the International Islamic Liquidity Management Corporation or any other organisation which any of the authors work for.

¹ Basel Committee on Banking Supervision, “*Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools*”, January 2013 (Bank for International Settlements), 1.

² The Islamic banks generally showed better resilience, mainly due to the non-existence of any of the toxic assets in their balance sheet as well as the high capitalization and ample liquidity that they enjoy. See Ibrahim Warde, “After the Meltdown: New Perspectives on Islamic Finance”, in *Building Bridges Across Financial Communities: The Global Financial Crisis, Social Responsibility, and Faith-Based Finance*, ed. S. Nazim Ali. (USA: The President and Fellows of Harvard College, 2012), 19-30.

institutions was also adversely affected.

Moreover, in terms of liquidity and liquidity management, many Islamic banks have long suffered from lack of liquidity instruments and inactive secondary market. This contributed to the inability of Islamic banks to optimise the use of their excess liquidity and this in turn will adversely affect their profitability. To the few jurisdictions that have a relatively more advanced Islamic interbank and money markets, like Malaysia, the said markets have not been fully tested in terms of their ability to withstand stress or liquidity pressures in full-blown financial crisis. Thus, it is felt that the strengthening of global capital and liquidity rules as per Basel III is equally vital and relevant to Islamic banks too.³ In addition, in line with the growing market share of Islamic financial institutions around the globe and the need for systemic soundness and stability of the global financial system, there were concerted efforts to introduce robust liquidity risk management framework for Islamic financial institutions.⁴

This study examines current efforts and future perspectives on developing *Sharī'ah*-compliant High Quality Liquid Assets (HQLA) for Islamic financial institutions. The study is organized into seven different but related parts. Beyond this introductory part, Part 2 provides a brief overview of Basel III and current global efforts in regulating liquidity management in financial institutions. Part 3 examines the dynamics of Liquidity Coverage Ratio (LCR) and HQLA while exploring the list of HQLA asset classes. Subsequently, Part 4 specifically explores the nature of HQLA in Islamic financial institutions and identifies the pronounced dearth of HQLA in Islamic finance. Part 5 examines the efforts towards developing *Sharī'ah* compliant instruments of HQLA, while Part 6 identifies a number of challenges in implementing *Sharī'ah* compliant HQLA in the global

³ Salman S. Ali, "State of Liquidity Management in Islamic Financial Institutions", *Islamic Economic Studies* 2, No.1 (2013), 63-98.

⁴ IFSB, "Guiding Principles On Liquidity Risk Management For Institutions Offering Islamic Financial Services [Excluding Islamic Insurance (Takaful) Institutions And Islamic Collective Investment Schemes]", *Islamic Financial Services Board* (Kuala Lumpur:2012) available at [http://www.ifsb.org/standard/eng_IFSB-12%20Guiding%20Principles%20on%20Liquidity%20Risk%20Mgmt%20_\(March2012\).pdf](http://www.ifsb.org/standard/eng_IFSB-12%20Guiding%20Principles%20on%20Liquidity%20Risk%20Mgmt%20_(March2012).pdf)

Islamic finance industry. Part 7 provides the conclusion and some policy recommendations.

2. Basel III and Global Efforts in Liquidity Management

In general terms, liquidity management can be ideally defined as a process where a well-managed bank establishes a well-defined mechanism to identify, measure, monitor, and mitigate liquidity risk, which will help the bank in timely recognition of the sources of liquidity risk to avoid losses.⁵ It involves the ability of the bank “to manage its short-term resources and obligations, for the purposes of tracking the amount and timing of cash inflows and outflows.”⁶ Effective liquidity management measures serve as an early warning system to predict potential problems in order to avoid illiquidity in the bank’s business.

The existence of a robust liquidity risk management infrastructure for Islamic financial institutions is increasingly viewed as an essential component of both Islamic financial market development and overall financial system stability,⁷ and one of the ultimate objectives of liquidity management is maintaining asset-liability balances. Hence, it manages funding and financing activities; forecasts of demand of funding and financing; and maintains sufficient capacity (reserves) to fulfill financial obligations

⁵ Comptroller of the Currency. *Liquidity: Comptroller’s Handbook*. (Washington DC.: 2001), Comptroller of the Currency: Administrator of the National Banks; A. Majid, “Development of Liquidity Management Instruments: Challenges and Opportunities, *International Conference on Islamic Banking: Risk Management, Regulation and Supervision, Jakarta-Indonesia*, (2003), 24.

⁶ William Wilcox, Philip A. Horvath, Stanley E. Griffis and Chad W. Autry., "A Markov Model of Liquidity Effects In Reverse Logistics Processes: The Effects of Random Volume and Passage." *International Journal of Production Economics* 129, no.1 (2011), 87.

⁷ IFSB, “Guiding Principles On Liquidity Risk Management For Institutions Offering Islamic Financial Services [Excluding Islamic Insurance (Takaful) Institutions And Islamic Collective Investment Schemes]”, *Islamic Financial Services Board* (Kuala Lumpur:2012) available at [http://www.ifsb.org/standard/eng_IFSB-12%20Guiding%20Principles%20on%20Liquidity%20Risk%20Mgmt%20_\(March2012\).pdf](http://www.ifsb.org/standard/eng_IFSB-12%20Guiding%20Principles%20on%20Liquidity%20Risk%20Mgmt%20_(March2012).pdf).

with the third parties.⁸

Generally, the function of liquidity management is essential to all financial institutions and it also play significant roles to Islamic financial institutions such as:

- Providing facilities of IFI for financing and portfolio adjustments in the short term.
- Financial instruments and investment between the banks will allow banks to channel surplus funds to deficit banks, therefore maintaining liquidity and funding mechanisms at the necessary level that will promote stability in the system.
- Expanding the capacity of liquidity and risk management among institutions that are involved in Islamic financial markets up to the international level.
- The improvement in cash flow to reduce the institution's liquidity risk and others (i.e.: liquidity risk, misplaced commercial risk, or operational risk).

In order to comply with Basel III requirements of engaging with HQLA, the assets will only be considered as HQLA if the asset is readily available and can be converted quickly into cash value at no loss or with a minimal rate of loss. Liquidity assets depend on the pressure of existing scenario, the amount to be withdrawn and a specific time period.⁹ There should be minimal legal, regulatory or operational obstacles to the sale or pledge of such assets in order to generate funding in a variety of market stress situations. The magnitude and composition of these assets should be in line with the Islamic financial institution's risk tolerance and its liquidity requirements as estimated by its stress testing exercises.¹⁰

⁸ R. Ismail, "Assessment Of Liquidity Management In Islamic Banking Industry". *International Journal of Islamic and Middle Eastern Financial and Management* 3, No.2 ,(2010), 147-167.

⁹ Bank Negara Malaysia.. "Liquidity Coverage Ratio", Kuala Lumpur: Prudential Financial Policy Department, Issued on 31 March 2015, available at http://www.bnm.gov.my/guidelines/01_banking/04_prudential_stds/Liquidity_Coverage_Ratio.pdf (accessed on 27 July 2017).

¹⁰ IFSB, "Guiding Principles On Liquidity Risk Management For Institutions Offering Islamic Financial Services [Excluding Islamic Insurance (Takaful)]"

In December 2010, the BCBS published the Basel III documents “Basel III: A global regulatory framework for more resilient banks and banking systems”¹¹ and “Basel III: International framework for liquidity risk measurement, standards and monitoring.”¹² In the BASEL III documents, BCBS suggested multi-layered strategies to strengthen the resilience of banks and the banking systems, especially in the face of financial and market crises.¹³ Among others, the strategies create multi-layered sources of liquidity and funds to cater for different levels and stages of liquidity shortages during crises. The strategies include:

- Strengthening of capital (tier 1 and tier 2) and capital buffers;
- Enhancement of counterparty credit risk (CCR) management;
- Introduction of the Leverage Ratio to prevent an excessive build-up of leverage on institutions’ balance sheets;
- New global liquidity standard that requires 2 liquidity ratios: the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR); and
- Enhanced governance and sanctions.

It is therefore important to clarify that this study focuses on only one aspect of the Basel III requirements, i.e., the global liquidity standard, specifically the Liquidity Coverage Ratio (LCR) and its main component, HQLA.

3. Liquidity Coverage Ratio (LCR) and High Quality Liquid Asset (HQLA)

With a focus on LCR and its main component of HQLA, this section explores the new liquidity standard and identifies what constitutes HQLA based on the asset classes identified under the Basel III regulatory framework. This provides a background for the

Institutions And Islamic Collective Investment Schemes]”, *Islamic Financial Services Board* (Kuala Lumpur:2012) available at [http://www.ifsb.org/standard/eng_IFSB-12%20Guiding%20Principles%20on%20Liquidity%20Risk%20Mgmt%20_\(March2012\).pdf](http://www.ifsb.org/standard/eng_IFSB-12%20Guiding%20Principles%20on%20Liquidity%20Risk%20Mgmt%20_(March2012).pdf)

¹¹ A revised version was published in June 2011.

¹² A revised version was published in January 2013.

¹³ For details, see Accenture, *Basel III Handbook*, (2012).

subsequent discussion on the need for Sharī'ah compliant HQLA for Islamic banks so that they can maintain sound capital ratio that is commensurate with their risk exposures.

3.1 New liquidity standard: Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR)

The new global liquidity standard was introduced in December 2010 by Basel III to achieve two objectives. The first objective, pursued by the LCR, is to promote short-term resilience of a bank's liquidity risk profile by ensuring that it has sufficient HQLA to survive a stress scenario lasting one month or 30 days. The second objective is to promote resilience over the longer term by creating additional incentives for a bank to fund its activities with more stable sources of funding through the NSFR, with a time horizon of one year.¹⁴ In summary, the new liquidity standard requires the following two liquidity ratios:

- (i) *Liquidity Coverage Ratio (LCR)*: The LCR will require banks to have sufficient HQLA to withstand a 30-day stressed funding scenario that is specified by the supervisors.¹⁵
- (ii) *Net Stable Funding Ratio (NSFR)*: The NSFR is a longer-term structural ratio designed to address liquidity mismatches. "Basel III requires a minimum amount of funding that is expected to be stable over a one-year time horizon based on liquidity risk factors assigned to assets and off-balance sheet exposures".¹⁶ It covers the entire balance sheet and provides incentives for banks to use stable sources of funding.¹⁷

¹⁴ Basel Committee on Banking Supervision, "Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools". *Bank for International Settlements (BIS)*, (2013), 1, accessed from https://www.bundesbank.de/Redaktion/EN/Downloads/Tasks/Banking_supervision/Basel_Committee/2013_01_basel3_liquidity_coverage_ratio_liquidity_risk_monitoring_tools.pdf?__blob=publicationFile

¹⁵ Juan Ramirez, "Minimum Capital Requirements." *Handbook of Basel III Capital: Enhancing Bank Capital in Practice*. (United Kingdom: John Wiley & Sons Ltd, 2017), 6.

¹⁶ Ibid.

¹⁷ Ibid.

The LCR and NSFR are supposed to be put in place by 2015 and 2018 respectively. The LCR promotes the short-term resilience of a bank's liquidity risk profile by ensuring that it has sufficient HQLA to survive a significant stress scenario lasting for one month¹⁸. It basically sets the minimum liquidity buffer to bridge liquidity mismatches for one month in a crisis scenario. On the other hand, the NSFR has a time horizon of one year and is being developed to provide a sustainable maturity structure of assets and liabilities.¹⁹

In January 2013, the LCR was updated particularly with regards to the definition of HQLA and on the implementation timetable (2015 – 2019), while the NSFR is still under development. The January 2013 document entitled “Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools” explains that “the objective of LCR is to promote the short-term resilience of the liquidity risk profile of banks. It does this by ensuring that banks have an adequate stock of unencumbered high-quality liquid assets (HQLA) that can be converted easily and immediately in private markets into cash to meet their liquidity needs for a 30 calendar day liquidity stress scenario.”²⁰ The LCR is expected to improve the bank's ability to absorb shocks from financial and economic stress, thus, reducing the risk of spill over from the financial sector to the real economy.

3.2 High Quality Liquid Assets

High Quality Liquid Assets can be defined broadly as such class of assets that has the potential of being converted into cash immediately with very little or absolutely no loss of value. “Although the liquidity

¹⁸ Spyros Pagratis, Nikolas Topaloglou and Mike Tsionas, “System Stress Testing of Bank Liquidity Risk.” *Journal of International Money and Finance* 73, (2017), 22-40.

¹⁹ European Banking Authority, “Report on Appropriate Uniform Definitions of Extremely High Quality Liquid Assets (Extremely HQLA) And High Quality Liquid Assets (HQLA) and on Operational Requirements For Liquid Assets Under Article 509(3) And (5) CRR”, 20 December 2013 available at <https://www.eba.europa.eu/documents/10180/16145/EBA+BS+2013+413+Report+on+definition+of+HQLA.pdf>.

²⁰ Basel Committee on Banking Supervision, “Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools”, *Bank for International Settlements*, (2013), 4.

of an asset depends on market conditions, the quantity to be monetised and the timeframe considered, there are certain assets that are more likely to generate funds without incurring large discounts in outright sale or repo markets”.²¹

While Basel III identifies the core features of HQLA, it did not however provide the specific asset classes that qualify as HQLA. The Basel III document of January 2013 on LCR laid down the characteristics of HQLA in paragraphs 24 – 27.²² The features of HQLA are divided into two main categories: fundamental and market-related characteristics. The four fundamental characteristics are: low risk, ease and certainty of valuation, low correlation with risky assets, listed on a developed and recognised exchange.²³ In addition, the market-related characteristics are:

- (i) There should be active and sizeable market for the asset either as outright sale or repo.
- (ii) Low volatility with a relatively stable market terms such as prices and haircuts.
- (iii) Flight to quality where investors could seek less risk despite lower profits²⁴.

The test of “high quality” in HQLA relates to the ability of the asset to resiliently retain its liquidity-generating capacity even in periods of market disruption. It is always difficult for lower quality assets to meet such a stringent test because in severe market stress, such assets are often subject to significant haircut.²⁵

A list of asset classes has been identified by European Banking Authority in their Report of 20 December 2013,²⁶ to potentially

²¹ Ibid. p.7; and European Banking Authority, 9.

²² Basel Committee on Banking Supervision, “Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools”, *Bank for International Settlements*, (2013), 7-8.

²³ Ibid., at paragraph 24.

²⁴ Ibid.

²⁵ Basel Committee on Banking Supervision, “Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools”. *Bank for International Settlements*, (2013), 8.

²⁶ European Banking Authority, “Report on Appropriate Uniform Definitions of Extremely High Quality Liquid Assets (Extremely HQLA) And High Quality Liquid Assets (HQLA) and on Operational Requirements For Liquid Assets Under Article

qualify as HQLA: Government bonds; Government guaranteed bonds; Bonds issued by local government; Bonds issued by multinationals; Bonds issued by Central Banks; Corporate bonds; Covered bonds; Bonds issued by banks; Bank guaranteed bonds; Residential mortgage-backed securities (RMBS); Asset-backed securities (ABS); Equities listed on a recognized exchange; and Gold.²⁷

It is pertinent to note that the United States in its final rule (U.S. Federal Register 2014) identifies what it recognises as HQLA asset classes and what is not. For instance, the United States does not consider vault cash, covered bonds, RMBS, and some municipal securities as HQLA. In addition, the United States does not consider asset-backed securities, mortgage loans, investment company shares (mutual funds and money market mutual funds) to be qualified as HQLAs.²⁸ For the United States LCR framework, Eva and Joe provide the reason for the non-recognition of ABS, RMBS particularly:

*...specific issues of ABS, RMBS, or covered bonds do not meet the liquidity and readily marketable standard in U.S. markets, even though these assets may have some liquidity characteristics that are similar to assets that are included in HQLA. This conclusion is supported by evidence from the 2007–2009 financial crisis, in which the market demand for a variety of securities, for example, certain ABS linked to subprime mortgages, declined rapidly.*²⁹

Such financial market specifics are not unusual in the global financial system. Such specificity goes beyond financial jurisdictions, as it may also apply to alternative finance models such as Islamic finance.

509(3) And (5) CRR”, 20 December 2013 available at <https://www.eba.europa.eu/documents/10180/16145/EBA+BS+2013+413+Report+on+definition+of+HQLA.pdf> (accessed on 28 July 2017).

²⁷ Ibid.

²⁸ Eva Liebmann and Joe Peek. “Global Standards for Liquidity Regulation”. *Federal Reserve Bank of Boston Research Paper Series Current Policy Perspectives Paper No. 15-3*, (2015), 16.

²⁹ Ibid.

This is acknowledged and recognized in the Basel III regulatory framework. Accordingly, Paragraph 68 of the Basel III document provides some guidelines on the HQLA treatment and the nature the asset class for what it refers to as “Sharī`ah-compliant banks”³⁰:

Sharī`ah compliant banks face a religious prohibition on holding certain types of assets, such as interest-bearing debt securities. Even in jurisdictions that have a sufficient supply of HQLA, an insurmountable impediment to the ability of Sharī`ah-compliant banks to meet the LCR requirement may still exist. In such cases, national supervisors in jurisdictions in which Sharī`ah compliant banks operate have the discretion to define Sharī`ah compliant financial products (such as sukūk) as alternative HQLA applicable to such banks only, subject to such conditions or haircuts that the supervisors may require. It should be noted that the intention of this treatment is not to allow Sharī`ah compliant banks to hold fewer HQLA. The minimum LCR standard, calculated based on the alternative HQLA (post-haircut) recognized as HQLA for these banks, should not be lower than the minimum LCR standard applicable to other banks in the jurisdiction concerned. National supervisors applying such treatment for Sharī`ah compliant banks should comply with supervisory monitoring and disclosure obligations similar to those set out in paragraph 66 above.

It is imperative to note that two international standard-setting bodies, the Accounting and Accounting Organisation of Islamic Financial Institutions (AAOIFI) and Islamic Financial Services Board (IFSB) have taken steps over the years to develop proposals for capital adequacy framework for Islamic banks.³¹ Specifically, in March

³⁰ Basel Committee on Banking Supervision, “Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools”. *Bank for International Settlements*, (2013), 19.

³¹ Rima Turk Ariss and Yolla Sarriddine, "Challenges in Implementing Capital

2012, IFSB introduced the *Guiding Principles on Liquidity Risk Management for Institutions Offering Islamic Financial Services [Excluding Islamic Insurance (Takaful) Institutions and Islamic Collective Investment Schemes]* otherwise known as IFSB-12. As a matter of fact, the IFSB-12 “set of Guiding Principles is intended to provide guidance to IIFS [Institutions offering Islamic Financial Services] in a number of key areas in their management of liquidity risk, and to facilitate the supervisory authorities’ assessment of the adequacy of IIFS’ liquidity risk management framework and levels of liquidity within their constituency.”³² The IFSB-12 addressed the need for high-quality liquidity buffer thus:

An institution offering Islamic financial services (IIFS) should maintain a liquidity buffer, composed of cash and other highly liquid Shari’ah compliant assets, in order to withstand a prolonged period of potential stress conditions. There should be minimal legal, regulatory or operational obstacles to the sale or pledge of such assets in order to generate funding in a variety of market stress situations.

Besides cash, the IFSB identifies the following as core features of HQLAs:

- Low credit risk
- Low market risk
- Low volatility in prices
- High credit rating
- Ease and certainty of valuation
- Listed on a recognized exchange
- The presence of committed market makers

Adequacy Guidelines to Islamic Banks." *Journal of Banking Regulation* 9, No.1 (2007), 47.

³² IFSB, “Guiding Principles On Liquidity Risk Management For Institutions Offering Islamic Financial Services [Excluding Islamic Insurance (Takaful) Institutions And Islamic Collective Investment Schemes]”, *Islamic Financial Services Board* (Kuala Lumpur:2012) available at [http://www.ifsb.org/standard/eng_IFSB-12%20Guiding%20Principles%20on%20Liquidity%20Risk%20Mgmt%20_\(March2012\).pdf](http://www.ifsb.org/standard/eng_IFSB-12%20Guiding%20Principles%20on%20Liquidity%20Risk%20Mgmt%20_(March2012).pdf).

- Low market concentration
- Large trading volumes
- Low risk weight according to the standardized approach for credit risk
- Not an obligation of a financial institution or any of its affiliated entities
- *Ṣukūk* issued by high-rated organization.³³

As will be discussed below, some existing liquidity instruments such as the IILM *Ṣukūk* meet most of the requirements enumerated above. Therefore, apart from such cross-border efforts, which were a result of a sustained consortium among several central banks and monetary authorities, national supervisory authorities should also take up the challenge to introduce *Sharī'ah*-compliant HQLAs that meet the liquidity requirements of Islamic financial institutions.

4. The Dearth of HQLA in the Islamic Financial Services Industry

Researchers and financial experts have since realised the significant dearth of *Sharī'ah*-compliant HQLA in the global Islamic financial services industry.³⁴ Beside the dedicated studies on this subject matter, this issue has been emphasised times without number in a number of reports emanating from the International Monetary Fund.³⁵ In a recent interview with the IMF Assistant Director of the Monetary and Capital Markets Department and the Deputy General

³³ Ibid., footnote 48 of Paragraph 90.

³⁴ Osama M. Al-Hares and Kashif Saleem, "Islamic Banks Financial Performance and Implications of Basel III Standards in the GCC: An Empirical Analysis", *Review of Economics & Finance* 7 (2017): 80-97; Abdul-Rahman, Aisyah, Ahmad Azam Sulaiman, and Noor Latifah Hanim Mohd Said, "Does Financing Structure Affects Bank Liquidity Risk?" *Pacific-Basin Finance Journal* (2017). <https://doi.org/10.1016/j.pacfin.2017.04.004>; Aqeeq, Muhammad Arsalan, "Should Islamic Bank Hold More Capital Compared to Conventional Banks? – A Holistic Assessment of Risk Profile vis-a-vis Capital Adequacy Regulations" (2015) <https://ssrn.com/abstract=2677355> or <http://dx.doi.org/10.2139/ssrn.2677355>

³⁵ Aledjandro Lopez Mejia, Suliman Aljabrin, Rachid Awad, Mohamed Norat, and Inwon Song, *Regulation and Supervision of Islamic Banks*. International Monetary Fund, 14 (2014), 219

Counsel conducted by NST Business team, the duo articulated some emerging challenges facing central banks considering the current Islamic banking practices and the available market instruments:

A key challenge for many central banks, particularly in countries with systemically important Islamic banking sector, is to adequately integrate Islamic banks in their liquidity management and monetary operations frameworks, which is important for the effective conduct of monetary policy and for financial stability. In particular, the lack of Islamic HQLA (high-quality liquid assets) in many countries diminishes the central bank's capacity to manage structural liquidity in the economy and provide effective lender of last resort services to Islamic banks, which is an important tool for central banks to safeguard financial stability.³⁶

Similarly, the potential challenges in implementing Basel III in Islamic banks were identified in a 2015 IMF report where it was observed that there is a need for clarity on the instruments that are eligible for Tier 1 and Tier 2 capital whose responsibility lies in the regulator. In addition, the dearth or inadequate *Shari'ah*-compliant HQLA was also identified as a major challenge to Islamic banks in trying to fulfil their regulatory requirements under Basel III LCR. The report therefore concluded that, "it is important that national authorities use the leeway given by Basel standards to grant highly rated and tradable *sukūk* HQLA status, and take steps to deepen local *sukūk* and money markets".³⁷

³⁶ NST Business. 2017. "Lack of High-Quality Liquid Assets a Challenge to Central Banks", *New Strait Times*, April 1 2017. <https://www.nst.com.my/news/2017/04/226169/lack-high-quality-liquid-assets-challenge-central-banks> (accessed on 29 July 2017).

³⁷ Alfred Kammer, Mohamed Norat, Marco Pinon, Ananthkrishnan Prasad, Christopher M. Towe and Zeine Zeidane, "Islamic Finance: Opportunities, Challenges, And Policy Options". *International Monetary Fund*, 15 (2015), 6.

5. Efforts Towards Developing *Sharī'ah*-Compliant Instruments of High Quality Liquid Asset

Having identified the dearth of *Sharī'ah*-compliant HQLA and the need for Islamic banks to meet the LCR requirements of Basel III in addition to the role of central banks, there is a need to identify existing efforts in developing *Sharī'ah*-compliant HQLA. The past decade has seen significant efforts to develop or introduce *Sharī'ah*-compliant HQLA through the establishment of a supranational institution, which was preceded by the establishment of a private-sector focused liquidity management centre. However, the entire industry had hitherto embraced a unique liquidity instrument known as commodity *murābahah* with mixed-feelings over the years. Regardless of the views of classical and modern Muslim jurists on commodity *murābahah*, it has proved to be the leading instrument for liquidity management in the past few decades.³⁸ In addition, moving beyond the existing instruments, there is a paradigm shift to the use of gold as an instrument to manage liquidity with the issuance of the AAOIFI *Sharī'ah* Standard No. 57 on Gold and its Trading Controls³⁹.

5.1 Has Commodity *Murābahah* outlived its relevance?

Over the years, commodity *murābahah* has been the main instrument for liquidity management in Islamic banks across the world.⁴⁰ It is the most popular technique to manage short-term liquidity in most Islamic banks in the GCC region.⁴¹ The commodity *murābahah* programme uses commodities that are traded on the London Metal

³⁸ Asyraf Wajdi Dusuki, "Commodity *Murābahah* Programme (CMP): An Innovative Approach to Liquidity Management." *Journal of Islamic Economics, Banking and Finance* 3, No.1 (2007), 1-23.

³⁹ AAOIFI and World Gold Council "The AAOIFI *Sharī'ah* Standard No. 57 on Gold and its Trading Controls", Bahrain: AAOIFI (2016).

⁴⁰ Asyraf Wajdi Dusuki, "Commodity *Murābahah* Programme (CMP): An Innovative Approach to Liquidity Management." *Journal of Islamic Economics, Banking and Finance* 3, No.1 (2007), 1-23

⁴¹ Mahmoud A. El-Gamal, *Islamic finance: Law, Economics, and Practice*. (Cambridge: University Press, 2006).

Exchange (LME) or other commodity houses or providers,⁴² where the commodity is purchased on a spot basis, which is then sold to the party in need of fund on a cost-plus basis for deferred payment. That party then sells the commodity to a third party on a spot basis to get the needed cash.⁴³ The maturity period for the transaction is usually from one week to six months while the sold commodities are delivered, or has the potential of being delivered, on a spot basis. In addressing the lack of *Shari'ah*-compliant emergency liquid instruments, a report from IMF identified this key challenge and the need for regulatory clarity from the central banks: "One possible HQLA could be based on the standardized master collateralized *Murabahah* agreement (MCMA), developed by the IIFM. This works like a 'repo' transaction and should help Islamic financial institutions to manage liquidity and credit risk."⁴⁴

Nevertheless, one important question that bothers the minds of some stakeholders is whether commodity *murabahah* has outlived its relevance considering the operational, regulatory, and *Shari'ah* challenges it faces in a more developed Islamic financial services industry.⁴⁵ Most Islamic financial institutions have heavily relied on commodity *murabahah* over the years but experts have continuously raised issues with the product as a weak form of liquidity management tool.⁴⁶ As articulated by the former Chief Executive Officer of the International Islamic Financial Market (IIFM), "many Islamic banks rely heavily on commodity *murabahah* for short-term investment and liquidity management. However, the technique, while providing IFI's with a window to invest their short term funds, leads

⁴² Such as Bursa Malaysia's Suq al-Sila' (BSAS); Able Ace Raikin, Sedania, etc.

⁴³ This actually is tantamount to a *tawarruq* arrangement.

⁴⁴ Alfred Kammer, Mohamed Norat, Marco Pinon, Ananthkrishnan Prasad, Christopher M. Towe, and Zeine Zeidane, "Islamic Finance: Opportunities, Challenges, And Policy Options". *International Monetary Fund* 15 (2015): 24-25

⁴⁵ Abdul Rais Abdul Majid, "Development of Liquidity Management Instruments: Challenges and Opportunities." In *International Conference on Islamic Banking: Risk Management, Regulation and Supervision, held in Jakarta Indonesia September* (2003), 1-24.

⁴⁶ Noraini Mohd Ariffin, and Salina Hj Kassim, "Liquidity Risk Management and Financial Performance of Islamic Banks: Empirical Evidence" *Islamic Banking and Financial Crisis: Reputation, Stability and Risks*, (2013), 124.

to an inefficient use of funds due to its low returns. Therefore, the challenge is to look for alternative instruments and solutions.”⁴⁷ There is also this lingering controversy about the *Sharī'ah* compliance or otherwise of commodity *murābahah* when it is embedded with *tawarruq* arrangement which widely applied in *sukuk* in particular. Among the controversial issues in relation to *murābahah sukuk* is *bay' al-dayn* (sale of debt) in which majority of Muslim jurists⁴⁸ put stringent restrictions on the trading of *murābahah sukuk* due to the said issue of debt trading. In this case, AAOIFI restricts that the trading of *murābahah sukuk* can only be done prior to the *sukuk* holders selling their commodity to the third party buyer, otherwise it will be considered as sale of debt, which is prohibited in *Sharī'ah* law.⁴⁹ Nevertheless, there are some alternatives offered in permitting sale of debt by way of using commodity as the consideration (*bay' al-dayn bi al-sila'*). This approach has been approved by the *Sharī'ah* Advisory Council of Bank Negara Malaysia⁵⁰. Nevertheless, due to different fatwa and jurisdiction of each country, the acceptance of the same arrangement of *bay' al-dayn bi al-sila'* in the global context can still be in question. Hence, other acceptable practical alternatives or solutions are obviously needed.

This sustained call for alternative instruments and solutions led a group of central banks under the auspices of the IFSB to come up with a proposal to establish the International Islamic Liquidity Management Corporation (IILM).

5.2 The IILM *Sukūk*

The International Islamic Liquidity Management Corporation (IILM) is a consortium of central banks and monetary authorities from Asia,

⁴⁷ Ibid, 3.

⁴⁸ Ibn Qayyim al-Jauziyyah, *I'lam al-Muwaqqi'in 'an Rab al-'Alameen.*, (n.d), Beirut: Dar al-Fikr, vol.1, p.388, Al-Kasani, *Bada'ie al-Sana'ie' fi tartib al-Shara'ie*, Beirut: Dar al-Fikr, vol.5, 148.

⁴⁹ AAOIFI, Shariah Standards. (2010) Shariah Standard no (17) Investment Sukuk, item 5/.2/15, 316-0317.

⁵⁰ Bank Negara Malaysia, *Resolusi Syariah dalam Kewangan Islam Majlis Penasihat Syariah Bank Negara Malaysia (2010 - 2011)*, p.7, http://www.bnm.gov.my/guidelines/05_shariah/cir_012_3.pdf.

the Middle East, Europe and Africa who came together to establish a supranational financial institution that is aimed at issuing high quality liquid instruments for cross-border liquidity management for institutions offering Islamic financial services. The IILM is backed by nine central banks, plus the Jeddah-based Islamic Corporation for the Development of the Private Sector (ICD). Its main aim is to issue short-term *sukūk* to be used as cross-border liquidity tools by Islamic financial institutions. This is expected to serve as *Sharī'ah*-compliant HQLA to fill the significant void in the global market. A 2015 IMF Report aptly identifies the challenge and possible solutions proffered by the IILM:

Islamic banks tend to hold high levels of liquidity, but they suffer from a lack of well-developed markets for Sharī'ah-compliant, high-quality liquid assets (HQLA). ... The growth and broadening of the sukūk issuer base (for example, recent issuances by China, Hong Kong SAR, and the United Kingdom) could also help alleviate this problem by increasing the supply of highly rated and tradable Islamic securities, as will the efforts of the International Islamic Liquidity Management Corporation (IILM), which is active in creating short-term, Sharī'ah-compliant securities.⁵¹

The IILM accelerates cross-border liquidity management among Islamic financial institutions through the regular issuances of short-term high quality *Sharī'ah*-compliant financial instruments in US dollars in a cost-efficient manner.⁵² The main objective is to facilitate greater international integration of the Islamic money and capital markets, while improving the efficiency of the cross-border intermediation of funds based on characteristics below:

- A high credit quality, backed by a pool of sovereign and quasi-sovereign obligations originated by IILM;

⁵¹ Alfred Kammer, Alfred, Mohamed Norat, Marco Pinon, Ananthakrishnan Prasad, Christopher M. Towe, and Zeine Zeidane, "Islamic Finance: Opportunities, Challenges, And Policy Options". *International Monetary Fund* 15 (2015), 22.

⁵² IFSB, "*Islamic Finance and Global Financial*", IDB, April 2010, Jeddah: Saudi Arabia, available at <http://www.ifsb.org/docs/IFSB-IRTI-IDB2010.pdf>

- Tradable and supported by a robust primary/secondary market infrastructure;
- Appropriate regulatory treatment;
- Widely acceptable under *Sharī'ah* principles;
- Denominated in USD and future potentials of utilising other reserve currencies; and
- Central bank monetary policy instrument and financial stability tool.⁵³

The IILM issued its debut USD490 million *sukūk* in August 2013. The IILM received an A-1 credit rating from Standard & Poor's for its short-term *sukūk* Programme, and as of 8 August 2017, the IILM had issued and reissued 40 series of its short-term *sukūk*. This has deepened the primary as well as the secondary markets for *sukūk*, as it has 10 Primary Dealers who are considered market-makers at the secondary market level.⁵⁴ The features of the IILM *sukūk* for a liquid, cross-border market for Islamic financial institutions are summarised thus:

- (i) The IILM *sukūk* are tradable *Sharī'ah*-compliant US Dollar-denominated short-term financial instruments issued at maturities of up to one year;
- (ii) The IILM *sukūk* are money-market instruments backed by sovereign assets;
- (iii) The IILM *sukūk* are distributed and tradable globally via a multi-jurisdictional primary dealer network; and
- (iv) The IILM *sukūk* have strong global support as they represent a unique collaboration between several central banks and a multilateral development organisation with the aim of enhancing the financial stability and the efficient functioning of Islamic financial markets.⁵⁵

⁵³ Ibid.

⁵⁴ The current Primary Dealers of the IILM *Sukūk* Programme are: Abu Dhabi Islamic Bank, Al Baraka Turk, Barwa Bank, Boubyan Bank, CIMB Islamic Bank Berhad, Kuwait Finance House, Marbank Islamic Berhad, National Bank of Abu Dhabi, Qatar Islamic Bank, and Standard Chartered Bank.

⁵⁵ See IILM, "The Features of the IILM *Sukūk*", <http://www.iilm.com/the-features-of-the-iilm-sukuk/>

Based on publicly available data gleaned from different sources, including press releases on IILM *sukūk* issuances, from January to December 2016, the IILM had issued nine series of its short-term *sukūk* issuances. Table 1 below shows details on the issuance date, maturity date, amount issued, profit rate, spread over LIBOR, and tenor.

Table 1: The IILM *Sukūk* Issuances (January – December 2016)

	Issuance Date	Spread Over LIBOR (bps)	Profit rate (%)	Amount issued (USD million)	Tenor (months)	Maturity
1	19-Jan-16	45	1.07360	860	3	19-Apr-16
2	24-Feb-16	42	1.03820	1,340	3	24-May-16
3	19-Apr-16	40	1.02985	860	3	19-Jul-16
4	24-May-16	42	1.04610	1,340	3	23-Aug-16
5	19-Jul-16	48	1.14910	1,110	3	18-Oct-16
6	23-Aug-16	44	1.24410	840	3	22-Nov-16
7	23-Aug-16	48	1.37389	500	4	14-Dec-16
8	18-Oct-16	48	1.35389	1,110	3	18-Jan-17
9	22-Nov-16	44	1.35122	840	3	22-Feb-17
10	14-Dec-16	40	1.34806	500	3	14-Mar-17

Source: Data from various press releases by the IILM on its *sukūk* issuances

In term of regulatory treatment of the IILM *sukūk* under the Basel regulatory framework, several jurisdictions have granted favourable regulatory treatment to the IILM *sukūk* paper and these include the central banks of Malaysia, Kuwait, United Arab Emirates, Turkey, Nigeria, Qatar, etc. For instance, in Malaysia, Bank Negara

Malaysia issued a circular on 23 August 2013 to the Banks under its regulation on the status of IILM *sukūk* where it emphasised that the “IILM *sukūk* are recognised as Class 1 liquefiable asset, with a yield slippage of 4.5% under the LF and LFi”.⁵⁶ Based on this circular, the IILM *sukūk* qualifies to be level 1 HQLA and can be used to meet LCR requirements as per Basel III. Other jurisdictions have also granted similar regulatory treatment to the IILM *sukūk* with some minor variations. However, the main challenge is to issue and create enough *sukūk* or other asset classes that qualifies as HQLA. The IILM *sukūk* are not enough in terms of volume and issuances to cater for the LCR requirements of many Islamic financial institutions. There is a need to issue more high-rated *sukūk* and other HQLAs. A number of parties have pointed out some of the difficulties and challenges IILM faces in its issuances:

- The need to comply with the regulatory framework of various countries and across jurisdictions
- The need to comply with the *Sharī'ah* resolution of *Sharī'ah* Boards of various institutions across jurisdictions
- The difficulty to get suitable asset/s that can be used for the purpose of the *sukūk* issuance. Most of the asset/s used thus far came from sovereign or quasi-sovereign assets.
- The IILM *sukūk* structures are perceived as complex, not flexible and lack real substance and are detached from or not integrated with the real economy.

For instance, Sami Suwailem suggested that sovereign *sukūk* needs simple structure, *Sharī'ah* compliance in form and substance, integration with economic activities, and flexibility to allow regular stream of issuance.⁵⁷ Since, the IILM *sukūk* so far is supported by sovereigns, or quasi-sovereign bodies, the same suggestions may also be applicable to them. Nevertheless, regardless of the observations of

⁵⁶ Bank Negara Malaysia, “Regulatory Treatment for IILM *Sukūk*”, (2013) <http://www.bnm.gov.my/index.php?ch=57&pg=137&ac=72&bb=file> (accessed on 30 July 2017).

⁵⁷ Sami Suwailem, “Sovereign *Sukūk*: Challenges and Opportunities”, (slides presentation at Seminar on 'Challenges of *Sukūk* Issuance' ,Organized by: The International Islamic Liquidity Management Corporation, Kuala Lumpur, Malaysia, (31st October - 1st November, 2013).

some stakeholders on issues relating to the IILM *sukūk*, the IILM instrument remains one of the most successful efforts in providing *Shari'ah*-compliant HQLA that satisfy the requirements of Basel III with particular reference to LCR. This game-changer in the global liquidity management framework has more scope in the future to expand its issuances.

5.3 Short-term Instruments of the Liquidity Management Centre

The Liquidity Management Centre (LMC) was established for the sole objective of managing the short-term liquidity needs of Islamic financial institutions.⁵⁸ Unlike the IILM which is an unregulated supranational financial institution, the LMC is an Islamic investment bank which was incorporated in July 2002 and operates under the regulatory framework of the Central Bank of Bahrain. The LMC provides the Islamic finance and investment solutions to Islamic financial institutions, which helps to develop the Islamic capital market.⁵⁹ The Islamic inter-bank market provided by LMC also allows Islamic financial institutions to manage their short-term liquidity needs.⁶⁰ In addition, one of the original objectives of establishing LMC was to introduce an inextricable link between the excess liquidity in the market and the requirements of HQLA for Islamic financial institutions. In essence, the major role of LMC is “to facilitate the placing of surplus funds of Islamic financial institutions in profitable traded instruments.”⁶¹ Rodney Wilson further

⁵⁸ Ali Adnan Ibrahim, "The Rise of Customary Businesses In International Financial Markets: An Introduction to Islamic Finance and the Challenges of International Integration." *Am. U. Int'l L. Rev.* 23 (2007):670; Molyneux, Philip, and Munawar Iqbal, "Islamic Banking" In *Banking and Financial Systems in the Arab World*, (UK: Palgrave Macmillan,2005), 146-173

⁵⁹ Khan, M. Mansoor and M. Ishaq Bhatti, "Development in Islamic banking: A Financial Risk-Allocation Approach." *The Journal of Risk Finance* 9 No. 1 (2008), 47.

⁶⁰ Philip Molyneux and Munawar Iqbal, "Islamic Banking" In *Banking and Financial Systems in the Arab World*, (UK: Palgrave Macmillan,2005), 146-173.

⁶¹ Rodney Wilson, "The Development of Islamic Finance in the Gulf Cooperation Council States." *The Transformation of the Gulf: Politics, Economics and the Global Order* (United Kingdom: Routledge, 2013), 158.

summarised the modus operandi of LMC: “*Shari’ah*-compliant assets are purchased through the centre from governments, financial institutions and companies and then pooled. *sukūk* securities are then issued based on the value of the underlying assets and can then be traded.”⁶² While this model looks similar to the IILM issuances, it however has its geographical limits and it combines both private and public sector investment needs in its securitisation policies.

The LMC role is quite limited when compared to the cross-border nature of the IILM instrument.⁶³ This is understandable as the LMC was not originally established to facilitate cross-border liquidity management. Another issue raised by experts is the tradability of some of the *sukūk* issuances of LMC such as *sukūk al-salam*, which are issued monthly and not tradable. This means such *sukūk* will be held till maturity. As such, it will not serve the purpose of developing an active secondary market for *sukūk* instruments. Besides, the *ijārah al-sukūk* issued by LMC, although tradable, are exposed to rate of return risk.⁶⁴ While these efforts are meant to deepen the secondary market for Islamic instruments, the responsibility of giving regulatory treatment to such instruments lies in the regulators or national supervisors who should classify what they regard as *Shari’ah*-compliant HQLA.

5.4 The Proposed Fund based deposit of Bank of England

There has been significant work by the Bank of England (BoE) over the years to develop liquidity tools for Islamic banks operating in England and Wales.⁶⁵ This is part of BoE’s efforts to develop London as a global hub for Islamic finance. In April 2017, BoE issued a Consultation Paper on “*Shari’ah*-compliant liquidity

⁶² Rodney Wilson, “Overview of the *Sukūk* Market, *Islamic Bonds: Your Guide to Issuing, Structuring and Investing in Sukūk*”, Euromoney Institutional Investor PLC (2004):12, PDF e-book.

⁶³ Habib Ahmed, “Basel III liquidity requirement ratios and Islamic banking.” *Journal of Banking Regulation* 16, no. 4 (2015), 251-264.

⁶⁴ Noraini Mohd Ariffin and Salina Hj Kassim. “Liquidity Risk Management and Financial Performance of Islamic Banks: Empirical Evidence.” *Islamic Banking and Financial Crisis: Reputation, Stability and Risks* (2013): 127.

⁶⁵ The Islamic banks operating in London include Qatar Islamic Bank, Al-Rayan Bank, the Bank of London and the Middle East (BLME), and Gatehouse Bank.

facilities: establishing a fund based deposit facility”.⁶⁶ This is the second consultation paper issued by the Bank with the initial one being issued in February 2016. In fact, the main groundwork on assessing the feasibility of introducing central bank *Sharī’ah*-complaint liquidity facilities at BoE started during the second half of 2015. This is primarily meant to provide flexibility to Islamic banks operating in the United Kingdom so that they can meet their liquidity requirements under the Basel III framework.

In the feedback received in the first consultation paper released in 2016, numerous respondents advised the BoE that providing a liquidity facility based on commodity *murābahah*, could pose serious reputational risks issues to the industry considering the *Sharī’ah* issues involved. This therefore led to the preference for a *wakālah*-based facility, which is currently being considered as a preferred product.

The process steps in the updated *wakālah* fund based model are summarised in the consultation paper as follows:

1. The Bank establishes the facility in the first instance, by placing a deposit with the SPV, which is equal to the aggregate value (at cost) of *sukūk* to be purchased for the backing fund.
2. and 3. The SPV purchases *sukūk* for the fund. At the same time, where *sukūk* are denominated in a non-sterling G4 currency (most likely US dollars), an accompanying static *Sharī’ah*-compliant FX hedge is purchased from one of the Bank’s existing counterparties – it will not be necessary to use conventional hedging instruments.
4. Islamic banks are invited to participate in the facility, paying an access fee commensurate with that for an equivalent conventional firm accessing the SMF. Islamic banks place deposits with the SPV, on a term basis and for an expected profit rate (EPR) which would be set at the start of the transaction. The term will be set at one week, but will be breakable by Islamic banks at any time. The Bank reduces its

⁶⁶ Bank of England, “*Sharī’ah* Compliant Liquidity Facilities: Establishing a Fund Based Deposit Facility”, April 2017, available at http://www.bankofengland.co.uk/markets/Documents/scf_consultationpaper2017.pdf (accessed on 30 July 2017).

own deposit in the facility by an amount corresponding to the aggregate deposits placed by the Islamic banks, to ensure the facility remains fully utilised – it will remain a co-depositor for any residual amount. The Bank will receive the same EPR on its deposits as the Islamic banks, meaning the SPV will not engage in any interest-based activity.

5. The Bank guarantees to each Islamic bank the principal amount of the deposits placed by it into the SPV. This would be an overarching or ‘master’ guarantee to cover the aggregate principal deposit, so as to avoid the need for a new guarantee to be entered into each time a firm increases or reduces its deposit. The Bank would not be remunerated for the guarantee, nor would the guarantee impose any financial or commercial obligation upon the depositor Islamic banks.
6. On maturity of the deposit, a *pari passu* return is paid to all depositors in the facility. This will depend on the performance of the *sukūk* portfolio, and may or may not be equal to the EPR. This profit rate references the return on the fund, net of any hedging or other operational costs, and contributions to a reserve fund.⁶⁷

The latest consultation paper containing the updated *wakālah* fund based model sought responses from the public until 23 May 2017 when the Bank is expected to begin work on the facility. It is expected the BoE would develop a set of standardised terms as well as provide relevant contractual documentation. The new facility is expected to be ready during or after Spring 2018. If this new model is widely accepted in the industry, more supervisory national bodies will adopt similar models to manage liquidity issues in Islamic banks and this will usher in a new era for a widely acceptable *Sharī'ah*-complaint HQLA that meets the Basel III LCR requirements.

5.5 Potentials of Gold as HQLA

An important asset class that has been considered and analysed for its potential usage as HQLA is Gold. The World Gold Council (WGC)

⁶⁷ Ibid, 12.

had strongly proposed “the case for gold in the Liquidity Coverage Ratio (LCR) and as a HQLA”. The main points of argument of WGC are:

- Gold has no credit risk (already allocated)
- Compared to sovereign bonds (that qualifies as HQLA), sovereign risk is real (example, Brazil, Russia, Greece)
- Gold has committed market makers – the London OTC market
- Gold is not correlated with other LCR assets
- The gold market is deep
- \$240 billion daily volume—topping most other assets
- Gold performs well during liquidity stress periods
- Gold was the best performing asset in most stress periods
- Demand for gold increases during crisis periods

The use of gold as underlying asset for financial products is not new in Malaysia as there are several financial products that have been approved by both SAC of BNM and Securities Commission Malaysia, which use gold as their underlying assets. Among others is KFH Gold Account-I that has been launched by Kuwait Finance House (Malaysia) Berhad in 2010,⁶⁸ which enables customers to purchase and invest in gold without having to keep the gold physically. Subsequently, the *Shari’ah* Advisory Council of the Securities Commission has also approved the Islamic Exchange Traded Fund (ETF-i), which uses gold and silver as its underlying assets and issued a guideline in the form of *Shari’ah* Parameters on Islamic Exchange-Traded Fund Based on Gold and Silver on 7 October 2014.⁶⁹

More specifically for the use of gold for HQLA, a relatively extensive study, commissioned by the World Gold Council, had been conducted by Amanie Advisors and KFH Research Ltd on the

⁶⁸ Kuwait Finance House, *Kuwait Finance House Launches Gold Account-i The First Shari’ah-based Gold Account in Malaysia*, (30 April 2010). (<http://www.kfh.com.my/kfhmb/v2/searchCntView.do?micrositeId=&contentTypeId=3000&displayPage=%2Fver2%2Fcontent%2Fstandard.jsp&contentId=11228&displayPhaseId=-1&phaseId=&pageTypeId=12875>).

⁶⁹ Securities Commission. (2014). *Shari’ah Parameters on Islamic Exchange-Traded Fund Based on Gold and Silver*”, pp.2-3. (https://www.sc.com.my/wpcontent/uploads/eng/html/icm/Shariah_Parameters_7October14.pdf).

suitability and potential of gold as a HQLA for the Islamic banking system. The report made, entitled “Gold as a High-Quality Liquid Asset (HQLA) for the Islamic Banking System” was presented for discussion in March 2014. A list of asset classes identified by European Banking Authority in their Report of 20 December 2013,⁷⁰ to potentially qualify as HQLA include gold. This is where the role of national supervisors such as central banks and monetary authorities would be needed to effectively undertake the task given to them in Basel III to clearly define *Sharī'ah*-compliant products that qualify as HQLA, which should be applicable to Islamic banks only⁷¹.

It is thought that the Islamic finance industry may consider gold as HQLA particularly with the issuance of AAOIFI *Sharī'ah* Standard No. 57 on Gold and its Trading Controls.⁷² When considering the use of gold as HQLA for Islamic financial institutions, there are several key *Sharī'ah* requirements that require serious commitment in term of *Sharī'ah* compliance. These *Sharī'ah* requirements are closely related to the trading of the *ribawi*-based items, in this case gold, which require the exchange to be: (i) in equal quantity for similar counter-values (gold with gold); and (ii) “on-the-spot” transaction in which both of the counter-values must be handed over immediately at the time of the contract. Nevertheless, if the exchange involves *ribawi* items with the same effective cause but of different type, such as the exchange of gold for silver it must fulfil only one requirement, that is, it is done on-the-spot where the exchange of counter values takes place immediately at the time of the

⁷⁰ European Banking Authority, “Report on Appropriate Uniform Definitions of Extremely High Quality Liquid Assets (extremely HQLA) and High Quality Liquid Assets (HQLA) and on Operational Requirements for Liquid Assets under Article 509(3) and (5) CRR”, 20 December 2013, p. 10, available at <https://www.eba.europa.eu/documents/10180/16145/EBA+BS+2013+413+Report+on+definition+of+HQLA.pdf> (accessed on 28 July 2017).

⁷¹ Basel Committee on Banking Supervision. “Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools”. *Bank for International Settlements*, (2013): 19, available at https://www.bundesbank.de/Redaktion/EN/Downloads/Tasks/Banking_supervision/Basel_Committee/2013_01_base13_liquidity_coverage_ratio_liquidity_risk_monitoring_tools.pdf?__blob=publicationFile, paragraph 68.

⁷² AAOIFI and World Gold Council, *The AAOIFI Sharī'ah Standard No. 57 on Gold and its Trading Controls*, (Bahrain: AAOIFI, 2016).

contract.⁷³ These are among the pertinent rules that need to be adhered to by the Islamic financial institutions in the use of gold for HQLA purposes.

6. Challenges of Implementing HQLA in the global Islamic finance industry

The challenges of implementing HQLA in the global Islamic finance industry have been identified above as acknowledged in Basel III and other relevant reports. Therefore, are the current liquidity management instruments sufficient for the size of the industry? What are the *Sharī'ah*, commercial and market issues militating against the development of *Sharī'ah*-compliant HQLA? Despite the efforts to address the liquidity issues in IFIs, there are still a number of challenges that need to be addressed for an effective solution to the problem. The real challenge for Islamic financial institutions in managing liquidity is developing suitable short-term financial instruments that are *Sharī'ah* compatible and can be used for Islamic interbank money market transactions.⁷⁴

In spite of the initiatives introduced to accommodate the liquidity requirement among Islamic financial institutions, the effort to improvise the practice has never stopped. However, by looking at the structure of the instruments that have been discussed above, there are several issues that arise which can be categorised into three: *Sharī'ah* issues, issues relating to the characteristics of a commercial instrument, and issues relating to market.

6.1 *Sharī'ah* issues

In promoting effective liquidity management strategies among Islamic financial institutions, the main concern that matters to all are globally accepted *Sharī'ah*-compliant liquidity management

⁷³ Securities Commission. (2014). *Sharī'ah Parameters on Islamic Exchange-Traded Fund Based on Gold and Silver*", pp.2-3. (https://www.sc.com.my/wpcontent/uploads/eng/html/icm/Shariah_Parameters_7October14.pdf).

⁷⁴ M. A. M. Al-Amine, "Managing Liquidity Risk in Islamic Finance" In K. Hunt-Ahmed, *Contemporary Islamic finance: Innovations, Applications, and Best Practices*, (New Jersey: John Wiley & Sons, Inc,2013), 121-146.

scheme.⁷⁵ Mutual understanding of *Sharī'ah* views on key issues across jurisdictions is essential as varying interpretations of *Sharī'ah* in key issues in different countries or markets add to the complexity when cross-border transactions are involved. Mutual recognition of financial standards and products across jurisdictions would facilitate the integration of Islamic finance across the world and in bridging the global markets. This convergence and harmonisation is taking place with the greater engagement among the regulators, practitioners and scholars in Islamic finance across jurisdictions. The industry also needs to develop innovative and diversified Islamic financial instruments which can be readily accepted by the Islamic financial institutions in various jurisdictions.⁷⁶

The *Sharī'ah* advisors from different countries have different views on the *Sharī'ah* contracts such as *Bay' al-'inah*, *Bay' al-dayn* and even commodity *murābahah* that inevitably involves *tawarruq* arrangement, which are commonly used in structuring some of the liquidity tools. Other controversial issues that are yet to be resolved among *Sharī'ah* advisors from different jurisdictions, particularly with reference to *sukūk* include the issue where the formula for the Exercise Price in the *mudārabah sukūk* and *mushārahah sukūk* particularly in asset-based *sukūk* has been predetermined,⁷⁷ and the issue of asset portfolio that consists only receivables, or a combination of tangible assets and receivables.

6.2 Commercial issues

Except for countries like Malaysia, many other countries are facing a shortage of short-term liquid instruments for *Sharī'ah*-compliant liquidity management. This leads to a situation where short-term liquidity instruments issued are held until maturity of such

⁷⁵ Daud Vicary Abdullah, "Liquidity Management in Institutions Offering Islamic Financial Services." In *Second Islamic Financial Stability Forum: Addressing Liquidity Management Challenges to Enhance the Financial Stability of the Islamic Financial Services Industry*, 14. (Jeddah: IFSB, 2010).

⁷⁶ IFSB. *Islamic Finance and Global Financial*. (Jeddah: Saudi Arabia, 2010).

⁷⁷ The practice of pre-determined exercise price has been prohibited by the AAOIFI *Shari'ah* Board in their *Shari'ah* pronouncement of February 2008, yet is still practiced in jurisdictions like Malaysia.

instruments without trading (hold until maturity). On top of that, the dependency level of Islamic financial institutions on central banks for liquidity management is still low, as most short-term financing from central banks has not been adapted to comply with *Shari'ah* rules and principles.⁷⁸

Moreover, the absence of a specific platform for trading of liquidity management products, particularly in the secondary market had put the liquidity issue among Islamic financial institutions in not too good position. In addition, the use of existing instruments that involve high costs will reduce competitive level of Islamic products when compared to their conventional counterparts. Besides the IILM *sukūk*, there is a need for more liquid short-term financial instruments that are well designed and considered suitable assets, and which can be traded on a cross-border basis for Islamic financial institutions to survive better in financial industry.⁷⁹

6.3 Market Issues

The size for secondary market is very small or almost nothing for *Shari'ah*-compliant liquidity instruments. In view of the small volumes and shortage of papers, most instruments are generally bought to hold till maturity rather than trade that would have developed an active secondary market. Even if a secondary market exists, the number of market participants is very small. Thus, liquidity is a problem and price determination and mark-to-market is difficult. This lack of market liquidity is a major constraint that needs to be addressed through a comprehensive market development strategy.⁸⁰

⁷⁸ Ibid.

⁷⁹ Daud Vicary Abdullah, "Liquidity Management in Institutions Offering Islamic Financial Services." In *Second Islamic Financial Stability Forum: Addressing Liquidity Management Challenges to Enhance the Financial Stability of the Islamic Financial Services Industry*, 14, (Jeddah: IFSB, 2010).

⁸⁰ IFSB, "*Technical Note On Issues In Strengthening Liquidity Management Of Institutions Offering Islamic Financial Services: The Development Of Islamic Money Markets.*", (Kuala Lumpur: IFSB, 2008). Retrieved from http://www.ifsb.org/docs/mar2008_liquidity.pdf

7. Conclusion and Recommendations

The role cash reserves play in optimal banking arrangements by reducing the vulnerability of banks to liquidity risks that arise from granting depositors the option to withdraw their funds has led to the need for banks to strategies for stress periods.⁸¹ This might lead to the event of bank run which will be even more frightening.⁸² Initiatives taken by Basel III, IFSB, IILM, LMC, central banks and many other parties to overcome this matter should be taken seriously by all. Bank of England is coming up with a *wakālah* fund based model, which is expected to be widely acceptable in the industry when compared to the controversial commodity *murābahah* model.

Even though there are some *Sharī'ah*-compliant liquidity management instruments in the current market, the existing instruments, which hold short-term maturity, are still inadequate to accommodate the needs of Islamic financial institutions. Despite that, some of the current instruments have the tradability issues because of *Sharī'ah* matters and the small size of the secondary market. The establishment of IILM is a good step, however the central banks should play a more proactive role, as being championed by BoE. The effort to standardise the structure and documentation is one of good initiative to enhance the establishment of appropriate cross-border liquidity management instruments like what has been done in the conventional counterparts. "There is a role for national authorities in helping relieve this liquidity shortage, including by: (i) granting highly rated and tradable *sukūk* the status of HQLA; (ii) taking steps to deepen local *sukūk* and money markets; and (iii) adopting the LCR framework at a pace that is commensurate with local systemic risks."⁸³

⁸¹ C. Calomiris, F. Heider and M. Hoerova, "A Theory of Bank Liquidity Requirements", *Columbia Business School Research Paper*, (2015), 14-39.

⁸² Abdullah, Daud Vicary. "Liquidity management in institutions offering Islamic financial services." In *Second Islamic Financial Stability Forum: Addressing Liquidity Management Challenges to Enhance the Financial Stability of the Islamic Financial Services Industry*,14, (Jeddah: IFSB, 2010).

⁸³ Alfred Kammer, Mohamed Norat, Marco Pinon, Ananthakrishnan Prasad, Christopher M. Towe, and Zeine Zeidane. "Islamic Finance: Opportunities, Challenges, And Policy Options". *International Monetary Fund* 15 (2015), 22.

It is therefore important to conclude that some of the efforts being made to develop *Shari'ah*-compliant HQLA have resulted in tremendous success in building an active secondary market for the instrument. As Rome was not built in a day, concerted efforts of stakeholders will help to identify areas that need to be addressed. As Governor Al-Hashel of the Central Bank of Kuwait aptly argues, “there is “no quick fix” and “quick wins” for the above issues, it requires a gradual approach to address the gaps for the HQLA requirements, and there is need for enhanced cooperation among different stakeholders including rating agencies, multilateral bodies, corporates, and infrastructure institutions. At the end, it may also appear that LCR is just a broad-brush liquidity buffer”.⁸⁴

⁸⁴ Mohammad Y. Al-Hashel, “Basel III HQLA Requirements and Considerations in the Implementation of HQLA – Supervisory Perspective”, discussion during the *IILM Roundtable on Liquidity Management “Short Term Financial Instruments”*, Washington DC, United States of America, (15-16 April, 2015), 11.